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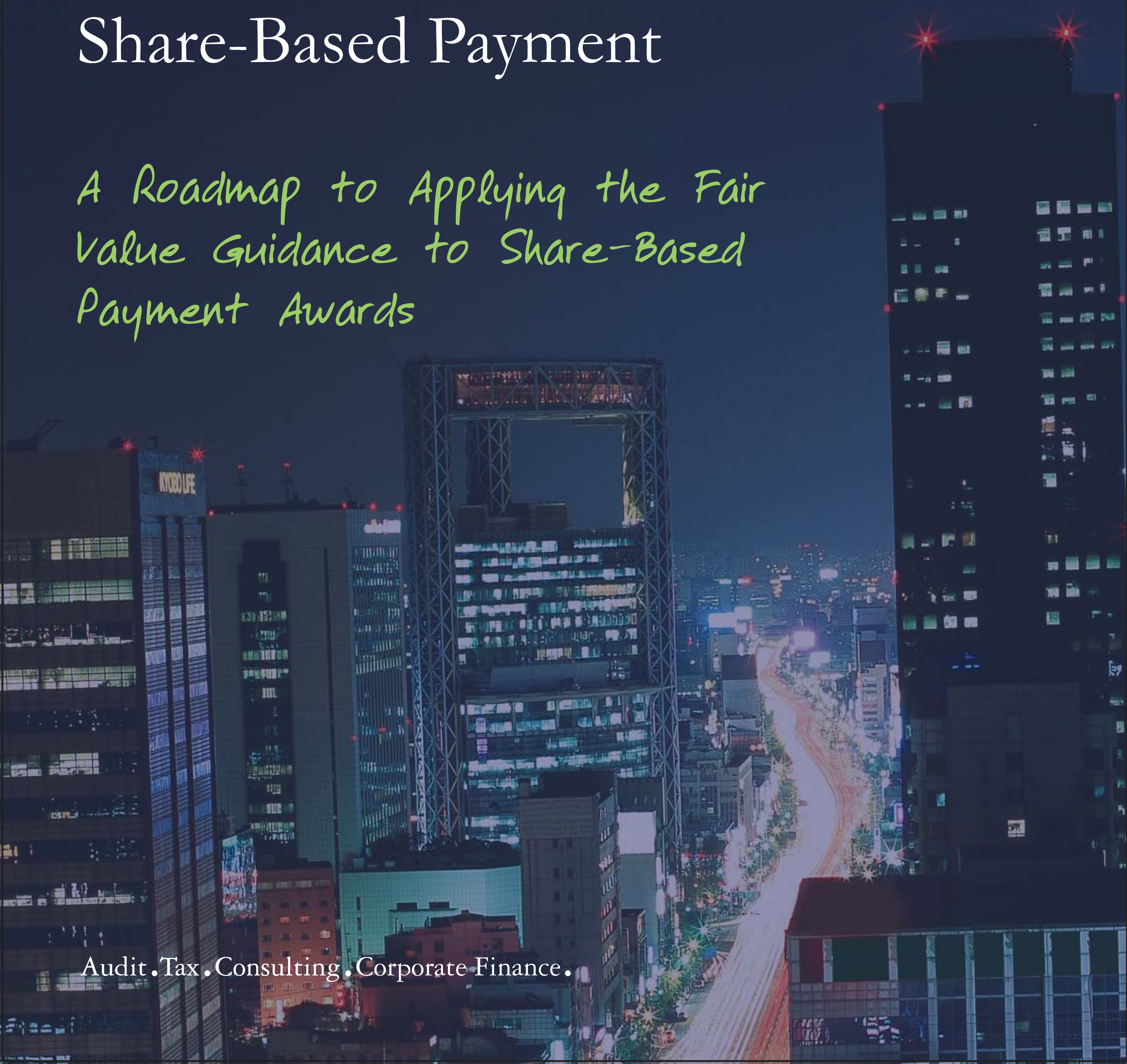
FASB Statement No. 123(R), Share-Based Payment

A Roadmap to Applying the Fair Value Guidance to Share-Based Payment Awards



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FASB Statement No. 123(R), Share-Based Payment

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[Rev. June 23, 2005]

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June 20, 2005

To Our Clients and Friends:

In December 2004, amid an outpouring of concern from many of its constituents, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment*, rebuking long-standing accounting guidance (Opinion 25) in requiring companies to record in their statements of operations the cost associated with share-based payment awards.

This publication includes Deloitte & Touche LLP's ("Deloitte & Touche") initial interpretations of this landmark accounting standard and focuses on three of the primary areas of the new standard: (1) measurement and valuation, (2) recognition, and (3) transition of share-based payment awards. Our interpretations incorporate the views of the SEC Staff as expressed in Staff Accounting Bulletin No. 107 (Topic 14) and the effect of the deferral promulgated by the SEC in its final Rule Release dated April 21, 2005. This publication also includes other resource materials, including a GAAP accounting and disclosure checklist, to assist financial statement preparers in the implementation and application of Statement 123(R).

The accounting for certain aspects of share-based payment transactions continues to evolve, particularly in the areas of accounting for tax benefits and in the assessment of whether an award is a liability. As standard setters and others continue to discuss these important topics, we will continue to provide insights.

Many hands and minds made this publication possible. John Sarno, Herbert Wong, and Gordon McDonald worked tirelessly to frame and answer issues, organize thoughts, and keep the project on time and comprehensive. They were assisted ably by many, including Doug Alkema, Doug Barton, Melissa Cloniger, Bo Davis, Bernie De Jager, Matt Himmelman, Sandie Kim, Adam Matteo, and Jill Volk. Jim Kroeker and Dawn Trapani supervised the preparation of this publication and would like to acknowledge the contribution of these professionals and extend to them Deloitte & Touche's deepest appreciation.

Sincerely,

Deloitte & Touche LLP

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Introduction

Statement 123(R)

1. This Statement requires that the cost resulting from all **share-based payment transactions**[1] be recognized in the financial statements. This Statement establishes **fair value** as the measurement objective in accounting for **share-based payment arrangements** and requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with **employees** except for equity instruments held by **employee share ownership plans**. However, this Statement provides certain exceptions to that measurement method if it is not possible to reasonably estimate the fair value of an award at the **grant date**. A **nonpublic entity** also may choose to measure its liabilities under share-based payment arrangements at **intrinsic value**. This Statement also establishes fair value as the measurement objective for transactions in which an entity acquires goods or services from nonemployees in share-based payment transactions. This Statement uses the terms compensation and payment in their broadest senses to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee.
2. This Statement amends FASB Statement No. 95, *Statement of Cash Flows*, to require that **excess tax benefits** be reported as a financing cash inflow rather than as a reduction of taxes paid.
3. This Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This Statement also supersedes or amends other pronouncements indicated in Appendix D. Appendix A is an integral part of this Statement and provides implementation guidance on measurement and recognition of compensation cost resulting from share-based payment arrangements with employees. Appendix B provides the basis for the Board's conclusions, and Appendix C provides background information. Appendix E defines certain terms as they are used in this Statement, and Appendix F indicates the effect of this Statement on the status of related authoritative literature, including American Institute of Certified Public Accountants (AICPA) literature, Emerging Issues Task Force (EITF) issues, and Statement 133 implementation issues.

Footnote 1 — Terms defined in Appendix E [reproduced herein as Appendix A], the glossary, are set in **boldface type** the first time they appear.

Scope

Statement 123(R)

4. This Statement applies to all share-based payment transactions in which an entity acquires goods or services by **issuing** (or offering to issue) its shares, **share options**, or other equity instruments (except for equity instruments held by an employee share ownership plan)[2] or by incurring liabilities to an employee or other supplier (a) in amounts based, at least in part,[3] on the price of the entity's shares or other equity instruments or (b) that require or may require **settlement** by issuing the entity's equity shares or other equity instruments.

Footnote 2 — AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, specifies the accounting by employers for employee share ownership plans.

Footnote 3 — The phrase *at least in part* is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

4-1: Scope of Statement 123(R)

Question

Are there share-based payment transactions or aspects of them that the provisions of Statement 123(R) do not address?

Answer

Yes. Although Statement 123(R) is a comprehensive source of guidance on accounting for stock-based compensation transactions, there are certain areas relating to stock-based compensation transactions that are not covered by Statement 123(R). Examples include:

- **Measurement date for nonemployee transactions**. Generally, the provisions of Statement 123(R) can be applied to the accounting for share-based payment transactions with nonemployees. However, for certain aspects of awards granted to nonemployees, authoritative guidance is found elsewhere. For example, the measurement date for awards granted to nonemployees is described in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services." See Q&A 8-1 for a more detailed discussion of the measurement date for nonemployee transactions and the grant date for employee transactions.

- **Equity instruments issued as consideration in a business combination**. Statement 123(R) does not address the accounting for equity instruments issued as consideration in a business combination. The measurement date for equity instruments issued in connection with a business combination is described in paragraphs 22–23 of FASB Statement No. 141, *Business Combinations*; and EITF Issue No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination."

  However, the exchange of stock options in connection with a business combination is addressed in Statement 123(R) and is considered a modification of an award. Refer to Q&A 53-1 for an explanation of the accounting for stock options exchanged in a business combination.

- **Employee Share Ownership Plans (ESOP)**. Appendix E to Statement 123(R) (reproduced herein as Appendix A) defines an ESOP as an "employee benefit plan that is described by the Employment

Retirement Income [Security] Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock." The accounting for ESOPs is described in AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, and AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*.

- **Detachable options or warrants issued in a financing transaction**. APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*, describes the accounting treatment for detachable warrants, or similar instruments, issued in a financing transaction.

- **Options or warrants issued for cash or other than for goods or services**. Financial instruments issued for cash or other financial instruments (i.e., other than for goods or services) should be accounted for in accordance with the relevant literature on the accounting and reporting for the issuance of financial instruments, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*; EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"; and EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock.'"

Recognition and Measurement Principles for Share-Based Payment Transactions

Statement 123(R)

5. An entity shall recognize the goods acquired or services received in a share-based payment transaction when it obtains the goods or as services are received.[4] The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (paragraphs 28–35). As the goods or services are disposed of or consumed, the entity shall recognize the related cost. For example, when inventory is sold, the cost is recognized in the income statement as cost of goods sold, and as services are consumed, the cost usually is recognized in determining net income of that period, for example, as expenses incurred for employee services. In some circumstances, the cost of services (or goods) may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed.[5]
6. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options. The **terms** of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a **reload feature**, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.
7. If the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction.[6] In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Statement, a **calculated value** or intrinsic value) of the equity instruments issued.

Footnote 4 — An entity may need to recognize an asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nevertheless, the goods or services themselves are not recognized before they are received.

Footnote 5 — This Statement refers to recognizing *compensation cost* rather than *compensation expense* because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

Footnote 6 — The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include stated or unstated rights. FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt*, provides pertinent guidance.

Share-Based Payment Transactions With Nonemployees

Statement 123(R)
8. This Statement does not specify the measurement date for share-based payment transactions with nonemployees for which the measure of the cost of goods acquired or services received is based on the fair value of the equity instruments issued. EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services," establishes criteria for determining the measurement date for equity instruments issued in share-based payment transactions with nonemployees.

8-1: Accounting Treatment for Share-Based Payment Awards Issued to Employees Versus Nonemployees

Question

Is the accounting treatment for share-based payment awards issued to nonemployees the same as for awards issued to employees under Statement 123(R)?

Answer

Generally, yes. The provisions of Statement 123(R) should be applied to all share-based payment awards issued in exchange for goods or services and where appropriate, should be applied to nonemployees as well. SEC Staff Accounting Bulletin Topic 14.A, "Share-Based Payment Transactions With Nonemployees" (SAB 107), states:

> With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in Statement 123R would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in Statement 123R by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in Statement 123R would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement. [Footnote omitted]

Examples of the provisions of Statement 123(R) that apply equally to employees and nonemployees include, but are not limited to, the following:

- The accounting for modifications to the terms of previously issued awards. Refer to Q&A 8-2 for a more detailed discussion of the accounting for modifications of nonemployee awards.

- The accounting for income tax effects on share-based payment transactions in the balance sheet, income statement, and statement of cash flows.

- Considerations when determining whether an award should be classified as a liability or equity instrument and the resulting accounting treatment (e.g., remeasure the fair value of a liability award at the end of each reporting period for public companies).

However, one key difference between the accounting treatment for awards issued to employees and nonemployees relates to an award's measurement date. Paragraph 8 of Statement 123(R) states that EITF Issue 96-18 should be used to determine the measurement date for equity instruments issued in share-based payment transactions with nonemployees. The criteria that is required to establish the measurement date for nonemployee transactions differs from what is required to establish the grant date for employee transactions. Accordingly, these two dates may not be the same.

Issue 1 of EITF Issue 96-18 describes the consensus reached on the appropriate measurement date and states, in part:

> The Task Force reached a consensus that the issuer should measure the fair value of the equity instruments using the stock price and other measurement assumptions as of the earlier of either of the following:
>
> 1. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a "performance commitment"); or
>
> 2. The date at which the counterparty's performance is complete.

Footnote 3 to EITF Issue 96-18 elaborates on the term "performance commitment" by stating, in part:

> A performance commitment is a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance…Forfeiture of the equity instruments as the sole remedy in the event of the counterparty's nonperformance is not considered a sufficiently large disincentive for purposes of applying this guidance.

The completion date of the counterparty's performance is the date when the counterparty has delivered or rendered, as the case may be, the goods or services.

The "measurement date" for nonemployee transactions is similar to the "grant date" for employee transactions in that the fair value of the award is not fixed until that point in time. Furthermore, EITF Issue 96-18 explains, in Issue 3, that when it is appropriate to recognize any cost of the transaction under generally accepted accounting principles prior to the measurement date, the fair value of the equity instruments should be remeasured as of the end of each reporting period. This is similar to the treatment for employee awards when the service inception date precedes the measurement date (which again, in an employee transaction, is the grant date).

Additionally, while EITF Issue 96-18 did not specifically address either the period or the manner in which costs associated with equity instruments issued to nonemployees for goods or services should be recognized, it did state, in Issue 2, that companies should use the same manner and period of recognition as if the company had paid cash for the goods or services.

The FASB intends to consider the accounting issues addressed by EITF Issue 96-18 in the second phase of its stock-based compensation project.

8-2: Modification to Equity Instruments That Are Issued to Other Than Employees

Question

What is the appropriate guidance to apply for modifications to equity instruments that are issued to nonemployees?

Answer

Paragraph 8 of Statement 123(R), EITF Issue 96-18, and EITF Issue 00-18 (Tentative Conclusion), address the accounting for stock-based compensation transactions with nonemployees. However, neither paragraph 8 nor paragraph 51 (modifications of awards of equity instruments) of Statement 123(R) provide guidance on accounting for modifications of share-based payment awards provided to nonemployees. Additionally, while both EITF Issue 96-

18 and EITF Issue 00-18 refer to applying the modification guidance in the context of non-discretionary adjustments pursuant to the original terms of the award, neither addresses the accounting for discretionary modifications.

Notwithstanding the lack of guidance, generally it is appropriate to analogize to the modification guidance applicable to share-based payment awards provided to employees in determining the appropriate accounting for the modification of share-based payment awards provided to nonemployees. Paragraph 51 of Statement 123(R) provides that incremental compensation cost shall be measured for the modification of an equity award as the difference, if any, between the fair value of the modified award immediately after the modification and the fair value of the original award immediately before the modification. See pages 70–88 for further details on the accounting for modifications of employee awards.

8-3: Performance Commitment — Determination of a Sufficiently Large Disincentive for Nonperformance

Question

What is considered a "sufficiently large disincentive for nonperformance" in determining whether a performance commitment has been reached in accordance with the provisions of EITF Issue 96-18?

Answer

The determination of whether a performance commitment contains a "sufficiently large disincentive for nonperformance" is based on the facts and circumstances of the individual arrangement and should consider both quantitative (i.e., the fair value of the total arrangement consideration) and qualitative factors. While not a bright line, a penalty of 10 percent or more of the fair value of the total arrangement consideration generally has been viewed as a sufficiently large disincentive for nonperformance. In addition, the penalty for nonperformance needs to be imposed as a direct result of nonperformance by the counterparty of the arrangement. The mere possibility of legal proceedings (the counterparty's right to sue) does not meet the definition of a sufficiently large disincentive.

Example

On January 1, 20X6, Company A (A) agreed to issue 150,000 warrants to purchase its stock in exchange for construction services from Company B (B). The fair value of the warrants on the date of the agreement is $1,000,000. If B fails to perform the construction services, then B is obligated to pay a $100,000 penalty plus any decline in the fair value of A's share price below $20 (A's share price on the date the parties entered into the agreement).

Based on the facts presented above, the penalty to be paid by B upon nonperformance represents a sufficiently large disincentive for nonperformance. Accordingly, a measurement date is established on the date the parties entered into the agreement (January 1, 20X6) based on the consensus reached in Issue 1 of EITF Issue 96-18. The determination of whether a performance commitment is "sufficiently large" should be based on the facts and circumstances of each individual arrangement.

8-4: Accounting for a Share-Based Payment Award Issued to a Nonemployee Prior to the Award's Measurement Date

A company has previously determined the following with respect to its share-based payment awards issued to nonemployees in exchange for goods or service: (1) the fair value of the equity instruments issued is more reliably measurable than the consideration received and (2) a performance commitment has not been reached; therefore, a measurement date has not been established.

Question

How should a company account for a share-based payment award (e.g., warrant) issued to nonemployees in exchange for goods or service prior to the measurement date?

Answer

Even though a measurement date has not occurred, a company accounts for a share-based payment award issued to a nonemployee at its then current fair value, each reporting period until a measurement date has been established. The requirement to remeasure the award each reporting period is the same measurement requirement established for liability awards pursuant to Statement 123(R). Refer to Q&A 36-1 for a discussion of the manner in which liability awards are recognized. In EITF Issue 96-18, Issue 3 states:

> when it is appropriate under generally accepted accounting principles for the issuer to recognize any cost of the transaction during financial reporting periods prior to the measurement date, for purposes of recognition of costs during those periods the equity instruments should be measured at their then-current fair values at each of those interim financial reporting dates. Changes in those fair values between those interim reporting dates should be attributed in accordance with the methods illustrated in Interpretation 28.

The recognition of expense is based on the assumption that the nonemployee will continue to provide the goods or service in exchange for earning the right to the award. A company is required to assess the probability that the nonemployee will continue to provide the goods or service in a manner similar to the analysis required for a performance condition included in a share-based payment award issued to an employee in exchange for employee service.

Further, while changes in fair value should be recognized in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, companies are not required to follow the recognition model prescribed in Example 2 of Interpretation 28 for share-based payment awards issued to nonemployees with a graded vesting schedule. The use of the straight-line or the graded-vesting attribution method is a policy decision that a company must make, and once made, should be disclosed and applied consistently.

Example

On January 1, 20X6, a company enters into an arrangement with an individual to provide consulting service for the next six months in exchange for 5,000 warrants to purchase the company's common stock. Assume the fair value of the warrants is more reliably measurable than the fair value of the consulting service. The only ramification to the individual of not providing the consulting service is the lost opportunity to earn the warrants. Therefore, based on these facts, a sufficiently large disincentive for nonperformance does not exist. The measurement date will occur on the date in which the individual's performance is complete (i.e., the end of the six month consulting period). The fair value of the warrants on March 31, 20X6, and June 30, 20X6, are $10 and $12, respectively.

On March 31, 20X6, the company records consulting expense ($25,000) with a corresponding amount in additional paid-in capital, based on the current fair value of the warrants ($10), the number of warrants to be issued (5,000), and the percent of services rendered (50% or 3 of 6 months). Further assume that the consulting services are provided ratably over the six month period, such that one-half of the service has been provided at March 31, 20X6. Refer to the journal entry below.

Journal Entry		Debit		Credit
Consulting expense	$	25,000		
Additional paid-in capital			$	25,000
To record consulting expense at an interim reporting period based on the number of awards issued (5,000), the fair value at the reporting period ($10), and the amount of services rendered (50%)				

On June 30, 20X6, the measurement date, the company adjusts the consulting expense and paid-in capital based on the current fair value of the warrants ($12), less amounts previously recognized ($25,000). Refer to the journal entry below.

Journal Entry		Debit		Credit
Consulting expense	$	35,000		
Additional paid-in capital			$	35,000
To record consulting expense at the measurement date based on the number of awards issued (5,000), the fair value at the measurement date ($12), and the amount of services rendered (100%) less consulting expense previously recognized				

8-5: Accounting for Fully Vested, Non-Forfeitable Share-Based Payment Awards Issued to a Nonemployee (EITF Issue No. 00-18)

Question

Assuming the fair value of the equity instruments issued is more reliably measurable than the consideration received, how does a company (grantor) account for a fully vested, non-forfeitable share-based payment award issued to a nonemployee in exchange for goods or service?

Answer

Since the award is not conditioned on the future performance of the nonemployee counterparty (i.e., the award is fully vested and non-forfeitable), the measurement date for the award is the grant date. EITF Issue No. 00-18, "Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees" (Tentative Conclusion), states, in part:

> The Task Force agreed that by eliminating any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached. Further, the Task Force expressed a view that the grantor should recognize the equity instruments when they are issued (in most cases, when the agreement is entered into).

Additionally, the compensation cost should be recognized in the same period(s) and in the same manner (i.e., capitalize versus expense) as if the company issuing the awards (grantor) had paid cash for the goods or services. Issue 00-18 (Tentative Conclusion) states, in part:

> [T]he Task Force observed that any measured compensation cost of the transaction should be recognized in the same period(s) and in the same manner (that is, capitalize versus expense) as if the enterprise had paid cash for the goods or services.…The SEC Observer noted that all facts and circumstances must be considered in determining the period(s) and manner in which measured cost of the transaction should be recognized.

Refer to Q&A 8-7 for the SEC staff's views on the classification of cost for share-based payment awards issued to nonemployees in exchange for goods or services.

8-6: Determining the Expected Term of Share-Based Payment Awards Issued to Nonemployees

When using an option pricing model, Statement 123(R) requires the use of an award's expected term rather than the contractual term in determining the fair value of a non-transferable share-based payment award issued to an employee.

Question

What is the appropriate term of a non-transferable share-based payment award (e.g., warrants) issued to a nonemployee in exchange for goods or service?

Answer

In footnote 7 of SEC Staff Accounting Bulletin Topic 14.A, "Share-Based Payment Transactions With Nonemployees" (SAB 107), the SEC staff indicated that in transactions with nonemployees, absent the nontransferability, nonhedgability, and the truncation of the contractual term features often associated with employee share options, the use of an expected term assumption shorter than the contractual term would not be appropriate. This is based on the view that a share-based payment award with a contractual term greater than the expected term poses a greater cost to the service provider, and likewise, the issuer generally negotiates the terms of the award to equate to the period required for the services being provided. Further, when the parties have had no prior business experience, the SEC staff previously has held that the issuer does not have a basis for determining the intent of the recipient, and therefore, the expected term of the share-based payment award.

8-7: Classification of the Cost of Share-Based Payment Awards Issued to Nonemployees

Question

Companies often issue various types of share-based payment awards to suppliers, customers, or other service providers. How should companies classify the cost of issuing share-based payment awards to nonemployees in the financial statements?

Answer

The SEC staff has previously reviewed a number of situations in which registrants issued warrants, shares, options, or convertible instruments to suppliers, customers, partners, or other service providers. The SEC staff addressed some classification issues related to these instruments, which they have identified. First, the SEC staff has consistently held that when share-based payment awards are issued to customers or potential customers in arrangements where the instrument will not vest or become exercisable without purchases by the recipient, the related cost must be reported as a sales discount — in other words, as a reduction of revenue. In substance, the customer is paying for two things: the product or service, and the equity. The fair value of the share-based payment award issued should therefore be subtracted from the proceeds received in determining how much revenue to record. This rationale is consistent with the accounting required under EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)."

Similarly, when share-based payment awards are issued to suppliers or potential suppliers, and the awards will not vest or become exercisable unless the recipient provides goods or services to the issuer, the cost of the share-based payment award should be reported as a cost of the related goods or services.

In some of these circumstances, the SEC staff has noted the presentation of separate line items within the income statement for the apparent purpose of emphasizing that a portion of the sales discounts or expenses did not involve a cash outlay. However, the SEC staff has adhered to the view that information highlighting the noncash nature of certain costs is most effectively presented in the statement of cash flows, and not in the income statement. In certain instances they have objected to presentations and disclosures that put undo emphasis on revenue, gross margin, or other income statement measures before reductions for the costs of equity instruments issued to customers or suppliers. The SEC staff reiterated their view in SEC Staff Accounting Bulletin Topic 14.F, "Classification of Compensation Expense Associated With Share-Based Payment Arrangements" (SAB 107). It states:

> **Question:** How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?
>
> **Interpretive Response:** The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. [Footnote omitted] The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements.
>
> Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

Refer to Q&A 84-2 for an illustration of the presentation of stock-based compensation cost in the income statement for equity instruments issued to employees.

The SEC staff has also noted situations in which companies have issued share-based payment awards in arrangements that do not appear to require any performance from the counterparty. Some have argued that the lack of such a performance requirement indicates that the cost should be recorded as a marketing or even a nonoperating expense, as opposed to a cost of sales or a reduction of revenue. However, the SEC staff has been skeptical of transactions that do not appear to require any performance from the potential customer or supplier for the options to vest, become exercisable, or both. In the absence of any required future performance, the SEC staff has generally viewed the issuance of such share-based payment awards as relating to past transactions between the companies and has asked that the cost be classified accordingly. Additionally, the SEC staff has held that to demonstrate that the issuance of equity in these situations is not related to past transactions, there should be evidence that the issuer has or will receive from the counterparty a direct benefit in return for the equity instrument that is separable from other business relationships between the issuer and counterparty. Furthermore, the SEC staff has considered whether there is sufficient, objective, and reliable evidence that indicates that the fair value of such benefit is at least as great as the fair value of the share-based payment awards.

In very rare and limited circumstances (e.g., where neither a performance commitment nor past relationship between the companies exists) the SEC staff has accepted classification of the cost of share-based payment awards as a marketing expense if that classification appeared reasonable. This has been allowed when detailed and transparent disclosures of the transaction were made, including documentation of the lack of any required performance and the fact that no consideration was received for the instrument.

As a further reminder, whenever significant amounts of share-based payment awards have been issued to or received from business partners, Management's Discussion and Analysis of the financial statements should include sufficient discussion of the effects of these non-cash transactions on the results of operations (i.e., why they are used and what effect their use has on the comparability of the results of operations in the periods presented).

Although these views have been stated by the SEC staff, the underpinnings are consistent with Issue 01-9 and EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received From a Vendor."

Share-Based Payment Transactions With Employees

Statement 123(R)

9. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed.
10. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in paragraphs 11–63 of this Statement. That is, the cost of services received from employees in exchange for awards[7] of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The fair value of liabilities incurred in share-based transactions with employees shall be remeasured at the end of each reporting period through settlement. Paragraphs 23–25 and 38 set forth exceptions to the fair-value-based measurement of awards of share-based employee compensation.

Footnote 7 — This Statement uses the term *award* as the collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. Provisions of this Statement that refer to *an award* also apply to a portion of an award.

10-1: Definition of a Common Law Employee

Question

What are the criteria established by IRS Revenue Ruling 87-41, "Employment Status Under Section 530(D) of the Revenue Act of 1978," that may aid in the assessment of whether an individual is an employee under common law?

Answer

The IRS developed the criteria (twenty factors) based on an examination of cases and rulings that determine whether an individual is an employee under common law. The degree of importance of each criterion varies depending on the factual context in which the services of an individual are performed. Additionally, because the criteria are designed as guides in assisting in the determination of whether an individual is an employee, scrutiny is required in applying the criteria to assure that the substance of an arrangement is not obscured by an attempt to achieve a particular employment status. The criteria include the following:

- **Instructions:** A worker who is required to comply with another person's instructions about when, where, and how he or she is to work is ordinarily an employee. Additionally, the existence of instructions that involve the integration of a worker's services into the business operations generally demonstrates that the worker is subject to direction and control.

- **Continuing Relationship:** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. Additionally, the worker's right to terminate the relationship or the employer's right to discharge the worker indicates an employer-employee relationship.

- **Set Hours of Work**: The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.

- **Hiring, Supervising, and Paying Assistant:** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job.

- **Working on the Employer's Premises**: If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere.

- **Full Time Required**: If the worker must devote substantially full time to business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working.

- **Payment:** Payment by the hour, week, or month generally points to an employer-employee relationship. Additionally, if the person or persons for whom the services are performed ordinarily pay the worker's business expenses, traveling expenses, or both, the worker ordinarily is an employee.

In addition to the foregoing general criteria, refer to IRS Revenue Ruling 87-41 for additional factors that should be considered when assessing if an individual is an employee under common law. For a further discussion of the definition of an employee, refer to Appendix E of Statement 123(R) (reproduced herein as Appendix A).

Share-Based Payment Transactions With Related Parties and Others

Statement 123(R)
11. Share-based payments awarded to an employee of the reporting entity by a **related party** or other holder of an **economic interest** in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

Employee Share Purchase Plans

Statement 123(R)

12. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation cost (that is, the plan is noncompensatory):
    a. The plan satisfies at least one of the following conditions:
        (1) The terms of the plan are no more favorable than those available to all holders of the same class of shares.[8]
        (2) Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount.[9]
    b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.
    c. The plan incorporates no option features, other than the following:
        (1) Employees are permitted a short period of time — not exceeding 31 days — after the purchase price has been fixed to enroll in the plan.
        (2) The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

Footnote 8 — A transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

Footnote 9 — An entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to paragraph 12(a)(2) of this Statement.

12-1: Discount on Employee Share Purchase Plans

Employee share purchase plans can be considered noncompensatory if all the criteria in paragraphs 12 through 13 of Statement 123(R) are met. One of the criteria of a noncompensatory plan requires that the discount from the market price offered to employees does not exceed the per-share amount of issuance costs the company would have incurred in a significant offering of capital in a public market. Paragraph 12 provides a safe harbor that a purchase discount of five percent or less from market is not considered compensatory. Many IRS Section 423 plans, however, provide for a discount of 15 percent from the market price of the shares to be purchased.

Question

Is a discount in excess of five percent (i.e., the discount offered in most current IRS Section 423 plans) considered compensatory under the provisions of Statement 123(R)?

Answer

Generally yes. A discount in excess of five percent may be considered compensatory under paragraph 12 of Statement 123(R). Unless a company can justify that the discount (e.g., the 15 percent provided by IRS Section 423) is equivalent to the share issuance costs that would have been incurred to raise a significant amount of capital in a public market, the plan may be considered noncompensatory (assuming the plan meets the remaining criteria in paragraphs 12 through 13 of Statement 123(R)). Paragraph 12(a)(2) of Statement 123(R) states, in part:

> A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount.[9]

Footnote 9 of Statement 123(R) states:

> An entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to paragraph 12(a)(2) of this Statement.

If a company can justify that a discount in excess of 5 percent is appropriate, then the discount is not recognized as compensation cost. AICPA Technical Practice Aids (TIS Section 4110.01), "Expenses Incurred in Public Sale of Capital Stock," provides guidance on what amounts should be considered for inclusion in the share issuance cost. It states, in part:

> Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers' salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance.

However, as discussed in footnote 9 of Statement 123(R), the company must continue to assess the discount percent at least annually and no later than the first share purchase offer during the fiscal year to justify the discount percentage. If a company is no longer able to justify a discount in excess of five percent, then the plan is considered compensatory. The inability to justify a discount on a current offering would not impact the compensatory nature of previous offerings. That is, a company would not record compensation cost for awards issued prior to a company being unable to justify a discount in excess of five percent.

Example

On January 1, 20X5, Company A (A), a calendar year-end public company, early adopts Statement 123(R). On January 10, 20X5, A offers to its employees a share purchase plan using a seven percent discount. Company A can justify that the seven percent discount is not greater than the costs the company would have incurred in an offering of the company's shares in a public market. Therefore, the employee share purchase plan is not considered compensatory (assuming all the other criteria in paragraphs 12 through 13 of Statement 123(R) have been met).

On July 10, 20X5, A offers its employees enrollment in another share purchase plan using the same seven percent discount. Company A does not need to reassess the seven percent discount used in the second employee share purchase plan offering in 20X5. Assuming all the other criteria in paragraphs 12 through 13 of Statement 123(R) continue to be met, the plan is not considered compensatory.

On January 10, 20X6, A has a third offering under its employee share purchase plan using the same seven percent discount. Pursuant to footnote 9 of Statement 123(R), A would have to justify that the seven percent discount remains appropriate for this offering. If, for the offering in January 20X6, A can no longer justify the seven percent discount, then the plan is considered compensatory (notwithstanding the other criteria in paragraphs 12 through 13 of this statement). The inability to justify the discount on the current employee share purchase plan offering would not impact the compensatory nature of prior offerings. That is, A would record no compensation cost for the awards issued prior to the company being able to justify the discount (the January 1, 20X5, and July 10, 20X5, offerings). Further, A must recognize the entire amount of the discount (seven percent) as compensation cost, not just the discount in excess of five percent.

Statement 123(R)
13. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory. Illustrations 19 (paragraphs A211–A219) and 20 (paragraphs A220 and A221) provide guidance on determining whether an employee share purchase plan satisfies the criteria necessary to be considered noncompensatory. 14. The **requisite service period** for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Measurement Principles — Equity Awards

Statement 123(R)

15. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.
16. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected **volatility**, at the grant date.
17. To satisfy the measurement objective in paragraph 16, the **restrictions** and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer **vested** equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's *expected term*).

17-1: The Impact of Post-Vesting Restrictions on the Fair Value of Options

Paragraph 17 of Statement 123(R) states, in part:

> A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer **vested** equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date.

Question

How are post-vesting restrictions taken into account in a closed form option pricing model like the Black-Scholes-Merton formula?

Answer

The impact of post-vesting restrictions can be taken into account by reducing the current market price of the underlying shares used as an input factor in the Black-Scholes-Merton formula. For example, assume an option is issued with a four-year service (vesting) condition and a post-vesting restriction that prohibits the employee from selling the shares obtained upon exercising the option for another two years. In estimating the fair value of the option (using a Black-Scholes-Merton formula), the input used for the current market price of the underlying shares might not be the quoted market price of the traded shares, since the option being valued contains a post-vesting restriction. Rather, it is more appropriate to use the fair value of a similar share as the input for the current market price (i.e., the market price of a share containing similar restrictions on transferability for a period of two years.) For similar shares not being traded in an active market, the fair value should be determined with the same valuation technique used to estimate the fair value of a traded instrument. The current market price of a restricted share generally should be lower than the current market price of a similar share without any restrictions. Therefore, the use of the current market price of a restricted share in the Black-Scholes-Merton formula will result in a lower estimated grant-date fair value of the option as compared to that of an option without any post-vesting restrictions (assuming all other inputs remain equal). However, to use a value that incorporates a discount from the value of an unrestricted share (in valuing a restricted share), the company must be able to provide objective and verifiable evidence supporting the amount of the discount.

Statement 123(R)

18. In contrast, a restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell **nonvested shares**, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.
19. Awards of share-based employee compensation ordinarily specify a **performance condition** or a **service condition** (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered). Some awards contain a **market condition**. The effect of a market condition is reflected in the grant-date fair value of an award.[10] Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied. Illustrations 4 (paragraphs A86–A104), 5 (paragraphs A105–A110), and 10 (paragraphs A127–A133) provide examples of how compensation cost is recognized for awards with service and performance conditions.

Footnote 10 — Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this Statement, are path-dependent options.

19-1: Service Condition

Appendix E of Statement 123(R) (reproduced herein as Appendix A) defines a service condition, in part, as:

> A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award and that depends solely on an employee rendering service to the employer for the requisite service period.

Question

What is a service condition and how should it be accounted for under the provisions of Statement 123(R)?

Answer

A service condition is the requirement of an employee to provide service (i.e., remain employed by the company for a specified time period) to a company in exchange for a share-based payment award. A service condition is stated explicitly in the terms of an equity award and is generally in the form of the vesting condition.

If an employee does not satisfy the requirements of a service condition (i.e., the employee forfeits the award), then the employee has not earned (i.e., vested in) the award. While a company accrues compensation cost over the service period, if an award is not earned, the company would reverse any previously recognized compensation cost. Ultimately, compensation cost is not recognized for awards that do not vest. Since the service condition affects the employee's ability to earn (i.e., vest in) the award, it is not directly factored into the grant-date fair value of the award. However, a service condition can impact the grant-date fair value indirectly by means of its affect on the expected term of an award. Since the expected term of an award cannot be shorter than the vesting period, the longer the vesting period the longer the expected term of an award.

Example

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest at the end of the third year of service (cliff-vesting).

For the employee to earn the award (i.e., for the employee's right to the award to vest and become exercisable), the employee must provide three years of continuous service to the employer. At the end of the third year of service, the employee will have earned all of the rights to the award; the employee's ability to exercise the award is no longer contingent on the employee providing additional service. If the employee fails to provide the three years of service (i.e., forfeits the award) the company ceases accruing any future compensation cost and reverses any previously recognized compensation cost.

19-2: Performance Condition

Appendix E of Statement 123(R) (reproduced herein as Appendix A) defines a performance condition, in part, as:

> A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities).

Question

What is a performance condition and how should it be accounted for under the provisions of Statement 123(R)?

Answer

A performance condition is the requirement of an employee to provide service (i.e., remain employed by the company for a specified time period) to a company in exchange for a share-based payment award. In addition to providing the required service, the employee's ability to earn the award is conditioned on the company attaining specified performance targets (e.g., revenue, earnings per share, etc.). The service period can be either explicitly stated in the form of a vesting condition (i.e., the same as a service condition) or stated implicitly as the time period it will take for the performance condition to be achieved.

If an employee does not provide the necessary service or the company does not attain the specified performance targets, then the employee has not earned the award. While a company accrues compensation cost over the service period, if an award is not earned, the company would reverse any previously recognized compensation cost. Ultimately, compensation cost is not recognized for awards that do not vest. Since the performance condition affects the employee's ability to earn the award, it is not factored into the grant-date fair value of the award.

During the service (vesting) period, a company must assess the probability of the performance target being achieved (i.e., the employee earning the award). If it is not probable the performance target will be achieved, then a company should not record any compensation cost. Paragraph 44 of Statement 123(R) states, in part:

> Accruals of compensation cost for an award with a performance condition shall be based on the probable [footnote omitted] outcome of that performance condition — compensation cost shall be accrued if it is probable that the performance

condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved.

Example

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The award vests only if cumulative net income over the next three annual reporting periods exceeds $1,000,000 and the employee is still in the employment of the company.

In this example, the service period is not explicitly stated in the terms of the share-based payment arrangement. However, one could infer from the terms of the arrangement that the service period is three years, since the employees must be employed by the company at the performance date (i.e., at the end of the third annual reporting period after the issuance of the award). Therefore, for the employee to earn the award, the employee must provide three years of continuous service to the employer. In addition, the company must meet the specified performance target of cumulative net income in excess of $1,000,000 over the next three annual reporting periods. If either (1) the employee has not remained in the employment of the company for the specified time period or (2) the company has not attained the performance target, then the award will be forfeited and any compensation cost previously recognized by the company will be reversed. Any compensation cost recorded would be recognized on a straight-line basis (i.e., one-third for each year of service) over the three-year service period.

Statement 123(R)

20. The fair-value-based method described in paragraphs 16–19 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. The remainder of this Statement refers to the required measure as fair value.

Measurement — Nonvested and Restricted Equity Shares

Statement 123(R)

21. A nonvested equity share or nonvested equity **share unit** awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date. A **restricted share**[11] awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties. Illustration 11(a) (paragraphs A134–A136) provides an example of accounting for an award of nonvested shares.

Footnote 11 — Nonvested shares granted to employees usually are referred to as restricted shares, but this Statement reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

21-1: Difference Between a Nonvested Share and a Restricted Share

Question

What is the difference between a nonvested share and a restricted share as described by Statement 123(R)?

Answer

A nonvested share is an award that is subject to being earned by an employee (i.e., subject to the employee providing the necessary requisite service). For example, an employee is granted a share or the right to purchase a share. The employee's ability to sell or transfer the share is contingent upon the employee providing three years of service. If the employee fails to provide the required three years of service, then the shares are forfeited to the company. Appendix E of Statement 123(R) (reproduced herein as Appendix A) defines nonvested shares as:

> Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

Additionally, refer to Q&A 21-2 for a discussion of the valuation of nonvested shares.

In contrast, a restricted share is an award that has been earned by an employee in that the employee is not required to provide any additional service; however, the award restricts the employee's ability to sell the share after it has been earned. For example, an employee is granted a share or the right to purchase a share. The employee's ability to sell the share is contingent upon the lapse of a two-year time period. If the employee terminates employment in the company prior to the end of the two-year period, then the employee will retain the shares; however, the employee's ability to sell the shares will remain contingent upon the two years lapsing. Appendix E of Statement 123(R) defines a restricted share as:

> A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed *nonvested shares* because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service

> period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. This Statement uses the term *restricted shares* to refer only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time. [Footnote omitted]

The significance of the difference is that the fair value of a nonvested share is recognized over the service period, whereas the restrictions on a restricted share may cause the fair value of the award to be lower (refer to Q&A 17-1 for a discussion of the impact of post-vesting restrictions on the grant-date fair value of a share-based payment award), but will have no effect on the period over which expense is recognized.

21-2: Valuation — Nonvested Shares

Question

Can the market value of a company's equity shares be used as the fair value of a nonvested share?

Answer

Yes. The grant-date fair value of a nonvested share shall be measured at the fair value of the company's equity shares as if the nonvested share was vested and issued on the grant date. That is, it is not appropriate to take a discount from the quoted market price of the company's equity shares to reflect the fact that the shares being valued are not vested.

However, as discussed in paragraph B93 of Statement 123(R), if an employee holding a nonvested share award is not entitled to receive dividends (i.e., a right of a normal shareholder), then the fair value of the award shall be lower than that of a normal equity share. To estimate the fair value of nonvested shares not entitled to dividends during the service (vesting) period, the market value of traded equity shares shall be reduced by the present value of expected dividends to be paid prior to the service (vesting) period, discounted using an appropriate risk-free interest rate. Refer to Q&A 22-12 for a more detailed discussion of the impact of dividends on the grant-date fair value of share-based payment awards.

Measurement — Equity Share Options

Statement 123(R)

22. The fair value of an equity share option or *similar instrument* shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (paragraph A7).[12] Otherwise, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has **time value**. For example, a share appreciation right (SAR) that requires net settlement in equity shares has time value; an equity share does not. Paragraphs A2–A42 provide additional guidance on estimating the fair value of equity instruments, including the factors to be taken into account in estimating the fair value of equity share options or similar instruments as described in paragraph A18.

Footnote 12 — As of the issuance of this Statement, such market prices for equity share options and similar instruments granted to employees are generally not available; however, they may become so in the future.

22-1: Factors to Consider in Estimating Expected Volatility of an Option

Appendix E of Statement 123(R) (reproduced herein as Appendix A) defines volatility, in part, as:

> A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period.

Question

What factors should companies consider in estimating expected volatility?

Answer

Paragraph A21 of Statement 123(R) states that "historical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience should be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past."

Statement 123(R) does not specify a method of estimating expected volatility; rather, paragraph B86 of Statement 123(R) clarifies that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option. Paragraph A32 of Statement 123(R) provides a list of factors that are required to be considered in estimating expected volatility. The methodology for estimating volatility based on these factors, including any adjustments to the factors below or assigning more weight to an individual factor, should be based on objective data that supports such an adjustment and should be applied consistently from period to period. New or different information that would be useful in estimating expected volatility should be incorporated in the estimation of expected volatility. Question 1 of SEC Staff Accounting Bulletin Topic 14.D.1, "Expected Volatility" (SAB 107), states that the staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility, or a combination of both into account will result in the best estimate of expected volatility. Refer to Q&As 22-2, *SEC Staff's Views on the Computation of Historical Volatility*, 22-3, *SEC Staff's Views on the Extent of Reliance on Implied Volatility*, and 22-4, *SEC Staff's Views on Relying Exclusively on Either Implied or Historical Volatility*. Factors required to be considered in estimating expected volatility are as follows:

1. Historical Volatility of the Share Price

Historical volatility is the input factor that companies typically have used to value stock options pursuant to Statement 123. Historical volatility is based on the most recent volatility of the stock price over the expected term of the option when the closed-form model is being used and contractual term when a lattice model is being used. Paragraph A32(a) of Statement 123(R) states that companies may disregard volatility for an identifiable period if the volatility was as a result of a condition (e.g., failed takeover bid) specific to the company and the condition is not expected to recur during the expected or contractual term. However, for a condition not specific to the company (e.g., general market declines), a company would generally not be allowed to exclude or place less weight on its volatility during that time period unless objectively verifiable evidence exists to support the expectation that market volatility will revert to a mean that will differ materially from the volatility during the specified period. Refer to Q&A 22-2 for a discussion of the SEC staff's views on the computation of historical volatility.

2. Implied Volatility

Implied volatility is not the same as historical volatility. Implied volatility is derived from the share price of traded options or traded financial instruments other than the company's own shares. Implied volatility can be calculated with the Black-Scholes-Merton formula by including the fair value of the option (i.e., the market price of the traded option) and other inputs (stock price, exercise price, dividend rate, and interest rate) and solving for volatility. Careful consideration should be given in determining if implied volatility of a traded option is an appropriate basis for expected volatility of employee share options. For example, traded options usually have much shorter terms than employee share options and the calculated implied volatility does not take into account the possibility of mean reversion.[1] To compensate for mean reversion, companies could calculate a long-term implied volatility with statistical tools. For example, companies with traded options with terms ranging from 2 to 12 months can plot the volatility of these options on a volatility curve and use statistical tools to plot a long-term implied volatility for a traded option with a life equal to an employee share option.

Generally, companies that can observe sufficiently extensive trading of options and can therefore plot an accurate long-term implied volatility curve should place greater weight on implied volatility than the historical volatility of their own share price. That is, traded option price volatility is more informative in the determination of expected volatility than stock price volatility, since option prices take into account the option trader's forecasts of future stock price volatility. In contrast to traded options, stock prices take into account the equity trader's forecast of future cash flows payable to the stock holders. Refer to Q&A 22-3 for a discussion of the SEC staff's views on the reliance of implied volatility.

3. Limitations on Availability of Historical Data

Public companies should consider the length of time a company's shares have been publicly traded compared to the expected term of the option. A newly public company may also consider the expected volatility of similar public companies.

Nonpublic companies may base their expected volatility on that of similar publicly traded companies. Additionally, in cases in which a nonpublic company is unable to reasonably

[1] Footnote 58 of Statement 123(R) states, "Mean reversion refers to the tendency of a financial variable, such as volatility, to revert to some long-run average level. Statistical models have been developed that take into account the mean-reverting tendency of volatility."

estimate fair value for an employee share option it may use calculated value. Refer to Q&A 23-1, *When to Use an Industry Sector Index*, and Q&A 23-2, *Selecting and Computing the Historical Volatility of an Appropriate Industry Sector Index*.

4. Data Intervals

If a company considers historical volatility in estimating the expected volatility of its own share price, then the company should use intervals for price observations that (1) are appropriate based on the facts and circumstances and (2) provide the basis for a reasonable estimate of fair value. Refer to Q&A 22-2 for a discussion of the SEC staff's views on frequency of price observations.

5. Changes in Corporate and Capital Structure

A company's corporate and capital structure could impact expected volatility. For example, highly leveraged companies tend to have higher volatilities. Changes in the corporate and capital structure should therefore be taken into account since historical volatility for a period when the company was, for example, highly leveraged may not be representative of future periods when the company is not expected to be highly leveraged.

22-2: SEC Staff's Views on the Computation of Historical Volatility

Question

What are the SEC staff's views on factors a company should consider in the computation of historical volatility?

Answer

Question 2 of SEC Staff Accounting Bulletin Topic 14.D.1, "Expected Volatility" (SAB 107), states:

> **Question 2:** What should Company B consider if computing historical volatility? [Footnote omitted]
>
> **Interpretive Response:** The following should be considered in the computation of historical volatility:
>
> **1. Method of Computing Historical Volatility**
>
> The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B's expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term [footnote omitted] of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B's historical volatility much more heavily than earlier periods. [Footnote omitted] For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history. [Footnote omitted]
>
> **2. Amount of Historical Data**
>
> Statement 123R, paragraph A32(a), indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of

the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

3. Frequency of Price Observations

Statement 123R, paragraph A32(d), indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate. [Footnote omitted] Company B should select a consistent point in time within each interval when selecting data points. [Footnote omitted]

4. Consideration of Future Events

The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option. [Footnote omitted] Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

5. Exclusion of Periods of Historical Data

In some instances, due to a company's particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility. [Footnote omitted] In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff believes these situations would be rare.

22-3: SEC Staff's Views on the Extent of Reliance on Implied Volatility

Question

What are the SEC staff's views on factors a company should consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

Answer

Question 3 of SEC Staff Accounting Bulletin Topic 14.D.1, "Expected Volatility" (SAB 107), states:

Question 3: What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

Interpretive Response: To achieve the objective of estimating expected volatility as stated in paragraph B86 of Statement 123R, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and 4) the similarity of the length of the term of the traded and employee share options. [Footnote omitted]

1. Volume of Market Activity

The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect a marketplace participant's expectations regarding expected volatility.

2. Synchronization of the Variables

Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. Similarity of the Exercise Prices

The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant. [Footnote omitted] If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option. [Footnote omitted]

4. Similarity of Length of Terms

The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share option's contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater. [Footnote omitted] However, when using traded options with a term of less than one year, [footnote omitted] the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option. The staff believes Company B's evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the market's expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.

22-4: SEC Staff's Views on Relying Exclusively on Either Implied or Historical Volatility

Question

What are the SEC staff's views on the exclusive reliance on either implied volatility or historical volatility in its estimate of expected volatility?

Answer

Question 4 of SEC Staff Accounting Bulletin Topic 14.D.1, "Expected Volatility" (SAB 107), states:

> **Question 4:** Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?
>
> **Interpretive Response:** As stated above, Statement 123R does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity's estimate of expected volatility be reasonable and supportable. [Footnote omitted] Many of the factors listed in Statement 123R are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in Statement 123R, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option. [Footnote omitted] The staff believes that a company, after considering the factors listed in Statement 123R, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.
>
> The staff would not object to Company B placing exclusive reliance on implied volatility [or historical volatility] when the following factors are present, as long as the methodology is consistently applied:

[Implied Volatility]	[Historical Volatility]
• Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options; [footnote omitted]	• Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past; [footnote omitted]
• The traded options on which implied volatility is based are actively traded;	• The computation of historical volatility uses a simple average calculation method;
• The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;	• A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and
• The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options; [footnote omitted] and	• A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period. [Footnote omitted]
• The remaining maturities of the traded options on which the estimate is based are at least one year.	

22-5: Factors to Consider in Determining the Expected Term of an Option

Paragraph A27 of Statement 123(R) states, in part:

> The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement).

Question

What factors should companies consider in estimating expected term?

Answer

Note: The SEC has provided companies with the option of using a simplified method to determine the expected term of "plain vanilla" options. This method is only available for employee share options granted before December 31, 2007. Refer to Q&A 22-6 for an illustration of the simplified method.

Paragraph A21 of Statement 123(R) states that "historical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience should be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past."

Statement 123(R) does not specify a method of estimating expected term; rather, paragraphs A28 through A30 provide the following list of factors that may be considered in estimating expected term. The methodology for estimating the term of an award must be objectively supportable, and any adjustments to historical observations should be based on objective data supporting the adjustment. Similarly, supportable data on why future observations are not expected to change should accompany historical observations.

1. **The vesting period of the award**

   Options generally cannot be exercised before vesting, as such; the expected term of an option cannot be less than the vesting period of the option.

2. **Employees' historical exercise and post-vesting employment termination behavior for similar grants**

   In applying the concept conveyed in paragraph A21 of Statement 123(R), expectations of future employee exercise and post-vesting termination behavior should be based on historical experience. Historical exercise patterns should be modified when current information suggests that future behavior will differ from that of the past. For example, rapid increases in the stock price in the past after a release of a new product could have resulted in more employees exercising their stock options as soon as the options vested. If a similar increase in the stock price is not expected, a company should adjust the historical exercise patterns.

3. **Expected volatility of the price of the underlying share**

   An increase in volatility tends to result in an increase in exercise activity as more employees take advantage of the volatility in the stock price to realize potential gains on the exercise of the option and subsequent sale of the underlying shares. Footnote 57 of Statement 123(R) states, "An entity also might consider whether the evolution of the share price affects an employee's exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time)." The exercise behavior based on the evolution of the stock price can be more easily incorporated in a lattice model.

4. Blackout periods

Blackout periods and other arrangements impacting exercise behavior for options can be included in a lattice model. For example, unlike a closed form model, a lattice model can calculate the expected term of an option by taking restrictions on exercises and other post vesting exercise behavior into account.

5. Employees' ages, lengths of service, and home jurisdictions

Historical exercise information could have been impacted by the profile of the employee group. For example, during a bull market companies are more likely to have greater turnover of their employees since more opportunities are available. Many of these employees will exercise their options as early as possible. These historical exercise patterns should be adjusted if similar turnover rates are not expected to reoccur in the future.

6. Other relevant information

Paragraph A29 of Statement 123(R) states that expected term may be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as public academic research. When external peer group data is taken into account, care should be taken to ensure that the data is comparable to the company's facts and circumstances; that is, evidence should be available to support that the peer group data is comparable to the company's situation (all the factors listed above should be comparable.)

7. Aggregation of awards into homogenous groups

Individual awards should be aggregated into relatively homogenous groups if identifiable groups of employees display or are expected to display significantly different exercise behaviors. For example, hourly employees will tend to exercise their options for a smaller percentage gain than salaried employees. Question 4 of SEC Staff Accounting Bulletin Topic 14.D.2, "Expected Term" (SAB 107), states that as it relates to employee groupings, the SEC staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings. The SEC staff believes that the focus should be on groups of employees with significantly different exercise behavior, such as executives and non-executives.

22-6: Illustration — Simplified Method for Determining Expected Term of an Employee Share Option

The SEC staff noted in Question 6 of SEC Staff Accounting Bulletin Topic 14.D.2, "Expected Term" (SAB 107), that they will accept the use of the simplified method for "plain-vanilla"[2] share options granted prior to December 31, 2007. While SAB 107 applies only to SEC registrants, the same simplified method would be available to nonpublic

[2] Question 6 of SEC Staff Accounting Bulletin Topic 14.D.2 defines plain vanilla employee share options as having the following basic characteristics: (1) the shares are granted at-the-money; (2) exercisability is conditional only on performing service through the vesting date; (3) if an employee terminates service prior to vesting, the employee would forfeit the share options; (4) if an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and (5) the share options are nontransferable and nonhedgeable.

companies. However, the same time constraints (share options granted prior to December 31, 2007) surrounding the use of the simplified method would also apply. If a company elects to use this method, it should disclose the use of the method in the notes to its financial statements and the method should be applied consistently to all "plain-vanilla" employee share options. That is, the simplified method must be applied to **all** employee share options with "plain-vanilla" characteristics. Companies that have the information (from whatever source) to make more refined estimates of expected term may choose not to apply this simplified method. In addition, the simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

The SEC staff prescribed the following formula to determine expected term under the simplified method:

Expected term = [(vesting term + original contractual term) ÷ 2].

Illustration

A company grants "at-the-money" employee share options each with a contractual term of 10 years. The awards vest in 25 percent increments each year (graded vesting schedule). Therefore, the expected term of the awards using the simplified method would be 6.25 years, calculated as follows:

Simplified-Method Calculation
({[1 year vesting term (for the first 25% vested)
+
2 year vesting term (for the second 25% vested)
+
3 year vesting term (for the third 25% vested)
+
4 year vesting term (for the last 25% vested)]
÷
4 total years of vesting}
+
a 10-year contractual term) ÷ 2.
That is, (((1 + 2 + 3 + 4) ÷ 4) + 10) ÷ 2 = 6.25 years.

Alternatively, a company grants "at-the-money" employee share options each with a contractual term of 10 years. The awards vest at the end of the fourth year of service (cliff-vesting). Therefore, the expected term of the awards using the simplified method would be 7 years [(4 year vesting term + 10 year contractual life) ÷ 2].

22-7: Impact of Input Factors Used in Valuation Models on Fair Value

A fair value measurement method should be used for all share-based payment transactions with employees. While Statement 123(R) does not require the use of any particular valuation model, paragraph A18 of Statement 123(R) does require, at a minimum, that the valuation model used incorporate the following inputs:

- The exercise price of the award,
- The expected term of the award,
- The current market price of the underlying share,
- The expected volatility of the underlying share,

- The expected dividends on the underlying share, and
- The risk-free interest rate for the expected term of the award.

Question

How does a change in each of the aforementioned inputs impact the fair value of a share-based payment award?

Answer

An individual option pricing model input will rarely, if ever, fluctuate without having an impact on the other inputs. For example, as volatility increases more option holders will take advantage of the fluctuation in share prices by exercising their options. The increase in the number of exercises will have an impact on the expected term, which in turn, will require an adjustment to the expected dividend and risk-free interest rates. Therefore, **assuming all other variables are held constant**, the impact of a change in each individual input factor on the fair value of a share-based payment award (e.g., an employee share option) is as follows:

1. **Exercise Price and Current Market Price**

   These inputs are generally defined by the terms of each award. That is, the current market price for an award granted by a public company is usually the quoted market price of the company's common stock on the date of grant and the exercise price is the amount of cash an employee is required to pay to exercise the award. The relationship between the exercise price of an award and the current market price of the company's common stock will impact the fair value of an award. That is, at the date of grant, an option that is issued "in-the-money" (i.e., the exercise price is less than the current market price of the company's common stock) will have a greater fair value than an option issued "at-the-money" or an option issued "out-of-the money." At-the-money options are awards with an exercise price equal to the current market price of the company's common stock, whereas out-of-the money options are awards with an exercise price exceeding the current market price of the company's common stock.

2. **Expected Term**

   The expected term of an option is the period of time for which the option is expected to be outstanding (i.e., the period of time from the initial measurement date, which is usually the grant date, to the date of expected exercise or settlement). The fair value of an option increases with an increase in the expected term of the option, resulting from an increase in the time value of the option. The time value of an option is that portion of an option's fair value that is based on the amount of time remaining until the expiration date of the option contract, and the notion that the underlying components that determine the value of the option may change during that time. Refer to Q&A 22-5 for a discussion of factors to consider in estimating the expected term of an option.

3. **Expected Volatility**

   Expected volatility of the underlying share price is a probability-weighted measure of the expected dispersion of share prices about the mean share price over the expected term of the option. The fair value of a traded option increases with an increase in volatility. A high volatility is an indication that the share price fluctuates more — up or down from the mean share price. A fluctuation in share price would therefore increase the likelihood that a holder of an option can benefit from the fluctuation. For example, if an option is issued at-the-money the holder of an option with a share price that is volatile has a greater chance of being able to exercise the option when the share price fluctuates to a higher value and sell that share for a profit as compared to a holder of a similar option with an underlying share price that does not fluctuate. Refer to Q&A 22-1 for a discussion of the factors to consider in estimating the expected volatility of an option.

4. Expected Dividends

The expected dividends input factor represents the expected dividends or dividend rate that will be paid out on the underlying shares during the expected term of the option. Expected dividends should only be included in the valuation model to the extent that the option holders are not entitled to receive those dividends. Consequently, as expected dividends increase the fair value of the option decreases. Refer to Q&A 22-12 for an example of applying the expected dividend yield assumption in an option-pricing model.

5. Risk Free Interest Rate

Higher interest rates will result in an increase in the fair value of an option. The risk-free rate is a theoretical interest rate at which an investment earns interest without incurring any risk. The notion is used extensively in option pricing theory where options are valued with a risk neutral assumption under which all assets may be assumed to have expected returns equal to the risk-free rate. The risk-free rate in the U.S. is assumed to be a short-term treasury rate such as U.S. Treasury zero-coupon issues.

22-8: Observable Market Price

Question

What constitutes an observable market price of a share-based payment award?

Answer

An observable market price is the price being paid for a liability or equity instrument (with the same or similar terms) in an active market. Judgment should be exercised to determine if an instrument is being traded in an active market and whether the instrument being traded is similar to the instrument being valued. Factors to consider include, but are not limited to:

- the volume of trading,
- the number of instruments available for trading,
- the purchaser of the instruments (e.g., related parties),
- whether the terms of the instrument incorporate adjustments to mirror employee termination behavior,
- indications the buyer was not paying market price, and
- potential impact from dilution as a result of the instruments being granted.

For example, a price established through an isolated transaction with a broker to sell options that are identical to options issued to employees might not be considered an observable market price used to value share options. Similarly, an active market for traded options may not be considered an appropriate basis for determining the fair value of options issued to employees if traded options are not similar to employee share options, which will most likely be the case for most exchange traded options. Employee share options generally differ from traded options in that (1) the employees cannot sell their share options — they can only exercise them and (2) the term of most employee share options truncates upon termination of the option holder's employment contract. In addition, some employee share options contain prohibitions on exercising options during blackout periods. This inability to sell an employee share option can effectively reduce the option's value and differentiates it from traded options.

22-9: Selecting a Valuation Model

Question

What considerations should a company take into account when selecting a valuation method?

Answer

Statement 123(R) requires the use of a fair value based measurement method. Fair value is described as the amount at which market participants would be willing to conduct transactions (i.e., the observable market price). Absent an observable market price, fair value should be estimated using a valuation technique. The most common valuation techniques currently used in practice are the Black-Scholes-Merton (closed-form) formula and the binomial (lattice) model. While Statement 123(R) does not require the use of any particular valuation technique, it does require that the selected technique is consistent with the fair value measurement objective.[3] To meet the fair value measurement objective, a valuation technique should (a) be applied in a manner consistent with the fair value measurement objective, (b) be based on established principles of financial theory and generally applied in the field, and (c) be capable of incorporating all of the substantive characteristics unique to employee share options. At a minimum, the selected valuation technique should incorporate the following inputs as listed under paragraph A18 of Statement 123(R):

- The exercise price of the award;
- The expected term of the award;
- The current market price of the underlying share;
- The expected volatility of the underlying share;
- The expected dividends on the underlying share; and
- The risk-free interest rate for the expected term of the award.

Both the Black-Scholes-Merton formula and the lattice model require companies to use the same groups of model inputs. The key difference is that the lattice model allows companies to assume variations to these inputs during the term of the award. The selection of an appropriate valuation technique will therefore depend on the substantive characteristics of the award being valued. For example, the lattice model produces, as an output, the expected term of the award, which will depend on the employees' exercise and post-vesting termination behavior. The lattice model also allows companies to vary the volatility of the underlying shares, the interest rate, and the dividend yield as changes in these factors are expected to occur over the contractual term of the option. The lattice approach can directly model the effect of different expected vesting periods on the fair value of the option, whereas the Black-Scholes-Merton formula assumes exercise occurs at the end of the expected term of the option.

The lattice model may therefore be better suited to capture and reflect the substantive characteristics of a particular share-based payment award. For example, when valuing a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton formula generally would not be an appropriate valuation model because, while it meets criteria (a) and (b) of the fair value measurement objective, it is

[3] The fair value measurement objective requires that assumptions should reflect information that is (or would be) available to form the basis for an amount at which the instruments being valued would be exchanged. In estimating fair value, the assumptions used should not represent the biases of a particular party.

not designed to take into account this type of market condition and therefore does not incorporate all of the substantive characteristics unique to the share option being valued. The lattice model is able to measure the fair value of an award containing a market condition more reliably since the model can incorporate multiple estimates of when the market condition will be achieved and thereby reflect all substantive characteristics of the instrument. Similarly, a lattice model can incorporate multiple vesting scenarios for awards with more than one vesting condition, whereas the Black-Scholes-Merton formula uses a single (weighted-average) input. Whether it is practical to use a lattice model is based on a variety of factors, including the availability of reliable data to support the variations in the input factors. Companies should develop reasonable and supportable estimates for each of the input factors and the underlying assumptions, regardless of the valuation technique applied.

The SEC also stated in Question 2 of SEC Staff Accounting Bulletin Topic 14.C, "Valuation Methods" (SAB 107), that the SEC staff understands that a company may consider multiple techniques or models that meet the fair value measurement objective before making its selection as to the appropriate technique or model. The SEC staff would not object to a company's choice of a technique or model as long as the technique or model meets the fair value measurement objective. For example, a company is not required to use a lattice model simply because that model was the most complex of the models the company considered.

22-10: Using More Than One Valuation Technique

Question

Can companies use more than one valuation technique to estimate the fair value of their share-based payment awards?

Answer

Yes, different valuation techniques may be used to estimate the fair value of different types of share-based payment awards. However, the model selected by a company should be used consistently with (1) similar type of awards and (2) awards with similar characteristics. For example, a company may use a lattice model to estimate fair value of awards with a market condition and use the Black-Scholes-Merton formula to estimate the fair value of awards with a service condition. Alternatively, a company may use a lattice model to estimate the fair value of employee share options and the Black-Scholes-Merton formula to estimate the fair value of awards in employee share purchase plans.

Companies are not expected to change valuation techniques or models frequently for similar types of share-based payment awards from period-to-period. Refer to Q&A 22-11 for a more detailed discussion of changes in valuation techniques or models.

Companies should apply the new valuation technique or model to all newly issued awards. A change in valuation method will not have any impact on the fair values of previously issued awards; awards issued before the new technique was adopted should not be remeasured or revalued.

22-11: Changing Valuation Techniques

Paragraph A23 of Statement 123(R) states that the valuation technique a company selects should be used consistently and should not be changed unless a different valuation technique is expected to produce a better estimate of fair value. A change in valuation technique should be accounted for as a change in accounting estimate and should be applied prospectively to new awards.

Question

In subsequent periods, may a company change the valuation technique or model previously used to value a specific type of award?

Answer

Question 3 of SEC Staff Accounting Bulletin Topic 14.C, "Valuation Methods" (SAB 107), states that the staff would not object to a company changing its valuation technique or model as long as the new technique or model meets the fair value measurement objective of Statement 123(R). Refer to Q&A 22-9 for a more detailed discussion on the measurement objective. However, the SEC staff also stated that they would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of the share-based payment award being valued. A company's reasons for changing its valuation technique or model generally should be to improve the estimate of fair value and not simply to reduce the amount of compensation cost recognized.

22-12: Valuation — Dividends Paid on Options During Vesting

Question

How should the expected dividend yield assumption in an option-pricing model be adjusted if the employee receives the dividends paid on the underlying shares during the vesting period or if the option is dividend protected (e.g., a dividend paid on the underlying shares is applied to reduce the exercise price of the option)?

Answer

Expected dividends are taken into account in using an option-pricing model to estimate the fair value of a share option because dividends paid on the underlying shares are part of the fair value of those shares and option holders generally are not entitled to receive those dividends. However, an award of share options may be structured to protect option holders from that effect by providing them with some form of dividend rights. Such dividend protection may take a variety of forms and shall be appropriately reflected in estimating the fair value of a share option. For example, the effect of the dividend protection is appropriately reflected by using an expected dividend assumption of zero, if all dividends paid to shareholders are also paid to option holders based on the underlying shares, or the dividends are applied to reduce the exercise price of the options being valued.

Additionally, paragraph A37 of Statement 123(R) states, in part:

> Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost.

Refer to Q&A 22-13 for an illustration of the accounting for dividends paid on share-based payment awards.

22-13: Illustration — Dividends Paid on Options During Vesting

Paragraph A37 of Statement 123(R) states, in part:

> Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost.

Further, footnote 61 to paragraph A37 of Statement 123(R) states:

> The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity's estimates of forfeitures.

Illustration

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $100. The awards vest at the end of one year of service (cliff-vesting). The option holders will receive an amount equal to dividends paid to normal shareholders during the vesting period. Employees are not required to return the dividends or dividend equivalents received if they forfeit their awards. On July 1, 20X6, the company declares a dividend of $1 per share. Further assume the company has estimated a forfeiture rate of 10 percent of the awards. Refer to the journal entries below. For simplicity purposes, the effects of income taxes have been ignored.

Journal Entry: March 31, 20X6	Debit	Credit
Compensation cost	$ 22,500	
Additional paid-in-capital		$ 22,500
To record compensation cost for the quarter ended March 31, 20X6 (1,000 awards × $100 fair value × 25% services rendered × 90% awards expected to vest)		

Journal Entry: June 30, 20X6	Debit	Credit
Compensation cost	$ 22,500	
Additional paid-in-capital		$ 22,500
To record compensation cost for the quarter ended June 30, 20X6 (1,000 awards × $100 fair value × 25% services rendered × 90% awards expected to vest)		

Journal Entry: Date of Dividend Declaration	Debit	Credit
Retained earnings	$ 900	
Compensation cost	100	
Dividends payable		$ 1,000
To record the declaration of dividends and the related compensation cost on awards not expected to vest (1,000 awards × $1 dividend × 10% dividends paid on awards not expected to vest)		

Journal Entry: September 30, 20X6	Debit	Credit
Compensation cost	$ 22,500	
Additional paid-in-capital		$ 22,500
To record compensation cost for the quarter ended September 30, 20X6 (1,000 awards × $100 fair value × 25% services rendered × 90% awards expected to vest)		

On December 31, 20X6, 980 of the 1,000 options that were granted become vested. On that date, the company would record the following amounts. Refer to the journal entries below.

Journal Entries: December 31, 20X6	Debit	Credit
Compensation cost	$ 30,500	
Additional paid-in-capital		$ 30,500
To record compensation cost for the quarter ended December 31, 20X6 [(980 awards vested × $100 fair value) - $67,500 compensation cost previously recognized]		
Retained earnings	80	
Compensation cost		80
To adjust compensation cost for the dividends paid on awards that did not vest [$100 compensation cost previously recognized – (20 awards forfeited × $1 dividend)]		

Measurement — Equity Instruments for Which It Is Not Possible to Reasonably Estimate Fair Value at the Grant Date

Statement 123(R)

23. A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value).[13] Paragraphs A43–A48 and Illustration 11(b) (paragraphs A137–A142) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

Footnote 13 — Throughout the remainder of this Statement, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

23-1: When to Use an Industry Sector Index

Question

When calculating the fair value of its share-based payment awards, what factors should a nonpublic company consider before using the historical volatility of an industry sector index as a substitute for expected volatility of its own share price (i.e., measure its awards using calculated value versus fair value)?

Answer

A nonpublic company should use the volatility of an appropriate industry sector index only when it is not practicable to estimate the expected volatility of its own share price.

A nonpublic company may be able to estimate expected volatility of its own share price even though its shares are not quoted on an exchange. In assessing whether it is practicable for a nonpublic company to estimate the expected volatility of its own share price, factors to consider include whether

- the company has an internal market for its shares (e.g., employees can purchase and sell shares);
- previous issuances of equity in a private transaction or convertible debt provide indications of the historical or implied volatility of the company's share price; and
- similar public companies, in terms of industry and size, exist whose historical volatility could be used as a substitute (including companies within an index).

If, after consideration of all the relevant factors, the nonpublic company determines that it is not practicable to estimate the expected volatility of its share price, then it is permitted to use the volatility of an appropriate industry sector index as a substitute in calculating the estimated fair value of its share-based payment awards. Refer to Q&A 23-2, *Selecting and Computing the Historical Volatility of an Appropriate Industry Sector Index*.

Due to possible scrutiny in this area, a nonpublic company should consider carefully whether it is practicable to estimate the expected volatility of its share price.

23-2: Selecting and Computing the Historical Volatility of an Appropriate Industry Sector Index

Question

What should a nonpublic company consider in selecting and computing the historical volatility of an industry sector index to be used as a substitute for the expected volatility of its own share price?

Answer

A nonpublic company should select an industry sector index that is narrow enough to reflect both the nature and size (if possible) of the company.

For example, the use of the Philadelphia Exchange (PHLX) Semiconductor Sector Index is not an appropriate industry sector for a small nonpublic software development company. This index is neither representative of the industry in which the nonpublic company operates nor the size of the company. The volatility of an index that is composed of smaller software companies is a more appropriate substitute for the company's volatility.

A company that uses an industry sector index to determine volatility is required to use the historical volatility (as opposed to implied volatility) as prescribed in paragraph A48 of Statement 123(R). In no circumstances may a broad-based market index like the S&P 500, Russell 3000®, or Dow Jones Wilshire 5000 be used, pursuant to paragraph A46 of Statement 123(R).

Statement 123(R), Appendix A

A46. There are many different indices available to consider in selecting an appropriate industry sector index.[65] An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and that also reflects, if possible, the size of the entity. If a nonpublic entity operates in a variety of different industry sectors, then it might select a number of different industry sector indices and weight them according to the nature of its operations; alternatively, it might select an index for the industry sector that is most representative of its operations. If a nonpublic entity operates in an industry sector in which no public entities operate, then it should select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000®, or Dow Jones Wilshire 5000 because those indices are sufficiently diversified as to be not representative of the industry sector, or sectors, in which the nonpublic entity operates.

A48. The calculation of the historical volatility of an appropriate industry sector index should be made using the daily historical closing values[66] of the index selected for the period of time prior to the grant date (or service inception date) of the equity share option or similar instrument that is equal in length to the expected term of the equity share option or similar instrument. If historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity shall use the closing values for the longest period of time available. The method used shall be consistently applied (paragraph A23). Illustration 11(b) (paragraphs A137–A142) provides an example of accounting for an equity share option award granted by a nonpublic entity that uses the calculated value method.

Footnote 65 — For example, Dow Jones Indexes maintain a global series of stock market indices with industry sector splits available for many countries, including the United States. The historical values of those indices are easily obtainable from its website.

Footnote 66 — If daily values are not readily available, then an entity shall use the most frequent observations available of the historical closing values of the selected index.

23-3: Difference in the Valuation Requirements of Statement 123(R) for Nonpublic Companies

Question

How does the measurement of share-based payment awards for nonpublic companies differ from that required for public companies?

Answer

There are two measurement principles available to nonpublic companies for the valuation of share-based payment awards that are not offered to public companies (i.e., calculated value and intrinsic value). The following table summarizes the circumstances where the use of those measurement principles is appropriate:

	Public Companies	Nonpublic Companies
Equity awards	Measured at fair value	Measured at fair value (volatility is based on own share price or comparable public company) *or* Calculated value (volatility is based on industry sector index when it is not practicable to estimate the expected volatility of its own share price)
Liability awards	Measured at fair value, remeasured each reporting period	Measured at fair value (or calculated value), remeasured each reporting period *or* Intrinsic value, remeasured each reporting period

Nonpublic companies should make every effort to value their share-based payment awards at fair value. However, there may be instances when it is not reasonably practicable to estimate fair value. The expected volatility assumption is the biggest challenge since a nonpublic company's shares are not traded in a public market. In these cases, nonpublic companies may substitute the historical volatility of an appropriate industry sector index in lieu of actual expected volatility (Refer to Q&A 23-1, *When to Use an Industry Sector Index*). This is referred to as calculated value.

Pursuant to paragraph 38 of Statement 123(R), notwithstanding the use of fair value or calculated value, nonpublic companies can elect, as a policy decision, to measure all liability awards at intrinsic value instead of fair value (or calculated value if fair value is not reasonably practicable) at the end of each reporting period until the award is settled. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Therefore, a nonpublic company that has elected to measure its liability awards at fair value (or calculated value) would not be permitted to subsequently change to the intrinsic value method.

Statement 123(R)
24. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. Appendix A illustrates techniques for estimating the fair values of several instruments with complicated features. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

24-1: Equity Instruments With Terms That Make It Not Possible to Reasonably Estimate the Fair Value at Grant Date

Question

Under what circumstances may it not be possible to reasonably estimate the fair value of an equity-based award at the grant date?

Answer

Paragraph 24 of Statement 123(R) states that in **rare** circumstances, it may not be possible to reasonably estimate the fair value of an equity-based award at the grant date. Statement 123(R) contains a strong presumption that fair value can be estimated unless there is substantial evidence to the contrary. Paragraph B103 of Statement 123(R) further emphasizes this presumption by stating that in light of the variety of options and option-like instruments currently trading in the external markets, and the advances in methods of estimating fair values, it is expected that few instruments will fall into the category of instruments for which it is not possible to reasonably estimate fair value at the grant date. Accounting for an equity-based award using the intrinsic value method pursuant to paragraph 25 of Statement 123(R) is therefore only allowed under rare circumstances and only when there is substantial evidence indicating that it is not possible to estimate the fair value of the award.

Statement 123(R)
25. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value, remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Measurement — Reload Options and Contingent Features

Statement 123(R)

26. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.
27. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (paragraph A5, footnote 44), shall not be reflected in estimating the grant-date fair value of an equity instrument. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs.

27-1: Forfeiture of Vested Awards and Clawback Provisions

Paragraph 27 of Statement 123(R) requires that the effect of certain contingent features such as clawback provisions be accounted for if and when the contingent event occurs. Paragraph A190 of Statement 123(R) states that contingent features such as clawback provisions be accounted for by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains the contingent feature and the fair value of the consideration received. Refer to Q&A 27-2 and Illustration 15 in Appendix A of Statement 123(R) for examples of the accounting for awards with clawback features. In contrast, absent a clawback provision, a credit to the income statement is not recorded for vested awards (e.g., awards for which the requisite services required to earn the options were delivered) even if the awards expire unexercised.

Question

Many stock option agreements contain provisions requiring employees to exercise vested awards within a specified period of time after termination of employment. Options not exercised within the specified period are usually cancelled. Can companies account for such a provision as a clawback provision and reverse compensation cost for vested awards returned as a result of employment termination?

Answer

No. Clawback provisions, as contemplated in Statement 123(R), relate to provisions designed to recover value previously transferred to option holders when option holders violate the conditions of the clawback (e.g., a non-compete agreement). The requirement to forfeit an option after a specified period of time is not considered a clawback. For example, a requirement to return only vested options not yet exercised does not represent a clawback. Paragraph 45 of Statement 123(R) requires that previously recognized compensation cost should not be reversed for awards not containing clawback provisions provided that the holder has rendered the requisite services for the award to vest. Refer to Q&A 27-2 for an illustration of the accounting for a clawback provision.

27-2: Illustration — Accounting for Clawback Provisions

Paragraph 27 of Statement 123(R) requires that the effect of certain contingent features such as clawback provisions be accounted for if and when the contingent event occurs. Paragraph A190 states that contingent features such as clawback provisions be accounted for by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains the contingent feature and the fair value of the consideration received. Also see Illustration 15 of Statement 123(R) for an example of the accounting for awards with clawback features.

Illustration

On January 1, 20X6, a company grants to its chief executive officer (CEO) 1,000,000 "at-the-money" employee share options, each with a grant-date fair value of $6. The awards vest at the end of the fourth year of service (cliff-vesting). However, the award contains a provision that requires the CEO to return vested awards (including any gain realized by the CEO related to vested and previously exercised awards) to the company for no consideration in the event the CEO terminates employment to work for a competitor anytime within six years of the grant date. Assume the clawback provision does not extend the service period of the award. The CEO completes four years of service and vests in the award (i.e., the company has recognized total compensation cost of $6,000,000 (1,000,000 awards × $6 grant-date fair value) over the four year service period). Approximately one year after vesting in the awards, the CEO terminates employment and is hired as an employee of a direct competitor. As a result of the award's provisions, the former CEO returns 1,000,000 shares of the company's common stock with a total fair value of $3,000,000. The company records the following amounts on the date the clawback provision is enforced (the date the CEO is hired by the direct competitor). For simplicity purposes, the effects of forfeitures and income taxes have been ignored. Refer to the journal entry below.

Journal Entry	Debit	Credit
Treasury stock	$ 3,000,000	
Other income		$ 3,000,000
To record other income for the consideration received as a result of the clawback provision		

Alternatively, assume in accordance with the provisions of the award, the former CEO returns 1,000,000 shares of the company's common stock with a total fair value of $7,500,000. Since the fair value of the awards returned ($7,500,000) is greater than the compensation cost previously recorded ($6,000,000), an amount equal to the compensation cost previously recorded would be recorded as other income. The difference ($1,500,000) would be recorded as an increase to paid-in capital. Refer to the journal entry below.

Journal Entry	Debit	Credit
Treasury stock	$ 7,500,000	
Other income		$ 6,000,000
Additional paid-in capital		1,500,000
To record other income and return of capital (for the consideration received in excess of compensation cost previously recognized) as a result of the clawback provision		

Statement 123(R), Appendix A

A190. On January 1, 20X5, Entity T grants its CEO an award of 100,000 shares of stock that vest upon the completion of 5 years of service. The market price of Entity T's stock is $30 per share on that date. The grant-date fair value of the award is $3,000,000 (100,000 × $30). The shares become freely transferable upon vesting; however, the award provisions specify that, in the event of the employee's termination and subsequent employment by a direct competitor (as defined by the award) within three years after vesting, the shares or their cash equivalent on the date of employment by the direct competitor must be returned to Entity T for no consideration (a clawback feature). The CEO completes five years of service and vests in the award. Approximately two years after vesting in the share award, the CEO terminates employment and is hired as an employee of a direct competitor. Paragraph A5 states that contingent features requiring an employee to transfer equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration) are not considered in estimating the fair value of an equity instrument on the date it is granted. Those features are accounted for if and when the contingent event occurs by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains the contingent feature ($3,000,000) and the fair value of the consideration received.[111] The former CEO returns 100,000 shares of Entity T's common stock with a total market value of $4,500,000 as a result of the award's provisions. The following journal entry accounts for that event:

Treasury stock	$4,500,000	
Additional paid-in capital		$1,500,000
Other income		$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

A191. If instead of delivering shares to Entity T, the former CEO had paid cash equal to the total market value of 100,000 shares of Entity T's common stock, the following journal entry would have been recorded:

Cash	$4,500,000	
Additional paid-in capital		$1,500,000
Other income		$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

Footnote 111 — This guidance does not apply to cancellations of awards of equity instruments as discussed in paragraphs 55–57 of this Statement.

Classification — Liability Awards

Statement 123(R)

28. Paragraphs 29–35 of this Statement provide guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in paragraphs 29–35 should be classified as a liability or as equity, an entity shall apply generally accepted accounting principles (GAAP) applicable to financial instruments issued in transactions not involving share-based payment.
29. FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*, excludes from its scope instruments that are accounted for under this Statement. Nevertheless, unless paragraphs 30–35 of this Statement require otherwise, an entity shall apply the classification criteria in paragraphs 8–14 of Statement 150, as they are effective at the reporting date, in determining whether to classify as a liability a **freestanding financial instrument** given to an employee in a share-based payment transaction. Paragraphs A230–A232 of this Statement provide criteria for determining when instruments subject to this Statement subsequently become subject to Statement 150 or to other applicable GAAP.
30. In determining the classification of an instrument, an entity shall take into account the deferrals contained in FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*." In addition, a call option[14] written on an instrument that is not classified as a liability because of the deferrals in FSP FAS 150-3 (for example, a call option on a mandatorily redeemable share for which liability classification is deferred under FSP FAS 150-3) also shall be classified as equity while the deferral is in effect unless liability classification is required under the provisions of paragraph 32 of this Statement.

Footnote 14 — Refer to the definition of share option in Appendix E [reproduced herein as Appendix A].

Statement 123(R)

31. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A puttable (or callable) share[15] awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met: (a) the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued,[16 17] or (b) it is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued. For this purpose, a period of six months or more is a *reasonable period of time*. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.[18]
32. Options or similar instruments on shares shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. For example, an entity may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.
33. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this Statement, and the additional factor shall be reflected in estimating the fair value of the award.[19] Paragraph A53 provides examples of such awards.

Footnote 15 — A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares.

Footnote 16 — A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (a) until it becomes probable that the event will occur within the reasonable period of time.

Footnote 17 — An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered.

Footnote 18 — SEC registrants are required to consider the guidance in ASR No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks*." Under that guidance, shares subject to mandatory redemption requirements or whose redemption is outside the control of the issuer are classified outside permanent equity.

Footnote 19 — For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in Euros granted to employees of a U.S. entity's foreign operation whose functional currency is the Euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in Euros.

Statement 123(R)

34. The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a **tandem award** under which an employee receives either a stock option or a cash-settled SAR is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash, or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether (a) it has the ability to deliver the shares[20] and (b) it is required to pay cash if a contingent event occurs (paragraph 32).
35. A provision that permits employees to effect a **broker-assisted cashless exercise** of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:[21]
    a. The cashless exercise requires a valid exercise of the share options.
    b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

    Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements[22] resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

Footnote 20 — Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this Statement, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.

Footnote 21 — A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

Footnote 22 — Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

Measurement Principles — Liability Awards

Statement 123(R)
36. At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 16. However, the measurement date for liability instruments is the date of settlement. Accordingly, liabilities incurred under share-based payment arrangements are remeasured at the end of each reporting period until settlement.

36-1: Accounting Treatment for Liability Awards Versus Equity Awards

Question

What is the difference between the accounting treatment of equity awards and liability awards under Statement 123(R)?

Answer

The primary difference between the accounting treatment of equity awards and liability awards is that the amount of compensation cost related to equity awards that is recognized in the financial statements is fixed at the grant date based on the award's grant-date fair value. For liability awards, the fair value of the award, which determines the measurement of the liability on the balance sheet, is remeasured at each reporting period until the award is settled. Fluctuations in the fair value of the liability award are recorded as increases or decreases in compensation cost, either immediately or over the remaining service period, depending on the vested status of the award. The fair value of a liability award is measured in the same way as an equity award — that is, a valuation technique such as an option pricing model will most often be used.

Example

Assume the following facts:

- One thousand stock appreciation rights (SARs) are granted to one employee on January 1, 2006.
- All the SARs vest at the end of two years from the date of grant (cliff-vesting).
- The fair values of each SAR are as follows:
  - $10 on January 1, 2006;
  - $15 on December 31, 2006;
  - $14 on December 31, 2007;
  - $18 on December 31, 2008; and
  - $16 on the date of settlement, May 15, 2009.
- For simplicity purposes, the effects of forfeitures and income taxes have been ignored.
- There are no interim reporting requirements.
- In Scenario 1, the employer is required to settle the SARs with shares (equity awards).
- In Scenario 2, the employer is required to settle the SARs with cash (liability awards).

Scenario 1 — Equity Awards		
Year Ended	**Compensation Cost**	**Comments**
December 31, 2006	$ 5,000	A company records compensation cost based on the number of awards granted, the grant-date fair value of the awards, and the amount of services rendered (1,000 awards × $10 × 50% services rendered*).
December 31, 2007	5,000	A company records compensation cost based on the number of awards granted, the grant-date fair value of the awards, and the amount of services rendered, less amounts previously recognized ((1,000 awards × $10 fair value × 100% services rendered) – $5,000).
December 31, 2008	—	A company does not record any compensation cost after the awards are fully vested.
Period from January 1, 2009, to May 15, 2009	—	A company does not record any compensation cost after the awards are fully vested.
Total	$ 10,000	

* Fifty percent represents the employee providing one of two years of service.

Scenario 2 — Liability Awards		
Year Ended	**Compensation Cost**	**Comments**
December 31, 2006	$ 7,500	A company records compensation cost based on the number of awards granted, the fair value of the liability award at the reporting date, and the amount of services rendered (1,000 awards × $15 fair value × 50% services rendered*).
December 31, 2007	6,500	A company records compensation cost based on the number of awards granted, the fair value of the liability award at the reporting date, and the amount of services rendered, less amounts previously recognized ((1,000 awards × $14 fair value × 100% services rendered) – $7,500).
December 31, 2008	4,000	Once all the services have been provided the company remeasures the liability each reporting date until the award is settled. Remeasurement is based on the number of awards vested and the fair value of the liability award at the reporting date, less amounts previously recognized ((1,000 awards × $18 fair value) – $14,000).
Period from January 1, 2009, to May 15, 2009	(2,000)	Once all the services have been provided the company remeasures the liability each reporting date until the award is settled. Remeasurement is based on the number of awards vested and the fair value of the liability award at the reporting date, less amounts previously recognized ((1,000 awards × $16 fair value) – $18,000).
Total	$ 16,000	

* Fifty percent represents the employee providing one of two years of service.

Statement 123(R)

37. A **public entity** shall measure a liability award under a share-based payment arrangement based on the award's fair value remeasured at each reporting date until the date of settlement. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method.
38. A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value.[23] Regardless of the method selected, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method. Illustration 11(c) (paragraphs A143–A148) provides an example of accounting for an instrument classified as a liability using the intrinsic value method.

Footnote 23 — Consistent with the guidance in paragraph 23, footnote 13, a nonpublic entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

Recognition — Requisite Service Period

Statement 123(R)

39. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.
40. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value (paragraph A60). An award may have one or more **explicit**, **implicit**, or **derived service periods**; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards.[24] Paragraphs A59–A74 provide guidance on estimating the requisite service period and provide examples of how that period should be estimated if an award's terms include more than one explicit, implicit, or derived service period.

Footnote 24 — An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (paragraph 42).

40-1: Derived Service Period

Question

For certain awards compensation cost is required to be recorded over the derived service period. What is a derived service period and when is it required to be determined?

Answer

A derived service period exists when share-based payment awards contain a market condition. Explicit and implicit service periods relate to service and/or performance conditions only. When an award only has a market condition, the derived service period is the requisite service period. Refer to paragraph A61 of Statement 123(R) for awards that are issued and contain a market condition, a service or performance condition, or both.

A derived service period is the period of time from the service inception date to the expected date of satisfaction of the market condition. This period of time can be inferred when applying valuation techniques used to estimate fair value of an award with a market condition.

For example, an award may have a condition where it is exercisable only when the share price increases by 25 percent. The derived service period of this award can be inferred by using a valuation technique such as a lattice-based model. In a lattice-based model, there will be a number of possible paths that reflect an increase in share price by 25 percent. The derived service period is inferred using the median share price path or, in other words, the mid-point period of time during which the share price is expected to increase by 25 percent.

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A61. An award with a combination of market, performance, or service conditions may contain multiple explicit, implicit, or derived service periods. For such an award, the estimate of the requisite service period shall be based on an analysis of (a) all vesting and exercisability conditions, (b) all explicit, implicit, and derived service periods, and (c) the probability that performance or service conditions will be satisfied. Thus, if vesting (or exercisability) of an award is based on satisfying both a market condition and a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the longest of the explicit, implicit, or derived service periods. If vesting (or exercisability) of an award is based on satisfying either a market condition or a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the shortest of the explicit, implicit, or derived service periods.

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41. The **service inception date** is the beginning of the requisite service period. If the service inception date precedes the grant date (paragraph A79), accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date). Illustration 3 (paragraphs A79–A85) provides guidance on the concept of *service inception date* and how it is to be applied.

42. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. Illustration 4(b) (paragraphs A97–A104) provides an example of the accounting for an award with a graded vesting schedule.

42-1: Valuation Techniques and Graded Versus Straight Line Attribution

When determining the fair value of an award with a graded vesting schedule, certain valuation techniques may directly or indirectly treat each portion of the award that vests separately as an individual award. That is, directly or indirectly, certain valuation techniques may cause an award with graded vesting to be characterized as multiple awards instead of a single award.

Question

If a company uses a valuation technique that values each portion of a graded vesting award separately, can compensation cost be recognized on a straight-line basis over the total requisite service period for the entire award?

Answer

Yes. Regardless of the valuation technique used, even though the valuation technique may directly or indirectly treat each portion of the award as individual awards, the company is able to make a policy decision to recognize compensation cost on a straight-line basis over the requisite service period. Alternatively, a company may elect a policy of recognizing compensation cost based on treating each component of the award as an individual award (i.e., the method described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans)*.

However, paragraph 42 of Statement 123(R) maintains the requirement that if straight-line attribution is used, "the amount of compensation cost recognized at any date must be at least equal to the portion of the grant-date value of the award that is vested at that date."

42-2: Graded Vesting — Awards Issued Prior to the Adoption of Statement 123(R)

Question

Upon adoption of Statement 123(R) companies are required to recognize (over the remaining service period) compensation for unvested awards for which compensation cost previously has not been recognized. Are companies with outstanding share-based payment awards with a graded vesting schedule permitted to change their method of recognizing compensation cost from (or to) an accelerated method (i.e., the method described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*) to (or from) a straight-line method for such preexisting grants?

Answer

No. Statement 123(R) applies to awards that are granted, modified, repurchased, or cancelled after the date of adoption. Accordingly, for awards granted prior to the adoption of Statement 123(R) companies must recognize compensation cost over the remaining service period based on the same methodology used either for recognition or pro forma disclosure purposes under Statement 123.[4] Paragraph 70 of Statement 123(R) states, in part:

> This Statement applies to all awards granted after the required effective date. This Statement shall not be applied to awards granted in periods before the required effective date except to the extent that prior periods' awards are modified, repurchased, or cancelled after the required effective date.

Further, paragraph 74 of Statement 123(R) states, in part:

> The compensation cost for those **earlier awards** shall be attributed to periods beginning on or after the required effective date of this **Statement using the attribution method that was used under Statement 123.** [Emphasis added]

For example, if a company recognized compensation cost under Statement 123 (either for income statement or pro forma disclosure purposes) for its outstanding awards with a graded vesting schedule following the method described in Interpretation 28, it should continue to follow that same recognition model for the unvested portion of the award after the adoption of Statement 123(R). Refer to Q&A 42-3 for a discussion of the policy election that companies can make for awards with a graded vesting schedule granted subsequent to the effective date of Statement 123(R).

42-3: Graded Vesting — Policy Election for Awards Granted Subsequent to the Effective Date of Statement 123(R)

Prior to the adoption of Statement 123(R) a company accounted for its share-based payment awards with graded vesting following the accelerated recognition method described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. Upon adoption, Statement 123(R) requires a company to make a policy decision to recognize compensation cost for its share-based payment awards with graded

[4] Paragraph 31 of Statement 123 states, in part: "Compensation cost for an award with a graded vesting schedule shall be recognized in accordance with the method described in Interpretation 28 if the fair value of the award is determined based on different expected lives for the options that vest each year, as it would be if the award is viewed as several separate awards, each with a different vesting date."

vesting either (1) on an accelerated basis (i.e., the Interpretation 28 approach) as though each separately vesting portion of the award was, in-substance, a separate award or (2) on a straight-line basis over the requisite service period. A company expects to issue new awards with graded vesting after the effective date of Statement 123(R).

Question

Could a company, upon adoption of Statement 123(R), change its method of recognizing compensation cost for any **newly issued awards** with a graded vesting schedule?

Answer

Yes. A change in the method of recognizing compensation cost is viewed as a change in accounting principle. Generally, once an accounting principle is adopted it cannot be changed unless the company can justify the use of an alternative accounting principle that is **preferable**. In this case, Statement 123(R) cites a preference towards neither the accelerated recognition model nor the straight-line recognition model. However, paragraph 16 of APB Opinion No. 20, *Accounting Changes*, cites as justification for such a change the following:

> **The issuance of a new pronouncement by the FASB** or by other designated bodies as described in categories (a)–(d) of SAS 69 that creates a new accounting principle…The issuance of such a pronouncement is considered to constitute sufficient support for making a change in accounting principle provided that the hierarchy established by SAS 69 is followed. [Emphasis added]

Since the company is changing its method of recognizing compensation cost as a result of the issuance of a new accounting pronouncement, the change is appropriate for any awards issued after the effective date of Statement 123(R).

Based on informal discussions with the FASB staff, the staff agrees that a change in the method of recognizing compensation cost (i.e., from the accelerated recognition method to a straight-line method and vice versa) for awards issued after the adoption of Statement 123(R) represents the adoption of an initial accounting policy pursuant to the policy election in paragraph 42 of Statement 123(R).

However, once a company selects a method of accounting for awards under Statement 123(R), any subsequent change in attribution methodology must be evaluated as a change in accounting principle with a requirement to justify the change as a change to a preferable method. Refer to Q&A 42-2 for a discussion of the recognition requirements of pre-existing awards.

42-4: Illustration — Graded Vesting Attribution Model

Illustration

Assume a company grants 1,000 “at-the-money” employee share options each with a grant-date fair value of $12. The awards vest in 25 percent increments each year over the next four years (i.e., a graded vesting schedule). Assume the company has elected, as their policy election, to recognize compensation cost using the graded vesting attribution model.[5] The graded vesting attribution model treats each award that vests separately as an individual award (tranche). In this illustration, since the awards vest on an annual basis there are only four tranches. However, if an award, for example, vested 1/48 each month for a four-year period, then the award would contain 48 separate awards (48 tranches).

[5] Paragraph 42 of Statement 123(R) allows companies to make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

The following table summarizes the allocation of the total compensation cost ($12,000 = 1,000 awards × $12 fair value) over each of the next four years of service. For simplicity purposes, the effects of forfeitures and income taxes have been ignored.

Award	Year 1	Year 2	Year 3	Year 4
Tranche 1 [(12,000 ÷ 4) × 1/1]	$ 3,000	—	—	—
Tranche 2 [(12,000 ÷ 4) × 1/2]	1,500	$ 1,500	—	—
Tranche 3 [(12,000 ÷ 4) × 1/3]	1,000	1,000	$ 1,000	—
Tranche 4 [(12,000 ÷ 4) × 1/4]	750	750	750	$ 750
Total compensation cost	$ 6,250	$ 3,250	$ 1,750	$ 750

Recognition — Amount of Compensation Cost

Statement 123(R)
43. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change.

43-1: Accounting for Forfeitures — Total Compensation Cost Recognized

When recognizing the grant-date fair value of share-based payment awards as compensation cost in the financial statements, Statement 123(R) requires that an estimate of forfeitures be made when the awards are granted. The alternative in Statement 123, which allowed companies to account for forfeitures as they occur, is no longer available.

Question

Will the requirement under Statement 123(R) of estimating forfeitures when awards are granted change the total amount of compensation cost recognized in the financial statements, as compared to recording the effect of forfeitures only when they occur (the method allowed under Statement 123)?

Answer

No. The **total** amount of compensation cost recognized in the financial statements will not differ whether or not forfeitures are estimated and accounted for up front, or as they occur. Under either Statement 123(R) or Statement 123, no compensation cost is recognized for unvested awards that are forfeited. However, the amount of compensation cost recognized in a given period may vary between the two methods.

Example

A company grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $10. The awards vest at the end of the fourth year of service (cliff-vesting).

At the date of grant, the company estimates that 100 of the stock options will be forfeited during the service (vesting) period. However, in Year 3, 150 options are forfeited; there are no other forfeitures during the service (vesting) period. The following table compares the compensation cost that is recognized under both methods of accounting for forfeitures — estimated up-front (and revised when information becomes available suggesting that actual forfeitures will differ) or recognized as they occur (no longer permitted by Statement 123(R)).

Forfeitures Estimated at the Grant Date (Required by Statement 123(R))		
Year	**Compensation Cost**	**Comments**
Year 1	$ 2,250	Since the company estimates that 100 options will be forfeited during the vesting period, compensation cost is recognized for only 900 of the 1,000 options granted. Compensation cost is based on the number of awards expected to vest, the grant-date fair value of the awards, and the amount of services rendered (900 awards × $10 fair value × 25% services rendered*).
Year 2	2,250	Since there is no change in forfeiture estimate, the amount of compensation cost is exactly the same as in Year 1. Compensation cost is based on the number of awards expected to vest, the grant-date fair value of the awards, and the amount of services rendered, less amounts previously recognized ((900 awards × $10 fair value × 50% services rendered) – $2,250).
Year 3	1,875	In Year 3, 150 options are forfeited and the company expects that no other forfeitures will occur prior to vesting. Compensation cost is based on the number of awards expected to vest, the grant-date fair value of the awards, and the amount of services rendered, less amounts previously recognized ((850 awards × $10 fair value × 75% services rendered) – $4,500).
Year 4	2,125	By the end of Year 4, 850 options are fully vested. Compensation cost is based on the number of awards vested, the grant-date fair value of the awards, and the amount of services rendered, less amounts previously recognized ((850 awards × $10 fair value × 100% services rendered) – $6,375).
Total	$ 8,500	

* Twenty-five percent represents the employee providing one of four years of service.

Forfeitures Estimated As They Occur (Permitted Under Statement 123)		
Year	**Compensation Cost**	**Comments**
Year 1	$ 2,500	Since no forfeitures occurred in the first year of service, a company would have assumed all awards were expected to vest. Compensation cost is based on the number of awards granted, the awards' grant-date fair value, and the amount of services rendered (1,000 awards × $10 fair value × 25% services rendered*).
Year 2	2,500	Since no forfeitures occurred in the second year of service, a company would have assumed all awards were expected to vest. Compensation cost is based on the number of awards granted, the awards' grant-date fair value, and the amount of services rendered, less amounts previously recognized ((1,000 awards × $10 fair value × 50% services rendered) – $2,500).
Year 3	1,375	In Year 3, 150 options are forfeited and the company expects that no other forfeitures will occur prior to vesting. Compensation cost is based on the number of awards expected to vest, the awards' grant-date fair value, and the amount of services rendered, less amounts previously recognized ((850 awards × $10 fair value × 75% services rendered) – $5,000).
Year 4	2,125	By the end of Year 4, 850 options are fully vested. Compensation cost is based on the number of awards vested, the awards' grant-date fair value, and the amount of services, less amounts previously recognized ((850 awards × $10 fair value × 100% services rendered) – $6,375).
Total	$ 8,500	

* Twenty-five percent represents the employee providing one of four years of service.

43-2: Information Used to Estimate Forfeitures

Question

What information can a company consider in estimating forfeiture rates?

Answer

A number of different sources of relevant information and data can be used to support a company's estimate of the number of stock options that eventually will vest. Examples are as follows:

- Historical rates of forfeiture (prior to vesting) for awards with similar terms
- Historical rates of employee turnover (prior to vesting)
- The intrinsic value of the award at the grant date
- The volatility of the company's share price
- The length of the vesting period
- The number of awards granted to individual grantees

- The nature and terms of the vesting condition(s) of the award[6]
- The characteristics of the grantee (e.g., whether the grantee is a top officer of the company)
- A large population of relatively homogenous employee grants
- Other relevant terms and conditions of the award that may affect forfeiture behavior (prior to vesting)

Consistent with paragraph B166 of Statement 123(R), companies without sufficient information may base forfeiture estimates on experience of other companies until entity-specific information is available.

43-3: Accounting for Phantom Stock Plans

Question

How should a company account for phantom stock plans under Statement 123(R)?

Answer

Under a typical phantom stock plan, an employee is granted for a specific period of time a theoretical number of units of stock that are convertible into common stock of the company. (Units are not legal securities and usually are issued only on a memorandum basis.) The value of each phantom unit is based on the company's stock and, therefore, appreciates and depreciates based on fluctuations in the value of the company's stock. Usually, the employee is entitled to the value of the units and any unpaid dividends.

The specific term of each "phantom stock" plan will ultimately dictate how the award should be accounted for. However, for phantom stock plans that are settled in cash, or in which the employee may choose to settle in cash, the awards generally are accounted for as liabilities (i.e., compensation cost is recognized over the service (vesting) period of the award based on the fair value of the award remeasured at each reporting period).

For phantom stock plans that require or permit the company to settle the award in stock, the awards will generally be considered equity awards. For equity awards, compensation cost is measured based on the fair value of the award on the date of grant and the compensation cost is recognized over the service (vesting) period of the award.

[6] Accruals of compensation cost for an award that has a performance condition are based on the probable (as used in FASB Statement No. 5, *Accounting for Contingencies*) outcome of that condition (paragraph 44 of Statement 123(R)).

Statement 123(R)

44. Accruals of compensation cost for an award with a performance condition shall be based on the probable[25] outcome of that performance condition — compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Illustration 5 (paragraphs A105–A110) provides an example of how to account for awards with multiple performance conditions.
45. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

Footnote 25 — *Probable* is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies*: "the future event or events are likely to occur" (paragraph 3).

Recognition — Changes in the Requisite Service Period

Statement 123(R)
46. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date if that date precedes the grant date) and shall base accruals of compensation cost on that period. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of (a) all vesting and exercisability conditions, (b) all explicit, implicit, and derived service periods, and (c) the probability that performance or service conditions will be satisfied. For such an award, whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of those conditions and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied. Paragraphs A59–A66 provide guidance on adjusting the initial estimate of the requisite service period.

Recognition — Effect of Market, Performance, and Service Conditions

Statement 123(R)

47. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost is recognized if the requisite service is rendered, and no compensation cost is recognized if the requisite service is not rendered. Paragraphs A49–A51 provide guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).
48. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (paragraph 19). For purposes of this Statement, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied. Accordingly, an entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

48-1: Impact of Service, Performance, and Market Conditions in Valuing Share-Based Payment Awards

Question

How do service, performance, and market conditions affect the measurement of a share-based payment award's grant-date fair value?

Answer

Service and Performance Conditions

A service or performance condition that affects either the vesting or the exercisablilty of a share-based payment award is considered a vesting condition. A vesting condition is not directly incorporated into the grant-date fair value of an award. Rather, a vesting condition will determine whether an award has been earned (i.e., whether a company will record compensation cost). However, a vesting condition can impact the grant-date fair value indirectly by means of its effect on the expected term of an award. Since the expected term of an award cannot be shorter than the vesting period, the longer the vesting period the longer the expected term of an award. Refer to Q&As 19-1 and 19-2 for a more detailed discussion of how service and performance conditions affect the recognition of compensation cost.

In contrast, a service or performance condition that affects a factor (e.g., exercise price, contractual term, quantity, conversion ratio, etc.) other than vesting or exercisability will be incorporated into an award's grant-date fair value. Refer to Q&A 49-1 for a more detailed discussion of how service and performance conditions that affect factors other than vesting or exercisability are incorporated into the grant-date fair value of an award.

Market Condition

A market condition is not considered a vesting condition pursuant to paragraph 48 of Statement 123(R). Since a market condition is not a vesting condition, it will be directly incorporated into the grant-date fair value of an award rather than the determination of whether compensation cost will be recorded. Paragraph 19 of Statement 123(R) states, in part, that the "effect of a market condition is reflected in the grant-date fair value of an award."

To incorporate a market condition into the grant-date fair value, the valuation technique must consider all the possible outcomes of the market condition. That is, the valuation technique must be able to estimate the value of path-dependent options. Footnote 10 of Statement 123(R) states, in part: "Awards with market conditions, as defined in this Statement, are path-dependent options." An example of a valuation technique that can value such options is a Monte Carlo simulation.

The following table illustrates when a service, performance, and market condition are included in the estimation of the grant-date fair value of an award.

Condition	Affects Vesting or Exercisability	Affects Factors Other Than Vesting or Exercisability
Service	No	Yes
Performance	No	Yes
Market	Yes	Yes

48-2: Service and Performance Conditions Impacting the Exercisability of a Vested Award

Question

On January 1, 20X6, a company grants employee share options. The awards vest ratably over a four-year period (graded vesting). How does a provision requiring that options can only be exercised upon the successful completion of an Initial Public Offering (IPO) impact the recognition of compensation cost?

Answer

The award contains an explicit service condition (i.e., the awards vest ratably over a four-year period) and a performance condition (i.e., the awards can only be exercised upon successful completion of an IPO and exercised by employees still in employment of the company at the completion of the IPO). The company should treat the exercisability condition similarly to the way it would a vesting requirement (the options vest only after four years and only when an IPO has been completed). Paragraph A64 of Statement 123(R) requires that if the vesting (or exercisability) of an award is based on satisfying both a service and performance condition, the company must initially determine which outcomes are probable of achievement and recognize the compensation cost over the longer of the explicit or implicit service period. As an IPO generally is not considered to be probable of occurrence until the IPO is effective, no compensation cost would be recognized until an IPO occurs. For example, if an IPO is completed in the second year, then the company would recognize compensation cost related to the options already vested upon completion of the IPO and record the unrecognized compensation cost ratably over the remaining two years of service.

Statement 123(R), Appendix A

A64. If an award vests upon the satisfaction of both a service condition and the satisfaction of one or more performance conditions, the entity also must initially determine which outcomes are probable of achievement. For example, an award contains a four-year service condition and two performance conditions, all of which need to be satisfied. If initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, then no compensation cost would be recognized unless the two performance conditions and the service condition subsequently become probable of achievement. If both performance conditions become probable of achievement one year after the grant date and the entity estimates that both performance conditions will be achieved by the end of the second year, the requisite service period would be four years as that is the longest period of both the explicit service period and the implicit service periods. Because the requisite service is now expected to be rendered, compensation cost will be recognized in the period of the change in estimate (paragraph 43) as the cumulative effect on current and prior periods of the change in the estimated number of awards for which the requisite service is expected to be rendered. Therefore, compensation cost for the first year will be recognized immediately at the time of the change in estimate for the awards for which the requisite service is expected to be rendered. The remaining unrecognized compensation cost for those awards would be recognized prospectively over the remaining requisite service period.

Statement 123(R)

49. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied. Paragraphs A52–A54 provide additional guidance on the effects of market, performance, and service conditions that affect factors other than vesting or exercisability. Illustrations 5 (paragraphs A105–A110), 6 (paragraphs A111–A113), and 8 (paragraphs A121–A124) provide examples of accounting for awards with such conditions.

49-1: Service and Performance Conditions That Affect Factors Other Than Vesting or Exercisability of Share-Based Payment Awards

Question

What impact do service or performance conditions have on the calculation of grant-date fair value of a share-based payment award?

Answer

When service or performance conditions exist that affect factors **other than** vesting or exercisability (e.g., exercise price, contractual term, quantity, conversion ratio, etc.), the grant-date fair value should be calculated for each possible outcome. Initial accruals of compensation cost should be based on the most probable outcome as described in Q&A 19-2. However, the final measure of compensation cost should be adjusted to reflect the grant-date fair value of the outcome that is actually achieved.

Example

A company grants 1,000 "at-the-money" employee share options in which the exercise price is determined based on whether the following performance conditions are met:

1. Exercise price is $10 per share if revenues are between $20 and $30 million in 20X5 (grant-date fair value of $2),
2. Exercise price is $8 per share if revenues are between $30 and $40 million in 20X5 (grant-date fair value of $3), or
3. Exercise price is $6 per share if revenues exceed $40 million in 20X5 (grant-date fair value of $4).

The company should calculate the fair value of the awards under each of the three possible alternatives described above — that is, the grant-date fair values assuming $10, $8, and $6 exercise prices, respectively.

If, at the grant date, the probable outcome is that revenues will exceed $40 million in 20X5, then initial accruals of compensation cost are based on the grant-date fair value of $4. If actual revenues for 20X5 were $35 million or it becomes probable that actual revenues will be $35 million, then cumulative compensation cost recognized is adjusted to reflect the grant-date fair value of $3.

Recognition — Changes in the Fair Value or Intrinsic Value of Awards Classified as Liabilities

Statement 123(R)
50. Changes in the fair value (or intrinsic value for a nonpublic entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation cost of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this Statement is an adjustment of compensation cost in the period of settlement. Illustration 10 (paragraphs A127–A133) provides an example of accounting for a liability award from the grant date through its settlement.

Modifications — General Principles

Statement 123(R)

51. A **modification** of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award.[26] In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

    a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date.[27] The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

    b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be (1) the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus (2) the incremental cost resulting from the modification. Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

    c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 25 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

    Illustrations 12-14 (paragraphs A149–A189) provide additional guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial instruments from equity to liability or vice versa, and modifications of vesting conditions. Illustration 22 (paragraphs A225–A232) provides additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this Statement but subsequently became subject to other applicable GAAP.

Footnote 26 — A modification of a liability award also is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or intrinsic value for a nonpublic entity that elects that method) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

Footnote 27 — As indicated in paragraph 23, footnote 13, references to *fair value* throughout paragraphs 24–85 of this Statement should be read also to encompass *calculated value*.

51-1: Accounting for the Modification of a Share-Based Payment Award

Question

How is a modification accounted for under the provisions of Statement 123(R)?

Answer

Modified awards are viewed as an exchange of the original award for a new award, presumably one with greater fair value. As a result, companies are required to record the incremental fair value, if any, of the modified award, as compensation cost on the date of modification (for vested awards) or over the remaining service (vesting) period (for unvested awards). The incremental compensation cost is the excess of the fair value of the modified award on the date of modification over the fair value of the original award immediately before the modification.

Generally, total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair value of the original award. The exception is when the original award is not expected to vest based on its original terms (i.e., the service condition, the performance condition, or neither are expected to be achieved.) Therefore, total recognized compensation cost attributable to an award that has been modified is (1) the grant-date fair value of the original award for which the required service has been provided (i.e., the award has been earned) or is expected to be provided and (2) the incremental compensation cost conveyed as a result of the modification.

Example 1

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest at the end of the fourth year of service (cliff-vesting). On January 1, 20X9, the company modifies the awards. The modification does not affect the remaining service period. The fair value of the original award immediately before modification is $4 and the fair value of the modified award is $6. For simplicity purposes, the effects of forfeitures and income taxes have been ignored.

Over the first three years of service the company records $6,750 (1,000 awards × $9 × 75% for three of four years of services rendered) of cumulative compensation cost. On the date of modification, the company computes the incremental compensation cost as $2,000 (($6 fair value of modified award – $4 fair value of original award immediately before the modification) × 1,000). The $2,000 incremental compensation cost is recorded over the remaining year of service. Additionally, the company records the remaining $2,250 of compensation cost over the remaining year of service attributable to the original award. Therefore, total compensation cost associated with this award is $11,000 ($9,000 grant-date fair value + $2,000 incremental fair value).

Example 2

Alternatively, assume all the same facts as above, except that the awards contain a graded vesting schedule (i.e., 25 percent of the awards vest at the end of each year of service). The company has elected to record compensation cost on a straight-line basis pursuant to the accounting policy election permitted by paragraph 42 of Statement 123(R).

Over the first three years of service the company records $6,750 (1,000 awards × $9 × 75% for three of four years of services rendered) of compensation cost. On the date of modification, the company computes the incremental compensation cost as $2,000 (($6 fair value of modified award – $4 fair value of original award immediately before the modification) × 1,000). Incremental compensation cost of $1,500 is recorded immediately, as 75 percent of the awards have vested. The remaining $500 of incremental compensation cost is recorded over the remaining year of service. Additionally, the company records the remaining $2,250 of compensation cost over the remaining year of service attributable to the original award. Therefore, total compensation cost associated with this award is $11,000 ($9,000 grant-date fair value + $2,000 incremental fair value).

51-2: Modification That Changes an Award's Classification From Equity to Liability

Question

How does a company account for a modification that results in a change in an award's classification from an item of equity to a liability?

Answer

A modification that changes an award's classification from an item of equity to a liability is accounted for in the same manner as any other modification. Refer to Q&A 51-1 for a discussion of the accounting for a modification of a share-based payment award.

To record the new liability award, the company recognizes a share-based liability for the portion of the award related to prior service, multiplied by the modified award's fair value. If the fair value of the modified award is less than or equal to the fair value of the original award, then the offsetting amount is recorded to additional paid-in capital (i.e., final compensation cost can not be less than grant-date fair value). If, on the other hand, the fair value of the modified award is greater than the fair value of the original award, then the excess is recognized as compensation cost either immediately (for vested awards) or over the remaining service (vesting) period (for unvested awards). Because the award is now classified as a liability, it is remeasured at fair value each reporting period.

It is important to note that if a company cash settles a fully vested equity award rather than modify its terms to reclassify the award as a liability (i.e., to allow for cash settlement), the resulting accounting would be different. That is, the cash settlement, as long as it is transacted at the award's then current fair value, would result in no additional compensation cost pursuant to paragraph 55 of Statement 123(R). Additionally, refer to Q&A 55-1 for a discussion of cash settlement at less than current fair value. In contrast, if the fair value of the modified liability award was greater than the grant-date fair value of the equity award on the date of modification, then the modification would result in additional compensation cost based on the previous discussion.

Example 1

On January 1, 20X6, a company grants 1,000 "at-the-money" share-settled stock appreciation rights (SAR) each with a grant-date fair value of \$3. The awards vest at the end of the fourth year of service (cliff-vesting). On December 31, 20X7, the company modifies the award from a share-settled SAR to a cash-settled SAR. The fair value of the award on December 31, 20X7, and December 31, 20X8, is \$4 and \$5, respectively.

Because the modification only affects the settlement feature of the award (i.e., cash settlement versus share settlement), presumably the fair value of the modified award equals the fair value of the original award immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the award and, therefore, no incremental compensation cost has to be recorded in connection with this modification from an equity award to a liability award.

As the modified fair value is greater than the grant-date fair value, the company (1) reclassifies the amount currently residing in additional paid-in capital, \$1,500 (1,000 awards × \$3 grant-date fair value × 50% services rendered = \$1,500), as a share-based liability; and (2) the excess \$500 ((\$4 modified-date fair value – \$3 grant-date fair value) × 1,000 awards × 50% services rendered = \$500) is recorded as additional compensation cost to record the new liability award at fair value, with a corresponding adjustment to share-based liability in the period of modification. Refer to the journal entries below.

Journal Entry: December 31, 20X6	Debit	Credit
Compensation cost	\$ 750	
Additional paid-in capital		\$ 750
To record compensation cost for the year ended December 31, 20X6		

Journal Entry: December 31, 20X7	Debit	Credit
Compensation cost	$ 750	
Additional paid-in capital		$ 750
To record compensation cost for the year ended December 31, 20X7		

Journal Entry: Date of Modification	Debit	Credit
Additional paid-in capital	$ 1,500	
Compensation cost	500	
Share-based liability		$ 2,000
To record the award as a liability on the date of modification		

Now that the award is classified as a liability, the company must remeasure the award at its fair value each reporting period pursuant to paragraph 50 of Statement 123(R). Additionally, refer to Q&A 36-1 for a discussion of the difference in accounting treatment for equity awards versus liability awards. Refer to the journal entry below.

Journal Entry: December 31, 20X8	Debit	Credit
Compensation cost	$ 1,750	
Share-based liability		$ 1,750
To remeasure the liability award at fair value at the end of the next reporting period (December 31, 20X8) [(1,000 awards × $5 fair value × 75% services rendered) – $2,000 compensation cost previously recognized]		

Example 2

Alternatively, assume all the same facts as above, except that the fair value of the award on the date of modification is $2.50 and $2 on December 31, 20X8. The company reclassifies the portion of the award's modified fair value of $1,250 (1,000 awards × $2.50 fair value × 50% services rendered) currently residing in additional paid-in capital as a share-based liability. Refer to the journal entries below.

Journal Entry: December 31, 20X6	Debit	Credit
Compensation cost	$ 750	
Additional paid-in capital		$ 750
To record compensation cost for the year ended December 31, 20X6		

Journal Entry: December 31, 20X7	Debit	Credit
Compensation cost	$ 750	
Additional paid-in capital		$ 750
To record compensation cost for the year ended December 31, 20X7		

Journal Entry: Date of Modification	Debit	Credit
Additional paid-in capital	$ 1,250	
Share-based liability		$ 1,250
To record the award as a liability on the date of modification		

Because the award is now a liability award, the company is required to remeasure the award each reporting period. If the value of the liability award at settlement is less than its grant-date fair value, then total compensation cost will equal grant-date fair value, with a portion of that value remaining in equity. On the other hand, if at settlement the value of the liability award is greater than its grant-date fair value, total compensation cost will equal the liability award's value at settlement. This is consistent with the requirement in Statement 123(R) that compensation cost for an equity award (the original treatment of this award pre-modification) should generally be recorded at least at its grant-date fair value. Refer to the journal entries below.

Journal Entry: December 31, 20X8	Debit	Credit
Compensation cost	$ 750	
Additional paid-in capital		$ 750
To record compensation cost based on the grant-date fair value ($3) and the continued employee service (one of four years)		
Additional paid-in capital	250	
Share-based liability		250
To remeasure the liability award at fair value at the end of the next reporting period (December 31, 20X8) [(1,000 awards × $2 fair value × 75% services rendered) – $1,250 share-based liability previously recognized]		

51-3: Modification That Changes an Award's Classification From Liability to Equity

Question

How does a company account for a modification that results in a change in an award's classification from a liability to an item of equity?

Answer

A modification that changes an award's classification from a liability to an item of equity is accounted for in a similar manner as any other modification. Refer to Q&A 51-1 for a discussion of the accounting for a modification of a share-based payment award. However, unlike other modifications, the basic premise regarding total compensation cost does not hold true (total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair value of the original award). Rather, the aggregate amount of compensation cost is the fair value of the award on the date of modification, which is the grant date of the equity award.

On the date of modification, the amounts previously recorded as a share-based liability are recorded as a component of equity by a credit to additional paid-in capital.

Example

On January 1, 20X6, a company grants 1,000 "at-the-money" cash-settled stock appreciation rights (SAR), each with a grant-date fair value of $3. The awards vest at the end of the fourth year of service (cliff-vesting). At December 31, 20X6, fair value remains $3. On December 31, 20X7, the company modifies the award from a cash-settled SAR to a share-settled SAR. The fair value of the award on December 31, 20X7, is $2.50.

Because the modification only affects the settlement feature of the award (i.e., share settlement versus cash settlement), presumably the fair value of the modified award equals the fair value of the original award immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the award and, therefore, no incremental compensation cost has to be recorded in connection with this modification from a liability award to an equity award.

On December 31, 20X7, the modified award is accounted for as an equity award from the date of modification with compensation cost fixed at $2.50, the fair value at the modification date. As a result, the company reclassifies the amount previously recorded as a share-based liability ($1,250 = 1,000 awards × $2.50 fair value × 50% for two of four years of services rendered) to additional paid-in capital. In addition, the company records the remaining $1.25 of the modified date fair value over the remaining service period. Refer to the journal entries below.

Journal Entry: December 31, 20X6		Debit		Credit
Compensation cost	$	750		
Share-based liability			$	750
To record compensation cost for the year ended December 31, 20X6				

Journal Entry: December 31, 20X7		Debit		Credit
Compensation cost	$	500		
Share-based liability			$	500
To record compensation cost for the year ended December 31, 20X7				

Journal Entry: Date of Modification		Debit		Credit
Share-based liability	$	1,250		
Additional paid-in capital			$	1,250
To record the award as an equity award on the date of modification				

Journal Entry: December 31, 20X8		Debit		Credit
Compensation expense	$	625		
Additional paid-in capital			$	625
To record compensation cost for the year ended December 31, 20X8, for an equity award based on the fair value ($2.50) fixed at the date of modification				

51-4: Modification of Awards With Performance and Service Vesting Conditions

Question

How does a company account for a modification that results in a change in the vesting conditions of an award?

Answer

The accounting for a modification of the vesting conditions of an award is consistent with the general modification guidance. That is, if as a result of the modification a company conveys additional value to the holder of an award, then the company must record incremental compensation cost for the award. Therefore, total compensation cost for an award whose vesting conditions have been modified is the grant-date fair value of the original award for which the required service has been provided or is expected to be provided, and the incremental compensation cost conveyed as a result of the modification. Refer to Q&A 51-1 for a more detailed discussion of the accounting for a modification.

The general rule for a modification requires the total recognized compensation cost attributable to an award that has been modified to be at least equal to the grant-date fair value of the original award. However, there is a deviation from that rule if the performance or service condition of the original award is not expected to be satisfied at the date of modification.

If at the date of modification the awards are expected (probable) to vest under the original vesting conditions of the award, then a company records compensation cost if either (1) the awards vest under the modified vesting conditions or (2) the awards vest under the original vesting conditions. Refer to Q&A 51-5 for an illustration of an award that has been modified and is expected to vest under the original vesting conditions. Refer to Type I and Type II modifications in the table below.

In contrast, if at the date of modification the awards are not expected (improbable) to vest under the original vesting conditions of the award, then a company only records compensation cost if the award vests under the modified vesting conditions. That is, if a company did not expect an award to vest based on the original vesting conditions at the date of modification, then no compensation cost is recorded. Assuming the award vests under the modified vesting conditions, total recognized compensation cost is based on the number of awards that vest and the total fair value of the modified award on the date of modification. The fair value of the original award is irrelevant. Refer to Q&A 51-6 for an illustration of an award that has been modified and is not expected to vest under the original vesting conditions. Refer to Type III and Type IV modifications in the table below.

Paragraph 43 of Statement 123(R) states, in part:

> The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed).

Additionally, paragraph 44 of Statement 123(R) states, in part:

> compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved.

The following table summarizes the varying types of modification, the accounting result, and the basis for the recognition of compensation cost. Additionally, it provides a cross reference to the applicable implementation guidance provided in Appendix A of Statement 123(R) and to Deloitte & Touche guidance.

Type of Modification	Accounting Result	Basis for Recognition of Compensation Cost	Statement 123(R) Guidance	Deloitte & Touche Guidance
Probable-to-Probable (Type I modification)	Record compensation cost if the award vests **either** under the original terms or the modified terms.	Grant-date fair value plus incremental fair value conveyed at the modification date, if any	Illustration 13(a) — Paragraphs A162–163	Q&A 51-5
Probable-to-Improbable (Type II modification)	Record compensation cost if the award vests **either** under the original terms or the modified terms.	Grant-date fair value plus incremental fair value conveyed at the modification date, if any	Illustration 13(b) — Paragraphs A164–A165	Expected to be rare
Improbable-to-Probable (Type III modification)	Record compensation cost if the award vests under the modified terms.*	Modified-date fair value	Illustration 13(c) — Paragraphs A166–A167	Q&A 51-6
Improbable-to-Improbable (Type IV modification)	Record compensation cost if the award vests under the modified terms.*	Modified-date fair value	Illustration 13(d) — Paragraphs A168–A169	Q&A 51-7

* For Type III and Type IV modifications, since the modified terms generally will be less than the original terms, a company should record compensation cost if the modified terms are achieved. However, if the original terms and the modified terms relate to different performance metrics (e.g., net income versus revenue) a company would record compensation cost only if the award vests under the modified terms.

51-5: Illustration — Modification of Vesting Conditions in Which Original Awards Are Expected to Vest (Probable-to-Probable)

Illustration

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest only if the company's cumulative net income over the succeeding four-year period is greater than $5,000,000. On January 1, 20X9, the company believes it is probable that the performance condition will be achieved. To provide additional retention incentives to the employees for the fourth year, the company modifies the performance condition to decrease the cumulative net income target to $4,500,000. After the modification, the company continues to believe the awards are expected to vest based on the revised cumulative net income target. The modification does not affect any of the other terms or conditions of the award.

If the modified performance condition ($4,500,000) is met, then the company will record total compensation cost based on the number of awards expected to vest (1,000 awards, assuming no forfeitures) and the grant-date fair value of the awards of $9.[7] Because the modification does not affect any of the other terms or conditions of the award, presumably the fair value before and after the modification will be the same. Accordingly, there is no incremental value conveyed to the holder of the award and, therefore, no incremental compensation cost has to be recorded in connection with this modification.

Alternatively, if the modified performance condition ($4,500,000) is not met, then the awards will not vest and the company should record no compensation cost for these awards.

[7] The principle in Statement 123(R) requires a company to record compensation cost if either the original performance condition or the modified performance condition is met. However, in this case, since the modified performance target is lower than the original performance target the attainment of the modified target would be sufficient to trigger the recognition of compensation cost.

Illustration 13(a) of Statement 123(R) (paragraphs A162–A163) offers an additional example of probable-to-probable modification.

Statement 123(R), Appendix A

A161. Illustrations 13(a)–13(d) [paragraphs A162–A169] are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Illustration 4 (paragraphs A86–A87), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (refer to Illustration 4(a), paragraph A88). For simplicity, this example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Illustration 13(e) is not based on the same scenario as Illustrations 13(a)–13(d) but, rather, provides an additional illustration of a Type III modification.

A162. Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that it is probable that the sales target will be achieved. At January 1, 20X7, 102,000 units of product A have been sold. During December 20X6, one of Entity T's competitors declared bankruptcy after a fire destroyed a factory and warehouse containing the competitor's inventory. To push the sales people to take advantage of that situation, the award is modified on January 1, 20X7, to raise the sales target to 154,000 units of product A (the modified sales target).[107] Additionally, as of January 1, 20X7, the options are out-of-the-money because of a general stock market decline.[108] No other terms or conditions of the original award are modified, and management of Entity T continues to believe that it is probable that the modified sales target will be achieved. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed to be $8 in this example at the date of the modification). Moreover, because the modification does not affect the number of share options expected to vest, no incremental compensation cost is associated with the modification.

A163. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 154,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $146,900. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of product A but less than 154,000 units (the modified sales target is not achieved). In that outcome, Entity T will recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T will recognize cumulative compensation cost of $0.

Footnote 107 — Notwithstanding the nature of the modification's probability of occurrence, the objective of this illustration is to demonstrate the accounting for a Type I modification.

Footnote 108 — The examples in Illustration 13 assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

51-6: Illustration — Modification of Vesting Conditions in Which Original Awards Are Not Expected to Vest (Improbable-to-Probable)

Illustration

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest only if the company's cumulative net income over the succeeding four-year period is greater than $5,000,000. On January 1, 20X9, based on the financial performance of the company over the preceding three years, the company does not believe the awards are probable of vesting. As such, the company modifies the performance condition to decrease the cumulative net income target to $3,000,000. The fair value of the modified award on the date of modification is $12. After the modification the company believes it is probable the awards will vest based on the revised net income target. The modification does not affect any of the other terms or conditions of the award.

Since the company did not expect the awards to vest prior to the modification, total recognized compensation cost as of the date of the modification is zero (0 awards expected to vest × $9 grant-date fair value). Now that the company has modified the performance condition it is probable the modified performance condition will be met, so the company records compensation cost based on the number of awards expected to vest (1,000 awards, assuming no forfeitures) and the fair value of the modified award on the date of modification ($12). As demonstrated in Illustration 13(c) of Statement 123(R) (paragraphs A166–A167), since it is improbable the award will vest prior to the modification, the compensation cost is based upon the fair value of the modified award.

Alternatively, if the modified performance condition ($3,000,000) is not met, then the awards will not vest and the company should record no compensation cost for these awards.

Statement 123(R), Appendix A

A161. Illustrations 13(a)–13(d) [paragraphs A162–A169] are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Illustration 4 (paragraphs A86–A87), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (refer to Illustration 4(a), paragraph A88). For simplicity, this example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Illustration 13(e) is not based on the same scenario as Illustrations 13(a)–13(d) but, rather, provides an additional illustration of a Type III modification.

A166. Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that none of the options will vest because it is not probable that the sales target will be achieved. At January 1, 20X7, 80,000 units of product A have been sold. To further motivate the salespeople, the sales target (150,000 units of product A) is lowered to 120,000 units of product A (the modified sales target). No other terms or conditions of the original award are modified. Management believes that the modified sales target is probable of achievement. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this example to be $8 at the modification date). Since the modification affects the number of share options expected to vest under the original vesting provisions, Entity T will determine incremental compensation cost in the following manner:

Fair value of modified share option	$ 8
Share options expected to vest under modified sales target	10,000
Fair value of modified award	$ 80,000
Fair value of original share option	$ 8
Share options expected to vest under original sales target	0
Fair value of original award	0
Incremental compensation cost of modification	$ 80,000

A167. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target and the modified sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 120,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $80,000. In Outcome 2, Entity T will recognize cumulative compensation cost of $80,000 because in a Type III modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance). In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T will recognize cumulative compensation cost of $0.

51-7: Illustration — Modification of Vesting Conditions in Which Original Awards Are Not Expected to Vest (Improbable-to-Improbable)

Illustration

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest only if the company's cumulative net income over the succeeding four-year period is greater than $5,000,000. On January 1, 20X9, based on the financial performance of the company over the preceding three years, the company does not believe the awards are probable of vesting. As such, the company modifies the performance condition to decrease the cumulative net income target to $4,000,000. The fair value of the modified award on the date of modification is $12.

Contemporaneously with the modification, the company loses a major customer, which will have a detrimental impact on the company's financial results for the year ended December 31, 20X9. Due to the loss of the customer the company continues to believe it is improbable the awards will vest based on the revised net income target. The modification does not affect any of the other terms or conditions of the award.

Since the company did not expect the awards to vest prior to the modification, total recognized compensation cost as of the date of the modification is zero (0 awards expected to vest × $9 grant-date fair value). Even though the company has modified the award to reduce to the performance target, due to the loss of a significant customer the company maintains that the achievement of the performance target is improbable. Therefore, total recognized compensation cost for the modified award is zero (0 awards expected to vest × $12 modified-date fair value). As demonstrated in Illustration 13(d) of Statement 123(R) (paragraphs A168–A169), since it is improbable the award will vest prior to the modification, the compensation cost is based upon the fair value of the modified award.

Alternatively, if the modified performance condition ($4,000,000) is met, then the awards will vest and the company should record compensation cost of $12,000 for these awards based on the number of awards vested (1,000 awards, assuming no forfeitures) and the fair value of the modified award on the date of modification ($12).

Statement 123(R), Appendix A

A161. Illustrations 13(a)–13(d) [paragraphs A162–A169] are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Illustration 4 (paragraphs A86–A87), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (refer to Illustration 4(a), paragraph A88). For simplicity, this example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Illustration 13(e) is not based on the same scenario as Illustrations 13(a)–13(d) but, rather, provides an additional illustration of a Type III modification.

A168. Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date it is not probable that the sales target will be achieved. At January 1, 20X7, 80,000 units of product A have been sold. To further motivate the salespeople, the sales target is lowered to 130,000 units of product A (the modified sales target). No other terms or conditions of the original award are modified. Entity T lost a major customer for product A in December 20X6; hence, management continues to believe that the modified sales target is not probable of achievement. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this example to be $8 at the modification date). Furthermore, the modification does not affect the number of share options expected to vest; hence, there is no incremental compensation cost associated with the modification.

A169. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target and the modified sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 130,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $80,000 (10,000 × $8). In Outcome 2, Entity T will recognize cumulative compensation cost of $80,000 because in a Type IV modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance). In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T will recognize cumulative compensation cost of $0.

Modifications — Other

Statement 123(R)
52. A **short-term inducement** shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.
53. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an **equity restructuring** or a business combination are modifications for purposes of this Statement.

53-1: Measuring the Cost of the Acquired Entity Resulting From the Exchange of Employee Stock Options or Awards

Question

How is the cost of the acquired entity related to the exchange of employee stock options or awards calculated under Statement 123(R)?

Answer

Vested Options — In a business combination, vested stock options or awards issued by an acquirer in exchange for outstanding awards held by employees of the acquiree shall be considered to be part of the purchase price paid by the acquirer for the acquiree. Accordingly, the fair value of the new (acquirer) awards shall be included as part of the purchase price.

Unvested Options — Unvested stock options or awards granted by an acquirer in exchange for stock options or awards held by employees of the acquiree shall be considered to be part of the purchase price for the acquiree, and the fair value of the new (acquirer) awards shall be included in the purchase price to the extent that the employee has provided service towards vesting. The date used to estimate fair value should be determined in accordance with EITF Issue No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination." However, to the extent that service is required subsequent to the consummation date of the acquisition in order to vest in the replacement awards, a portion of the unvested awards shall be recognized as compensation cost over the remaining future service (vesting) period.

The amount allocated to unearned compensation cost shall be based on the portion of the fair value at the consummation date related to the future service (vesting) period. That amount shall be calculated as the fair value of the replacement awards at the consummation date multiplied by the fraction that is the remaining future service (vesting) period divided by the total service (vesting) period (the vesting period prior to the consummation date plus the remaining future period required to vest in the replacement award). Any fair value of the replacement awards that is to be recognized as future compensation cost shall be deducted from the fair value of the awards for purposes of the allocation of the purchase price to the other assets acquired.

53-2: Illustration — Measuring the Cost of the Acquired Entity Resulting From the Exchange of Employee Stock Options or Awards

Company X (X), a public company, acquires 100 percent of Company Y (Y) in a transaction accounted for as a business combination. The measurement date of the combination is April 1, 2006, and the consummation date is October 1, 2006. Company X will exchange all employee options held in Y with options of X.

Company Y had two employees (Employee A (A) and Employee B (B)) that will continue to be employed by X. At the consummation date A will hold 100 options, all of which will be fully vested, and B will hold 200 options. Employee

B's unvested options will cliff vest on October 1, 2007, as long as B continues to be employed by X. All of B's options were granted on October 1, 2005.

Employee	Number of Options
A	100
B	200

Summary of Company X Option Values (Per Option) at Certain Dates*	Amount
Fair value on April 1, 2006	$ 12
Fair value on October 1, 2006	10
* Values for illustrative purposes only	

Question

What amount should X include in its purchase price for the options issued to employees of Y in exchange for the outstanding awards of Y?

Answer

The amount included in the cost of the acquired entity is calculated as follows:

Employee A	
Total options held	100
Fair value on measurement date	× $ 12
Total	$ 1,200

Employee B	
Total options held	200
Fair value on measurement date	× $ 12
Total	$ 2,400

Amount to Be Recognized Over Remaining Service Period	
Total options held	200
Fair value on consummation date	× $ 10
Total	2,000
Remaining future service (vesting) period ratio	50%
Total	$ 1,000

The amount included in the cost of the acquired entity related to employee stock options is $2,600 (Employee A $1,200 + Employee B $2,400 – Employee B amount to be recognized over the remaining service period ($1,000)). As B renders service to X, the remaining $1,000 (relating to the future service period) is recorded as compensation cost with a corresponding increase to paid-in capital.

In a future project, the FASB will be addressing the accounting treatment for share-based payment awards issued by an acquiring entity in exchange for share-based payment awards of the acquired business that are held by employees of that business.

Statement 123(R)
54. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 51. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. Illustration 12(e) (paragraphs A156–A159) provides further guidance on applying the provisions of this paragraph.

Cancellation of Equity Awards

Statement 123(R)
55. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

55-1: Settlement of an Unvested Award for Less Than Fair Value

Question

How does a company account for the settlement of an unvested award at less than its current fair value?

Answer

Statement 123(R) does not specifically address the settlement of an award for an amount less than the fair value at the settlement date. However, consistent with paragraph 55 of Statement 123(R), the amount of cash or other assets transferred (or liabilities incurred) to settle an award is charged directly to equity, provided that the amount transferred does not exceed the fair value of the instruments settled on the settlement date. However, the settlement of an unvested award effectively vests the award. Therefore, any previously unrecognized compensation cost attributable to the award shall be recognized immediately at the date of settlement.

Example

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest at the end of the fourth year of service (cliff-vesting). On December 31, 20X7, the market price of the stock has declined dramatically such that the company wishes to terminate the award as it provides no future incentive to the employees. In this case, employees may be willing to relinquish the award for an amount less than its current fair value because payment would be immediate and would not require future service. The fair value of the award at the date of settlement is $3.50 and the company wishes to cash settle the awards for $2.

Prior to the settlement, the company would have recorded compensation cost of $4,500 based on the number of awards expected to vest (1,000 awards, assuming no forfeitures), the grant-date fair value of the awards ($9), and the amount of services rendered (50% for two of four years of services rendered). At the date of settlement, the company would record the amount of cash paid ($2,000 = 1,000 awards × $2 cash paid at settlement) with a corresponding charge to equity. Simultaneously, the company records the remaining unvested compensation cost ($4,500) as the settlement has fully vested the award. Refer to the journal entries below that are recorded at the date of settlement.

Journal Entries		Debit		Credit
Compensation cost	$	4,500		
Additional paid-in capital			$	4,500
To record the remaining unrecognized compensation cost on the date of settlement				
Additional paid-in capital		2,000		
Cash				2,000
To record the amount of cash paid to settle the award with a corresponding charge to equity				

Statement 123(R)

56. Cancellation of an award accompanied by the concurrent grant of (or offer to grant)[28] a **replacement award** or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 51. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

Footnote 28 — The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.

56-1: Modifications Versus Cancellations

Question

What is the accounting difference between a modification of an existing award and a cancellation of an award with a concurrent issuance of (or promise to issue) an award?

Answer

There is no accounting difference between a modification of an existing award and a cancellation of an award with a concurrent issuance of (or promise to issue) an award. That is, companies are required to record the incremental fair value, if any, of the replacement award as compensation cost on the date of cancellation (for vested awards) or over the remaining service (vesting) period (for unvested awards). The incremental compensation cost is the excess of the fair value of the replacement award over the fair value of the cancelled award on the cancellation date.

Generally, total recognized compensation cost attributable to an award that has been cancelled is at least equal to the grant-date fair value of the original award. Therefore, total recognized compensation cost attributable to an award that has been cancelled is (1) the grant-date fair value of the original award for which the required service has been provided (i.e., the award has been earned) or is expected to be provided and (2) the incremental compensation cost conveyed as a result of the cancellation and replacement.

In contrast, a cancellation of an award without a concurrent issuance of (or promise to issue) an award requires a company to immediately recognize any unvested compensation cost attributable to the cancelled award.

Example 1

On January 1, 20X6, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $9. The awards vest at the end of the fourth year of service (cliff-vesting). On January 1, 20X9, the company cancels the award with an offer to issue a replacement award in one month. The service period of the replacement award covers the remaining original vesting period of the cancelled award (one year). The fair value of the replacement award is $7 and the fair value of the cancelled award is $4 on the date of cancellation.

Over the first three years of service, the company records $6,750 (1,000 awards × $9 × 75% for three of four years of services rendered) of compensation cost (assuming no forfeitures). On the cancellation date, the company computes the incremental compensation cost as $3,000 (($7 fair value of replacement award – $4 fair value of cancelled award on the date of cancellation) × 1,000). The $3,000 incremental compensation cost is recorded over the remaining one year of service attributable to the replacement award. Additionally, the company records the remaining $2,250 of compensation cost over the remaining year of service attributable to the cancelled award. Therefore total compensation cost associated with this award (assuming no forfeitures) is $12,000 ($9,000 grant-date fair value + $3,000 incremental fair value) recorded over four years of required service for both the cancelled and replacement awards.

Example 2

Alternatively, assume all the same facts as above, except that the company cancels the original award with no concurrent issuance of (or offer to issue) a replacement award. Six months later the company issues 1,000 new "at-the-money" employee share options each with a grant-date fair value of $12. The awards vest over the remaining service period attributable to the cancelled award (six months).

Over the first three years of service, the company records $6,750 (1,000 awards × $9 × 75% for three of four years of services rendered) of compensation cost (assuming no forfeitures). On the cancellation date, the award is treated as a fully vested award. As such, the company records the remaining unvested compensation cost ($2,250) associated with the cancelled award. Therefore, total compensation cost associated with the cancelled award (assuming no forfeitures) is the $9,000 grant-date fair value.

For the award issued six months later, the company records $12,000 (1,000 awards × $12) of compensation cost over the remaining service period of the replacement award (six months). Assuming all of the awards vest, the company will record total compensation cost of $12,000 for this award.

Statement 123(R)
57. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Income Tax Accounting

Statement 123(R)

58. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under U.S. tax law at the issuance date of this Statement, allowable tax deductions are generally measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

59. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying FASB Statement No. 109, *Accounting for Income Taxes*. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an award, shall be recognized in the income statement.[29] Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee's disqualifying disposition of shares under U.S. tax law at the issuance date of this Statement, can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

Footnote 29 — Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

59-1: Tax Effects of Stock-Based Compensation

Question

Will all grants of share-based payment awards result in tax effects being recorded in the financial statements?

Answer

Under U.S. tax law, there are generally two types of compensatory stock options:

- **Statutory Options (Incentive Stock Options (ISOs)) and Employee Stock Purchase Plans (ESPPs) that are qualified under Internal Revenue Code Section 423):** The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the employer unless a disqualifying disposition by the employee or former employee is made. As a result, until or unless a disqualifying disposition is made, recognition of income tax benefits is not permitted when ISOs or ESPPs have been granted. Refer to Q&A 59-2 for the definition of an ISO.

- **Nonstatutory Options (also known as Nonqualified Stock Options (NQSOs or NSOs)):** The exercise of a NQSO results in a tax deduction for the grantor equaling the intrinsic value of the option when exercised. As a result, income tax accounting is required when compensation cost is recorded in the financial statements for NQSOs that are granted. Refer to Q&A 59-3 for the definition of a NQSO.

59-2: Incentive Stock Options

Question

What is an incentive stock option (ISO)?

Answer

An incentive stock option is a stock option that is subject to the rules of Section 422 of the Internal Revenue Code. Code sections 421 and 424 contain additional rules regarding ISOs. In general, an option is considered an ISO if:

- The option is granted within ten years of adoption of the plan, or, if earlier, the date the plan is approved by the stockholders.
- The maximum term of the option is ten years from the date of grant. For employees that own more than ten percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the maximum term is five years.
- The option price is not less than the fair market value of the stock at the time such option is granted. For employees that own more than ten percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the option price must not be less than 110 percent of the fair market value.
- The option is transferable only in the event of death.
- The employee is employed by the employer (or its parent or subsidiary) for the entire period up to three months before the date of exercise of the option.

Generally, ISOs are not taxable to the employee (or former employee) until the stock acquired through exercise of the ISO has been disposed. At that time, the employee will be subject to long-term capital gains tax for the difference between the proceeds received upon disposal and the exercise price, assuming the individual has met the required holding periods. Additionally, the employer does not receive a tax deduction for the issuance, exercise, or disposition of the ISO if the employee meets the holding periods.

As indicated above, the individual acquiring the stock upon exercising the option may not dispose of the stock within two years of grant date or within one year of the exercise date and receive the favorable tax treatment. If an individual violates these requirements a disqualifying disposition occurs, and the option no longer qualifies for ISO treatment. If a disqualifying disposition occurs, for tax purposes the lesser of the excess of the fair market value of the stock at the date of exercise over the strike price or the actual gain on sale is included in the employee's income as compensation in the year of disposition (assuming the option is not gifted, sold to a related person, or sold in a so-called wash sale). The employer receives a tax deduction for the amount of income included by the individual. The employer is not required to withhold income and payroll tax on the ordinary income resulting from the disqualifying disposition.

The maximum amount of ISOs that may first become exercisable in a calendar year is $100,000. Generally, any amounts in excess of $100,000 should be treated as nonqualified stock options. Refer to Q&A 59-3 for a discussion of Nonqualified Stock Options. The $100,000 is calculated based on the fair market value of the underlying shares (not the grant-date fair value of the options) when granted, not the fair market value at the vesting date.

Under the tax law, the exercise of an ISO requires the individual to recognize a "tax preference" item, equal to the difference between the exercise price and the fair market value at the date of exercise. This tax preference item may cause the alternative minimum tax (AMT) to apply. Generally, the AMT may be avoided, as it pertains to ISOs, if the shares obtained via option exercise are sold in the same calendar year in which they were purchased. Selling the shares in the same year eliminates the AMT preference and results in a disqualifying disposition, the effects of which are discussed above.

59-3: Nonqualified Stock Options

Question

What is a nonqualified stock option (NQSO)?

Answer

A nonqualified stock option is an option that does not qualify for treatment as an incentive stock option (ISO) under the provisions of Internal Revenue Code Sections 421 through 424. The taxation of NQSOs is generally governed by Internal Revenue Code Section 83. The terms of a NQSO can be more flexible than an ISO. For example, with a NQSO

- The option price may be less than fair value.
- The option term may extend longer than 10 years (but generally is limited to 10 years by the plan).
- The option may be granted to non-employees.
- Shareholder approval is not required for tax purposes (but may be required for other purposes).

Generally, the exercise of a NQSO generates ordinary income for the employee exercising the option. The amount of ordinary income is calculated as the difference between the option exercise price and the fair market value at the exercise date. The employer that issued the option is entitled to a tax deduction equal to the ordinary income included in income by the employee at the same time the employee recognizes the income (assuming the stock is not restricted upon exercise). The employer can safeguard the ability to claim the deduction by properly reporting the ordinary income on a Form W-2. The employer also is required to withhold income and payroll tax on the ordinary income resulting from the exercise of the stock option.

59-4: Change in Tax Status of an Award — Prior to the Change

Some share-based payment awards (e.g., incentive stock options (ISOs) or awards granted under a qualified employee stock purchase plan) are not tax deductible to the grantor unless a disqualifying disposition occurs. Therefore, no corresponding tax benefit is recorded in the income statement when compensation cost relating to such awards is recorded.

Question

Can a company record a tax benefit in the income statement for non-tax-deductible awards (e.g., ISOs) that are expected to be subject to disqualifying dispositions?

Answer

No. Paragraph 59 of Statement 123(R) explains that the tax effects of an event (e.g., a disqualifying disposition) that gives rise to a tax deduction for awards that ordinarily do not result in tax deductions should not be accounted for until the event occurs. Therefore, no tax benefit should be recorded on compensation cost relating to such an award until a disqualifying disposition occurs.

59-5: Change in Tax Status of an Award — Upon the Change

Question

What is the appropriate accounting for the tax effects when a disqualifying disposition of an award occurs?

Answer

When a disqualifying disposition occurs, a deduction is available to be taken in the employer's tax return. If the tax deduction exceeds the compensation cost recorded, a tax benefit would be recorded in the income statement based on the compensation cost of that award (e.g., the ISO) recorded in the financial statements. The tax benefit of the excess of the amount of the deduction taken over the cumulative compensation cost recorded would be recorded in additional paid-in capital and included in the employer's "APIC pool." Refer to Q&A 63-1 for a discussion of the APIC pool and accounting for income tax effects of share-based payment awards.

Example

A company grants an ISO with a grant-date fair value of $100, which is recorded in the income statement as compensation cost. Since the award is an ISO, no corresponding tax benefit or deferred tax asset is recorded because the award does not result in a tax deduction to the company.

Assume a disqualifying disposition occurs and results in the company taking a deduction of $120 in its tax return. If the company's combined statutory tax rate is 40 percent, the company would record a tax benefit of $40 in the income statement and an increase to additional paid-in capital (which would also serve to increase its APIC pool) of $8 [($120 deduction taken in the tax return – $100 grant-date fair value) × 40% tax rate].

Statement 123(R)

60. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.
61. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.[30] Differences between (a) the deductible temporary difference computed pursuant to paragraph 59 of this Statement and (b) the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under this Statement.

Footnote 30 — Paragraph 21 of Statement 109 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." That paragraph goes on to describe the four sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards.

61-1: Measuring Deferred Tax Assets in Reference to the Current Stock Price

Question

In assessing whether (1) a valuation allowance should be provided on deferred tax assets relating to stock-based compensation cost or (2) the gross amount of the deferred tax asset should be adjusted, should the current price of the grantor's stock be considered?

Answer

No. Paragraph 61 of Statement 123(R) explains that deferred tax assets relating to stock-based compensation (both valuation allowance and gross tax assets) are not impacted by changes in the grantor's stock price that do not impact compensation cost recorded in the financial statements.

Valuation Allowance

The need to record a valuation allowance on deferred tax assets, even those that relate to stock-based compensation cost, is not dependent upon the employer's current stock price. Instead, companies should follow the guidance in paragraphs 17(e) and 21 of FASB Statement No. 109, *Accounting for Income Taxes*, in assessing whether a valuation allowance is needed. That is, the need to record a valuation allowance depends on whether, more likely than not, sufficient taxable income exists to realize that deferred tax asset. The four possible sources of taxable income are also described in paragraph 21 of Statement 109.

Therefore, even if the award is deep out-of-the-money such that exercise of the award is unlikely or the intrinsic value at the exercise date is likely less than the award's grant-date fair value, a valuation allowance should not be recorded unless or until it is more likely than not that future taxable income will not be sufficient to realize the related deferred tax assets.

Gross Deferred Tax Asset

The gross deferred tax asset is computed based on the cumulative amount of stock-based compensation cost recorded in the financial statements and is not impacted by the grantor's current stock price.

As a result, similar to valuation allowances, gross deferred tax assets should not be remeasured or written off because the stock price has declined so significantly that an award's exercise is unlikely to occur or that the intrinsic value at the exercise date will likely be less than the cumulative compensation cost recorded in the financial statements.

However, for share-based payment awards classified as liabilities, the measurement of the gross deferred tax assets does implicitly consider the grantor's current stock price since liability awards are remeasured at fair value at the end of each reporting period. The deferred tax asset resulting from compensation cost on liability awards would change as the fair value of the award changes.

Example

On January 1, 2006, a company grants 1,000 "at-the-money" employee share options each with a grant-date fair value of $7. The awards vest at the end of the third year of service (cliff-vesting), have an exercise price of $23, and expire after the fifth year from the date of grant. The company's combined statutory tax rate is 40 percent. On December 31, 2010, the company's share price is $5. The company has generated taxable income in the past and expects to continue to do so in the future.

Each reporting period the company would record compensation cost based on the number of awards expected to vest, the grant-date fair value of the award, and the amount of services rendered. Contemporaneously, a deferred tax asset would be recorded based on the amount of compensation cost recorded and the company's combined statutory tax rate. On December 31, 2010, even though the likelihood that the employee will exercise the award is remote (i.e., the award is "deep-out-of-the-money" prior to expiration) and therefore the deferred tax asset will not be realized, a company would not be allowed to write off or provide a valuation allowance against the deferred tax asset until the award expires unexercised (January 1, 2011) (if there is sufficient future taxable income to realize those deferred tax assets). Only in situations where it is more likely than not that the company will not generate sufficient taxable income to realize the deferred tax asset would the company be able to record a valuation allowance against the deferred tax asset.

Statement 123(R)

62. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments (the excess tax benefit) shall be recognized as additional paid-in capital.[31] However, an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

Footnote 31 — If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

62-1: Illustration — Basic Income Tax Effects of Shared-Based Payment Awards

Question

How does a company recognize the income tax effects related to share-based payment awards?

Answer

Statement 123(R) requires companies to account for income taxes in a manner similar to the method prescribed in Statement 123. That is, companies record excess tax benefits as an increase (credit) to paid-in capital, never affecting the income statement (excess benefits arise when the ultimate tax deduction is greater than recorded book expense). Tax benefit deficiencies (the book expense is greater than the ultimate tax deduction) are recorded as a decrease (debit) to paid-in capital, again bypassing the income statement — but only to the extent previous excess tax benefits exist (often referred to as the "APIC pool"). In the absence of an APIC pool, tax benefit deficiencies must be recorded as an expense in the income statement in the period of the tax deduction.

Example

A company grants to its employees 1,000 "at-the-money" non-qualified stock options each with a grant-date fair value of $1. The awards vest at the end of the fourth year of service (cliff-vesting). The company's combined statutory tax rate is 40 percent. As the $1,000 (1,000 awards × $1 fair value) of compensation cost is recognized over the service period, the company records a deferred tax asset in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, equal to the book compensation cost multiplied by the corporation's combined statutory tax rate. This is required because the company is recording compensation cost for financial statement purposes that does not yet represent a current deductible item for tax purposes.

Journal Entries: Each of the Four Years of Service	Debit	Credit
Compensation cost	$ 250	
Additional paid-in capital		$ 250
To record compensation cost (1,000 awards × $1 fair value × 25% services rendered) over the requisite service period		
Deferred tax asset	100	
Deferred tax benefit		100
To record the related deferred tax asset ($250 × 40% tax rate) for the deductible temporary difference over the requisite service period		

If the tax deduction[8] on exercise is greater than the $1,000 of compensation cost, for example $1,200, the deferred tax asset is reduced in full, and the excess benefit is credited to equity.

Journal Entry	Debit	Credit
Income tax receivable/payable	$ 480	
Deferred tax asset		$ 400
Additional paid-in capital		80
To adjust income tax receivable/payable ($1,200 × 40% tax rate), reverse previously recorded deferred tax asset, and record excess tax benefit upon exercise		

If the tax deduction is less than the $1,000 of compensation cost, for example $800, the deferred tax asset likewise is reduced; however, the recognition of the difference (i.e., the amount of the deferred tax asset in excess of the tax benefit) will depend on the existence of an APIC pool. If a sufficient APIC pool exists, the shortfall is recorded as a reduction to paid-in capital. On the other hand, if the APIC pool is insufficient, the shortfall is recorded as an increase to current period income tax expense.

Journal Entry	Debit	Credit
Income tax receivable/payable	$ 320	
Additional paid-in capital/current period income tax expense	80	
Deferred tax asset		$ 400
To adjust income tax receivable/payable ($800 × 40% tax rate), reverse previously recorded deferred tax asset, and record tax benefit shortfall upon exercise		

If the APIC pool is insufficient, the shortfall is recognized as a current period tax expense in the period the award results in either a tax deduction on the tax return or expires unexercised. Paragraph 61 of Statement 123(R) precludes recognizing that shortfall in earlier periods through either an adjustment to the deductible temporary difference (remains at $1,000 in the example) or through a valuation allowance.

62-2: Recognizing Income Tax Effects on an Award-by-Award Basis

At any given point in time, an entity may have awards outstanding that relate to different grants that have occurred over different points in time. As a result, an entity's deferred tax asset relating to stock-based compensation will be composed of deferred tax assets relating to grants of awards with different exercise prices and different grant-date fair values.

[8] The tax deduction is computed as the difference between the company's share price on the date of exercise and the exercise price stated in the award, multiplied by the number of options awarded.

Question

When determining whether or how much of an excess tax benefit or tax benefit deficiency exists, does the employer consider only the individual awards exercised, or does the employer consider the entire pool of outstanding awards as of the date of exercise?

Answer

The determination of whether the exercise of an award creates an excess tax benefit or tax benefit deficiency should be made on an individual award basis. That is, the deferred tax asset that is "relieved" from the balance sheet when an award is exercised should be the amount that relates to that award only. The deferred tax assets related to other awards that have not yet been exercised should not be considered in accounting for the income tax effects of awards that are exercised. Furthermore, when a portion of an award is exercised, only the portion of the deferred tax asset that relates to the portion of the award that was exercised should be relieved from the balance sheet.

Therefore, it is important for a company to keep track of the source of the different components of its deferred tax asset balance relating to each share-based payment award.

Example

In 2006, a company grants three separate awards of "at-the-money" fully vested employee share options as follows. All of the awards expire on December 31, 2015. Assume these are the company's only grants. The company's combined statutory tax rate is 40 percent.

Number of Options	Grant Date	Exercise Price (Per Option)	Grant-Date Fair Value (Per Option)	Compensation Cost Recorded
100	February 1, 2006	$16	$2	$200
100	April 1, 2006	$13	$3	$300
100	May 1, 2006	$10	$4	$400

On June 1, 2006, the company's deferred tax balance, related to stock-based compensation is $360 [($200 + $300 + $400) × 40% tax rate]. On June 10, 2006, of the 100 options that were granted on April 1, 2006, 75 options were exercised. On June 10, 2006, the stock price of the company was $20 per share. The deduction the company would claim on its tax return would be $525 [($20 fair value on date of exercise – $13 exercise price) × 75 options exercised]. This will create an excess tax benefit of $120, computed as follows:

Deduction for tax purposes	$ 525
Grant-date fair value ($3 × 75 options exercised)	$ (225)
Excess deduction	$ 300
Combined statutory tax rate	40%
Excess tax benefit	$ 120

The journal entry to record the income tax effect of the exercise of the stock option on June 10, 2006, would appear as follows:

Journal Entry	Debit	Credit
Income taxes payable (deduction for tax of $525 × 40%)	$ 210	
Deferred tax asset (grant-date fair value $3 × 40% × 75 options)		$ 90
Additional paid-in capital (excess tax benefit)		120
To record the income tax effects associated with the exercise of the award		

Therefore, the company's deferred tax asset balance would be $270 ($360 – $90) immediately following the exercise of the 75 stock options.

62-3: Recording Tax Benefits When No Corresponding Deferred Tax Asset Exists Upon Exercise

Subsequent to the adoption of Statement 123(R), an entity may not have a corresponding deferred tax asset recorded when a share-based payment award is exercised. This situation may occur when an entity adopts Statement 123(R) using the modified prospective application (MPA) method and the grant date and exercise date of the award "straddle" the adoption date of Statement 123(R). That is, the grant date occurs prior to the adoption of Statement 123(R), all or a portion of the award is vested prior to adoption, and its exercise occurs subsequent to the adoption of Statement 123(R).

Under the MPA method, awards that are granted and vested prior to the adoption of Statement 123(R) would have been accounted for under Opinion 25, which may not have resulted in compensation cost being recognized in the financial statements. Accordingly, a deferred tax asset and tax benefit would not have been recognized over the vesting period as compensation cost was not recognized under Opinion 25.

Question

How should the reduction in income taxes payable resulting from the exercise of options be recorded when no corresponding deferred tax asset exists?

Answer

The entire reduction in current income taxes payable should be recorded as a credit to additional paid-in capital when no corresponding deferred tax asset was previously recorded for the award that was exercised. However, only a portion of this credit will be available to offset future deficiencies. Refer to Q&A 62-4, below, for a discussion of the amounts available to offset future tax deficiencies.

62-4: Determining the APIC Pool When No Corresponding Deferred Tax Assets Exist Upon Exercise

Question

For awards granted prior to and exercised subsequent to the effective date of Statement 123(R) (as described in the facts above), of the amounts credited to additional paid-in capital (APIC), how much is available to offset future tax deficiencies?

Answer

Only the tax benefit of the excess of (1) the intrinsic value upon exercise over (2) the grant-date fair value (the same value used for Statement 123 pro forma disclosure purposes) may be used to determine excess tax benefits available to offset future write-offs of deferred tax assets. This would be the same amount as if a deferred tax asset had been recorded on the compensation cost had the company elected to restate prior periods using the modified retrospective method (i.e., the APIC pool calculated as if Statement 123 had been applied since its required effective date).

Therefore, if the deduction claimed in the tax return was greater than the grant-date fair value, only a portion of the reduction in income taxes payable recorded as a credit to APIC may offset tax benefit deficiencies that arise in the future. If the deduction claimed in the tax return was less than the grant-date fair value of that award, no amounts from that exercise would be available to offset future tax benefit deficiencies.

This will result in some amounts being recorded in APIC that, although they relate to a reduction of taxes payable due to the exercise of share-based payment awards, will never be used to offset future tax benefit deficiencies.

Example

On March 31, 20X5, a company grants 1,000 "at-the-money" fully vested employee share options each with a grant-date fair value of $4. The company's combined statutory tax rate is 40 percent. On March 31, 20X5, the company was still accounting for its share-based payment awards in accordance with the provisions of Opinion 25 and therefore recorded no compensation cost in its financial statements.

The company adopts Statement 123(R) using the MPA method. On September 30, 20X6, all of the stock options are exercised. In the period of exercise, the deduction taken on the company's tax return is $5,000 (the intrinsic value of the award on the date of exercise).

The journal entry on the exercise date to record the income tax effects of the exercise would appear as follows:

Journal Entry	Debit	Credit
Income taxes payable	$ 2,000	
Additional paid-in capital		$ 2,000
To record the income tax effects ($5,000 tax deduction × 40%) associated with the exercise of the award		

However, of the $2,000 credited to additional paid-in capital, only $400 (($5,000 income tax deduction - $4,000 compensation cost recognized for Statement 123 pro forma disclosure purposes) × 40% tax rate) can be used to offset future tax benefit deficiencies (i.e., the company's APIC pool is increased by only $400).

Alternatively, if the deduction taken in the company's tax return was only $3,000 (i.e., an amount less than the compensation cost recognized), the company's Statement 123(R) APIC pool would be reduced by $400, but only to the extent that is does not reduce the APIC pool to below zero.

Statement 123(R)

63. The amount deductible on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement. An entity that continued to use Opinion 25's intrinsic value method as permitted by Statement 123 shall calculate the amount available for offset as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method. In determining that amount, no distinction shall be made between excess tax benefits attributable to different types of equity awards, such as restricted shares or share options. An entity shall exclude from that amount both excess tax benefits from share-based payment arrangements that are outside the scope of this Statement, such as employee share ownership plans, and excess tax benefits that have not been realized pursuant to Statement 109, as noted in paragraph A94, footnote 82, of this Statement. Illustrations 4(a) (paragraphs A94–A96), 10 (paragraphs A132 and A133), 11(a) (paragraphs A135 and A136), and 14(a) (paragraphs A178–A180) of this Statement provide examples of accounting for the income tax effects of various awards.

63-1: Amounts Included in the Excess Tax Benefits Available for Offset ("APIC Pool")

To the extent previous net excess tax benefits exist (often referred to as the "APIC pool"), tax benefit deficiencies (i.e., the book expense is greater than the ultimate tax deduction) are recorded as a decrease to paid-in capital, bypassing the income statement.

Question

Upon adoption of Statement 123(R), what amounts included in a company's net excess tax benefits are available for offset against tax benefit deficiencies (i.e., the "APIC pool")?

Answer

A company should include in its APIC pool any excess tax benefits from awards that would have been accounted for under the fair value method (i.e., issued, modified, repurchased, or cancelled after the effective date of Statement 123), regardless of whether the company has been following the recognition provisions of Opinion 25 or Statement 123. Companies should be careful to (1) include all excess tax benefits of Statement 123 equity awards (e.g., nonvested shares, restricted shares, and stock options), (2) exclude excess tax benefits from awards that fall outside of the scope of Statement 123(R) (e.g., employee stock ownership plans), and (3) exclude excess tax benefits that have not been realized pursuant to FASB Statement No. 109, *Accounting for Income Taxes* (refer to footnote 82 of paragraph A94 of Statement 123(R)).

Companies have been reporting the income tax effects (i.e., the excess tax benefits and tax benefit deficiencies) of their share-based payment awards since the issuance of Statement 123 for either recognition or pro forma disclosure purposes. Given that the amounts included in the APIC pool are an outgrowth of the reported tax effects, the amounts that comprise the APIC pool should be available by referring back to prior Statement 123 disclosure calculations, prior tax filings, or both. However, for companies that previously may have been recognizing excess tax benefits prior to their realization, paragraph 81 of Statement 123(R) indicates such amounts should be reduced from their APIC pool. As discussed in Q&A 76-2, *Transition — Recognition of Prior Period Income Tax Benefits*, any changes to the income tax effects previously reported are precluded.

63-2: Tax Effects of Expiration or Cancellation of an Award

Question

What is the accounting impact on the deferred tax asset recorded relating to a non-statutory award that has expired unexercised or that has been cancelled by the grantor?

Answer

When a non-statutory award has expired unexercised or has been cancelled, the tax effects are accounted for as if the tax deduction taken is zero. As a result, the deferred tax asset recorded in the financial statements would be reduced to zero through a reduction of additional paid-in capital to the extent that sufficient APIC pool exists. Refer to Q&A 63-1 for a discussion of the APIC pool calculation. The excess of deferred tax asset over the APIC pool would be recorded as tax expense in the income statement. Refer to paragraph A95 of Statement 123(R) for a further description and illustration.

Example

A company grants 1,000 "at-the-money" fully vested non-statutory share options each with a grant-date fair value of $4. The company's combined statutory tax rate is 40 percent. Further assume that no valuation allowance has been established for the deferred tax asset and the awards subsequently expire unexercised. At the date of expiration the company's then current APIC pool is $1,000. Refer to the journal entries below.

Journal Entries: Upon Grant		Debit		Credit
Compensation cost	$	4,000		
Additional paid-in capital			$	4,000
To record compensation cost upon the grant of the award				
Deferred tax asset		1,600		
Income tax expense				1,600
To record the tax effects upon the grant of the award				

Journal Entry: Upon Expiration		Debit		Credit
Income tax expense	$	600		
Additional paid-in capital		1,000		
Deferred tax asset			$	1,600
To write-off the deferred tax asset upon the expiration of the award*				
* Compensation cost is not reversed when a vested award expires unexercised.				

Statement 123(R), Appendix A

A94. In this example, the difference between the market price of the shares and the exercise price on the date of exercise is deductible for tax purposes pursuant to U.S. tax law in effect at the date of this Statement's issuance (the share options do not qualify as incentive stock options). Realized benefits of tax return deductions in excess of compensation cost recognized are accounted for as a credit to additional paid-in capital.[82] With the share price of $60 at exercise, the deductible amount is $22,425,780 [747,526 × ($60 – $30)]. Entity T has sufficient taxable income to fully realize that deduction, and the tax benefit realized is $7,849,023 ($22,425,780 × .35).

At exercise:

Deferred tax expense	$3,843,405	
Deferred tax asset		3,843,405

To write off the deferred tax asset related to deductible share options at exercise ($10,981,157 × .35 = $3,843,405).

Current taxes payable	$7,849,023	
Current tax expense		$3,843,405
Additional paid-in capital		$4,005,618

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon exercise of share options.

The credit to additional paid-in capital is the tax benefit of the excess of the deductible amount over the recognized compensation cost [($22,425,780 – $10,981,157) × .35 = $4,005,618].

A95. If instead the share options expired unexercised, previously recognized compensation cost would not be reversed. There would be no deduction on the tax return and, therefore, the entire deferred tax asset of $3,843,405 would be charged to income tax expense[83] or additional paid-in capital, to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123 (paragraph 63).[84]

Footnote 82 — A share option exercise may result in a tax deduction prior to the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable.

Footnote 83 — If employees terminated with out-of-the-money vested share options, the deferred tax asset related to those share options would be written-off when those options expire.

Footnote 84 — A write-off of a deferred tax asset related to a deficiency of deductible compensation cost in relation to recognized compensation cost for financial reporting purposes shall not be reflected in the statement of cash flows because the unit of account for cash flow purposes is an individual award (or portion thereof) as opposed to a portfolio of awards.

Disclosures

Statement 123(R)
64. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand: a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders b. The effect of compensation cost arising from share-based payment arrangements on the income statement c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period d. The cash flow effects resulting from share-based payment arrangements. Paragraphs A240 and A241 indicate the minimum information needed to achieve those objectives and illustrate how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond that listed in paragraph A240 to achieve the disclosure objectives.

64-1: Disclosure in Quarterly Financial Statements

Question

What employee stock-based compensation information is required to be disclosed by an SEC registrant in its Reports on Form 10-Q, quarterly filings of interim condensed financial statements?

Answer

Paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*, as amended by Statement 123(R), does not require additional disclosures at interim reporting dates regarding stock-based compensation costs. However, SEC Regulation S-X, Rule 10-01(a)(5) generally has been interpreted by the SEC staff to require registrants to include all of the disclosures required by newly adopted accounting standards so the interim information presented is not misleading. In the past, the SEC staff has stated that the quantified disclosures required for stock-based compensation need to be provided for options granted or modified during the interim period, but only if award activity in the period was material.

In the course of adopting Statement 123(R), public companies should refer to SEC Staff Accounting Bulletin Topic 14.H, "First Time Adoption of Statement 123R in an Interim Period," for the required interim disclosures. In providing comparable information of prior interim periods in which fair value accounting has not been applied (i.e., the company applied the provisions of Opinion 25 for recognition purposes), public companies should continue to disclose pro forma footnote information as detailed in paragraph 84 of Statement 123(R).

64-2: Disclosure in a Subsidiary's Stand-Alone Financial Statements

Question

Whether a subsidiary is a public registrant or not, is it required to comply with the disclosure requirements of Statement 123(R) in its stand-alone financial statements?

Answer

Yes. The conclusions outlined in SEC Staff Accounting Bulletin Topic 1.B.1, "Costs Reflected in Historical Financial Statements," provide for the recording of the expenses in the subsidiary's financial statements to ensure that the user of the financial statements understands all of the subsidiary's costs of doing business. The same rationale should be used to determine the disclosures required in the stand-alone financial statements of the subsidiary, which are outlined in Statement 123(R). SAB Topic 1.B requires that expenses incurred by a parent on behalf of its subsidiary be reflected in the historical financial statements of the subsidiary. Examples of such expenses include, but are not limited to:

- Officer and employee salaries,
- Rent or depreciation,
- Advertising,
- Accounting and legal services, and
- Other selling, general, and administrative expenses.

Statement 123(R)

65. An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraph 64 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation (paragraph A240).

Earnings Per Share Implications

Statement 123(R)
66. FASB Statement No. 128, *Earnings per Share*, requires that employee equity share options, nonvested shares, and similar equity instruments granted to employees be treated as potential common shares in computing diluted earnings per share. Diluted earnings per share shall be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting in or the ability to exercise (or retain) an award is contingent on a performance or market condition, such as the level of future earnings, the shares or share options shall be treated as contingently issuable shares in accordance with paragraphs 30–35 of Statement 128. If equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments are outstanding.

66-1: Compensation Awards That Do Not Result in the Issuance of Stock

Question

Is there any effect on the earnings per share computation of certain forms of compensation awards based on the price of the company's stock that do not result in actual issuance of stock, either subsequent to vesting in a stock award or upon exercise of an option?

Answer

Certain forms of compensation awards are based on the price of a company's stock (e.g., cash settled stock appreciation rights and certain formula plans) and do not anticipate the actual issuance of stock to the employee; rather, the compensation to the employee is settled entirely in cash and hence will be accounted for as a liability. For awards that require settlement in cash, the computation of earnings per share will not be affected by the existence of the plan other than for the effect of the compensation cost charged to expense.

Statement 123(R)
67. Paragraphs 21–23 of Statement 128 provide guidance on applying the treasury stock method for equity instruments granted in share-based payment transactions in determining diluted earnings per share.

67-1: Illustration of the Treasury Stock Method for Employee Stock Options

Paragraphs 17–23 of FASB Statement No. 128, *Earnings per Share*, describe the treasury stock method of computing the dilutive effect of outstanding call options and warrants (and their equivalents). In particular, paragraph 21 of Statement 128, as amended by Statement 123(R), states, in part:

> In applying the treasury stock method described in paragraph 17, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay upon exercise, (b) the amount of compensation cost attributed to future services and not yet recognized, and (c) the amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the options.

The following are illustrations of the treasury stock method used to compute diluted earnings per share (EPS) when stock options have been granted by a company.

Illustration 1

Assumptions:

- Company A has net income of $5 million for the year ended December 31, 2007.
- Company A has one million common shares outstanding for the entire year ended December 31, 2007.
- As of December 31, 2007, Company A has 100,000 stock options outstanding. All the stock options are subject to a service condition only. On December 31, 2006, 50,000 stock options vested. The remaining 50,000 stock options were granted on January 1, 2007, and vest on December 31, 2008.
- All the stock options have an exercise price of $10 per option.
- All the stock options have a grant-date fair value of $2 per option.
- The average price of Company A's stock for the year ended December 31, 2007, was $15 per share.
- Company A's combined statutory tax rate is 35 percent.
- For simplicity purposes, the effect of forfeitures has been ignored.

Calculation of Diluted Earnings Per Share	
Shares to be issued upon exercise of stock options outstanding as of December 31, 2007	100,000
Proceeds:	
Exercise price (100,000 options × $10)	$ 1,000,000
Average unrecognized compensation cost [(beginning of year unrecognized compensation cost ($100,000) + end of year unrecognized compensation cost ($50,000)) ÷ 2]	75,000
Excess tax benefit {[($15 – $10) – $2] × 100,000 options} × 35 percent	105,000
Total hypothetical proceeds	$ 1,180,000
Average stock price	$ 15
Number of shares reacquired ($1,180,000 ÷ $15)	78,667
Net number of shares issued (100,000 – 78,667)	21,333
Weighted average number of common shares outstanding during the year — basic	1,000,000
Shares included in diluted EPS computation	1,021,333
Net income available to common shareholders	$ 5,000,000
Diluted EPS	$ 4.90

Illustration 2

The following illustrates a computation of diluted EPS if stock options were exercised during the period in question.

Paragraph 19 of Statement 128 states:

> Dilutive options or warrants that are issued during a period or that expire or are canceled during a period shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive options or warrants exercised during the period shall be included in the denominator for the period prior to actual exercise. The common shares issued upon exercise of options or warrants shall be

included in the denominator for the period after the exercise date. Consequently, incremental shares assumed issued shall be weighted for the period the options or warrants were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

Assumptions:

Assume the same facts as Illustration 1, above, except for the following:

- The 50,000 options that vested on December 31, 2006, were exercised on June 30, 2007.
- The average price of Company A's stock for the period from January 1, 2007, to June 30, 2007, was $12 per share.

Calculation of Diluted Earnings Per Share	
Shares to be issued upon exercise of stock options outstanding as of December 31, 2007	50,000
Proceeds:	
Exercise price (50,000 options × $10)	$ 500,000
Average unrecognized compensation cost [(beginning of year unrecognized compensation cost ($100,000) + end of year unrecognized compensation cost ($50,000)) ÷ 2]	75,000
Excess tax benefit {[($15 – $10) – $2] × 50,000 options} × 35 percent	52,500
Total hypothetical proceeds	$ 627,500
Average stock price (year ended December 31, 2007)	$ 15
Number of shares reacquired ($627,500 ÷ $15) (relating to options outstanding at December 31, 2007)	41,833
Net number of shares issued (50,000 – 41,833) (relating to options outstanding at December 31, 2007)	8,167
Proceeds (relating to options exercised during the year):	
Exercise price (50,000 options × $10)	$ 500,000
Unrecognized compensation cost	N/A
Excess tax benefit {[($12 – $10) – $2] × 50,000 option}* × 35 percent	0
Total hypothetical proceeds	$ 500,000
Average stock price (January 1, 2007, to June 30, 2007)	$ 12
Number of shares reacquired ($500,000 ÷ $12)	41,667
Net number of shares issued weighted for half a year (relating to options exercised during the year) [(50,000 – 41,667) × 6/12]	4,167
Net shares issued (8,167 + 4,167)	12,334
Weighted average number of common shares outstanding during the year — basic (1 million shares outstanding at the beginning of the year plus 50,000 options exercised weighted for half a year)	1,025,000
Shares included in diluted EPS computation	1,037,334
Net income available to common shareholders	$ 5,000,000
Diluted EPS	$ 4.82

* If the intrinsic value upon hypothetical exercise is less than the grant-date fair value, then the resultant tax deficiency would reduce the hypothetical proceeds to the extent that an APIC pool exists to offset such a deficiency.

67-2: Estimating Expected Disqualifying Dispositions in Calculating Assumed Proceeds Upon Exercise of Incentive Stock Options

Question

Incentive stock options (ISOs) generally do not result in a tax deduction for a company unless the employee makes a disqualifying disposition. If a company has determined that employees have a history of making disqualifying dispositions, can the company then estimate expected disqualifying dispositions in calculating the assumed proceeds available to repurchase shares using the treasury stock method?

Answer

No. Paragraph 21 of FASB Statement No. 128, *Earnings per Share*, as amended by Statement 123(R), defines assumed proceeds to include "the amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the options." The tax benefit associated with an ISO does not occur upon exercise, but rather at some later date when the employee takes an action that disqualifies the option.

Further, paragraph 59 of Statement 123(R) (and paragraph 42 of Statement 123) state that an employee's disqualifying disposition of stock under existing U.S. tax law can give rise to a tax deduction for an award that ordinarily does not result in a tax deduction, and that the tax effects of such an event shall be recognized only when it occurs. While paragraph 59 specifically does not address earnings per share implications, it does state that the tax benefit associated with a disqualifying event should not be recorded until it occurs. By analogy, the expected effect of disqualifying dispositions that will occur in the future should not be estimated in calculating the assumed proceeds, because such dispositions have not yet occurred.

67-3: Calculating the Unrecognized Compensation Component of Assumed Proceeds Under the Treasury Stock Method for Outstanding Employee Stock Options

Paragraph 21 of FASB Statement No. 128, *Earnings per Share*, as amended by Statement 123(R), describes the application of the treasury stock method in calculating the dilutive effect of options and warrants. Paragraph 21 requires companies to calculate assumed proceeds available to repurchase shares issued upon assumed exercise of stock options as the total of (1) the amount, if any, the employee must pay upon exercise; (2) the amount of unrecognized compensation associated with the option; and (3) the amount of excess tax benefits, if any, that would be credited to additional paid-in capital upon exercise of the option.[9]

If the assumed proceeds (as described above) result in repurchase of more shares than the number of shares issued for any option, then the option will not have a dilutive effect, and should not be included in the denominator of the EPS calculation. This situation could occur either if the options are currently out-of-the-money, or if the options are in-the-money, but the effects of (2) and (3), above, are sufficient to offset any resulting dilution.

Question

In calculating the amount of the unrecognized compensation component of assumed proceeds, should a company include the unrecognized compensation cost associated with out-of-the-money awards in the total assumed proceeds available to repurchase shares?

Answer

No. The treasury stock method should be applied on an option-by-option basis (or, if option grants generally are made to employees on the same day at the same exercise price, the treasury stock method could be applied to each

[9] If the intrinsic value upon hypothetical exercise is less than the grant date fair value, then the resultant tax deficiency would reduce the hypothetical proceeds to the extent an APIC pool exists to offset such a deficiency.

individual grant). If an option (or grant) is out-of-the-money based on the stated exercise price, the effects of including any component of the assumed proceeds associated with that option (or grant) in the treasury stock method calculation would be antidilutive.

Example

Company A (A) is calculating the number of shares associated with outstanding employee stock options to include in the diluted EPS denominator for the year ended December 31, 2008. Company A has the following employee stock options outstanding at December 31, 2008. The average stock price for 2008 was $20.

Grant Date	Options	Strike Price	Average Unrecognized Compensation Cost	Excess Tax Benefits
January 1, 2006	200	$ 10	$ 400	$ 400
March 15, 2006	100	17	700	0
November 15, 2006	300	25	800	0
March 15, 2007	200	30	900	0

The assumed proceeds for the January 1, 2006, award and the March 15, 2006, award are calculated as follows:

January 1, 2006, Award	
Amount employee must pay upon exercise	$ 2,000
Average unrecognized compensation cost	400
Excess tax benefit credited to APIC	400
Total assumed proceeds	$ 2,800

The assumed proceeds of $2,800 would be available to repurchase 140 shares at an average stock price of $20, so of the 200 shares to be issued assuming exercise, 60 shares would be included in the diluted EPS denominator for the January 1, 2006, award.

March 15, 2006, Award	
Amount employee must pay upon exercise	$ 1,700
Average unrecognized compensation cost	700
Excess tax benefit credited to APIC	0
Total assumed proceeds	$ 2,400

The assumed proceeds of $2,400 would be available to repurchase 120 shares at an average stock price of $20. Since the assumed exercise would result in the issuance of 100 shares, and application of the treasury stock method results in the repurchase of 120 shares, the effects of including the March 15, 2006, award in the diluted EPS calculation would be antidilutive. Accordingly, no adjustment is made to the denominator.

For the remaining two awards, because the exercise price of the November 15, 2006, and March 15, 2007, options exceed the average stock price in 2008, using the treasury stock method the assumed proceeds would repurchase more than 300 shares for the November 15, 2006, award and more than 200 shares for the March 15, 2007, award; therefore, the effects of including these awards in the diluted EPS calculation would be antidilutive.

The average unrecognized compensation associated with the antidilutive awards would not be available as assumed proceeds for the only dilutive award, the January 1, 2006, award; therefore, A's total shares to be added to the diluted EPS denominator would be the 60 dilutive shares attributable to the January 1, 2006, award.

67-4: The Effect of Expected Tax Deficiencies on the Assumed Proceeds for Use in the Treasury Stock Method

Paragraph 21 of FASB Statement No. 128, *Earnings per Share*, as amended by Statement 123(R), states in part:

> The excess tax benefit is the amount resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes…If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.

Question

When calculating assumed proceeds in the computation of diluted EPS under the treasury stock method, will all expected tax deficiencies serve to reduce assumed proceeds?

Answer

No. Expected tax deficiencies (i.e., when the intrinsic value upon the assumed exercise of awards is less than the grant date fair value) will only serve to reduce assumed proceeds to the extent that paid-in capital at the end of the period includes amounts relating to excess tax benefits previously recognized. If paid-in capital does not include amounts relating to excess tax benefits previously recognized (i.e., the tax deficiencies are recorded as a tax expense instead of a reduction of paid-in capital), then the expected tax deficiencies would not affect the determination of assumed proceeds.

Statement of Cash Flows

Statement 123(R)

68. Statement 95 is amended by adding the underlined wording as follows:

[19] e. Cash retained as a result of the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services that is recognizable for financial reporting purposes. For this purpose, excess tax benefits shall be determined on an individual award (or a portion thereof) basis.

[23] c. Cash payments to governments for taxes, duties, fines, and other fees or penalties and the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services recognizable for financial reporting purposes also had not been deductible in determining taxable income. (This is the same amount reported as a financing cash inflow pursuant to paragraph 19(e) of this Statement.)

[27] f. Income taxes paid and, separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not recognizable as a cost of goods or services for accounting purposes also had not been deductible in determining taxable income (paragraph 19(e))

68-1: Income Tax Effects on the Statement of Cash Flows

Question

How does Statement 123(R) change the presentation of the statement of cash flows?

Answer

Companies are required to display in the statement of cash flows the impact of any excess tax deduction (over book expense). This "excess deduction" is separate and apart from taxes paid, and is reported as a component of **cash inflows from financing activities**. Actual taxes paid (an operating cash outflow) are increased by the same amount, resulting in an operating cash flows total that shows taxes that a company would have paid had it not been for the excess deduction.

The changes to the statement of cash flows shall be reflected in all periods after the effective date of Statement 123(R). In addition, these changes shall be reflected in any period for which a company elects to apply the modified retrospective application method. Paragraph 78 of Statement 123(R) states:

> The amendments to Statement 95 in paragraph 68 of this Statement shall be applied to the same periods for which the modified retrospective application method is applied.

Example

A company grants to an employee 100 non-qualified stock options, each with a grant-date fair value of $10. Further, assume that the stock price at the grant date is $30, as is the exercise price of each option. The company's combined statutory tax rate is 40 percent. As a result, the company will record a $400 tax benefit and a related deferred tax asset, for financial reporting purposes, over the life of the award.

Four years later, the employee exercises all 100 options. On the date of exercise, the company's common stock has a fair value of $42 per share. Under current U.S. income tax law, the company will receive a tax deduction based upon the difference between the fair value of the stock on the exercise date and the amount the employee pays to exercise ($1,200 = ($42 – $30) × 100 options). As a result of the increase in the company's share price, the company realizes a tax benefit of $480 ($480 = $1,200 deduction × 40 percent tax rate) for income tax purposes. The $480 tax benefit exceeds the tax benefit recognized for book purposes by $80 (which will be recorded directly to equity), and represents the excess deduction discussed in the following paragraph.

Also, assume that in the year of exercise, the company has taxable income in the amount of $2,100 (prior to considering the impact of the $1,200 stock compensation deduction) or $900 of taxable income after the stock compensation deduction. The company pays tax of $360 ($900 taxable income × 40 percent = $360). In accordance with Statement 95, the $360 of taxes paid is reflected as an operating cash outflow. However, absent the excess deduction, the company would have paid an additional $80 (($1,200 tax deduction – $1,000 compensation cost) × 40 percent = $80) of taxes. The amount of taxes the company would have paid in the absence of an excess deduction ($80) should be shown as an additional cash outflow from operations, and a corresponding cash inflow from financing activities.

68-2: Tax Benefit Deficiencies in the Statement of Cash Flows

Question

Do tax benefit deficiencies (tax shortfalls) reduce the amount of realized excess tax benefits presented as cash inflows from financing activities?

Answer

No. The amount presented as financing cash inflows relating to excess tax benefits should be determined on a gross basis (i.e., the sum of excess tax benefits on an award-by-award basis only). Tax benefit deficiencies realized in the same period do not reduce the amount of cash inflows from financing activities in the statement of cash flows for that period. Paragraph B228 of Statement 123(R) states:

> The Board considered whether the cash flow statement should report an increase in operating cash flows and a decrease in financing cash flows in a reporting period in which there is a charge to paid-in capital as a result of the write-off of a deferred tax asset related to an award that did not result in deductible compensation cost. The Board decided not to require that presentation because it believes that the operating and financing sections of the cash flow statement should reflect **only the effects of awards that generated tax savings from excess tax benefits**. [Emphasis added]

Therefore, for the same period, the amount presented as a financing cash inflow and an operating cash outflow for realized excess tax benefits will differ from the increase in additional paid-in capital due to the realization of excess tax benefits because the increase in additional paid-in capital is recorded net of tax benefit deficiencies realized in the period.

Example

Assume that, in the same period:

- 100 stock options are exercised that result in the realization of a $100 excess tax benefit, and
- Another 100 stock options are exercised that result in the realization of a $20 tax benefit deficiency.

In the statement of cash flows, the financing cash inflow and the operating cash outflow relating to excess tax benefits would be $100. However, the increase in additional paid-in capital for the same period would be $80.

Effective Dates

Statement 123(R)

69. This Statement is effective:

   a. For public entities that do not file as **small business issuers** — as of the beginning of the first interim or annual reporting period that begins after June 15, 2005

   b. For public entities that file as small business issuers — as of the beginning of the first interim or annual reporting period that begins after December 15, 2005

   c. For nonpublic entities — as of the beginning of the first annual reporting period that begins after December 15, 2005.

The effective date for a nonpublic entity that becomes a public entity after June 15, 2005, and does not file as a small business issuer is the first interim or annual reporting period beginning after the entity becomes a public entity. If the newly public entity files as a small business issuer, the effective date is the first interim or annual reporting period beginning after December 15, 2005, for which the entity is a public entity.

69-1: Illustration — Effective Dates of Statement 123(R) as a Result of SEC's Deferral

The following table sets out the effective dates of Statement 123(R) by both year end and type of company, taking into account the deferral of Statement 123(R) due to the release of the SEC's Final Rule Release, "Amendment to Rule 4-01(a) of Regulations S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment."[10] The deferral does not affect a company's ability to early adopt the provisions of Statement 123(R). Refer to Q&A 73-1 for a discussion of a company's ability to early adopt.

Required adoption dates of Statement 123(R) are as follows:

Year End	Public Company	Small Business Issuer & Nonpublic Company
January 31	February 1, 2006	February 1, 2006
February 28	March 1, 2006	March 1, 2006
March 31	April 1, 2006	April 1, 2006
April 30	May 1, 2006	May 1, 2006
May 31	June 1, 2006	June 1, 2006
June 30	**July 1, 2005**	July 1, 2006
July 31	**August 1, 2005**	August 1, 2006
August 31	**September 1, 2005**	September 1, 2006
September 30	**October 1, 2005**	October 1,2006
October 31	**November 1, 2005**	November 1, 2006
November 30	**December 1, 2005**	December 1, 2006
December 31	January 1, 2006	January 1, 2006

[10] Pursuant to the SEC's Final Rule Release each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end public company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006. Registrants that file as small business issuers are required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after December 15, 2005.

69-2: Effective Date for Foreign Private Issuers

Paragraph 69 of Statement 123(R) states, in part: "This Statement is effective...[f]or public entities that do not file as **small business issuers** — as of the beginning of the interim or annual reporting period that begins after June 15, 2005." Paragraph 70 of Statement 123(R) states, in part: "This Statement applies to all awards granted after the required effective date."

Question

For foreign private issuers, what is the effective date of Statement 123(R)?

Answer

Footnote 127 of Statement 123(R) states:

> [Statement 123(R)] also applies to *foreign private issuers* (as defined in SEC regulation C §230.405) that are Public (as designated in the preceding footnote). Foreign private issuers should initially apply this Statement no later than the interim (quarterly or other) or annual period beginning after the specified effective date for which U.S. GAAP financial information is required or reported voluntarily.

Footnote 8 of the SEC's Final Rule Release, "Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment" states:

> Similarly, a foreign private issuer is required to comply with Statement No. 123R in its annual report on Form 20-F for the first fiscal year that begins after June 15, 2005, or in a prospectus or registration statement that is required to include an interim period of the first fiscal year that begins after June 15, 2005.

Therefore, a foreign private issuer is not required to adopt the provisions of Statement 123(R) until the first annual period beginning after June 15, 2005, for which U.S. GAAP financial information is prepared.

For example, a foreign private issuer with a calendar year-end is not required to apply the provisions of Statement 123(R) until its fiscal year beginning January 1, 2006.

Statement 123(R)
70. This Statement applies to all awards granted after the required effective date. This Statement shall not be applied to awards granted in periods before the required effective date except to the extent that prior periods' awards are modified, repurchased, or cancelled after the required effective date and as required by paragraph 74. The cumulative effect of initially applying this Statement, if any, shall be recognized as of the required effective date (paragraphs 79–82).

Transition — General

Statement 123(R)
71. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 shall apply the modified prospective application transition method (paragraphs 74 and 75). For periods before the required effective date, those entities may elect to apply the modified retrospective application transition method (paragraphs 76–78).

71-1: Methods of Transition — Public Companies

Question

What methods of transition are available to public companies?

Answer

For the periods from the adoption date forward — Public companies are **required** to adopt Statement 123(R) using the modified prospective application method. The modified prospective application method requires public companies to (1) record compensation cost for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption (using the amounts previously measured under Statement 123 for either recognition or pro forma disclosure purposes) and (2) record compensation cost for any awards issued, modified, repurchased, or cancelled after the effective date of Statement 123(R). Refer to Q&A 74-1 for an illustration of the modified prospective application method. Note that the modified prospective application applies to the reporting as of the beginning of the period in which Statement 123(R) is adopted.

For periods prior to adoption — Statement 123(R) does **not require** companies to restate prior periods. However, a company may elect to adopt Statement 123(R) using the modified retrospective application method. The modified retrospective application method allows companies to recognize, in their prior period financial statements, the exact amount of compensation cost that was previously disclosed in their pro forma footnote disclosure. Changes to the amounts originally disclosed in prior periods are precluded. Refer to Q&A 76-1 for an illustration of the modified retrospective application method.

If companies adopt Statement 123(R) during an interim period, they may elect to apply the modified retrospective application method for either all prior periods for which Statement 123 was effective, or only the prior interim periods of the initial year of adoption, if any. Refer to Q&A 77-1 for a discussion of the cumulative effect adjustments related to the application of the modified retrospective application method.

Statement 123(R)
72. Nonpublic entities that used the minimum value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method (paragraph 83) as of the required effective date.

72-1: Methods of Transition — Nonpublic Companies

Question

What methods of transition are available to nonpublic companies?

Answer

Nonpublic companies that have used the "minimum value method" under Statement 123 for either recognition or pro forma disclosure purposes are required to use the prospective method for transition. The prospective method requires nonpublic companies to record compensation cost in accordance with Statement 123(R) only for awards issued, modified, repurchased or cancelled after the effective date. Additionally, nonpublic companies should continue to account for previously issued awards that remain outstanding at the date of adopting Statement 123(R) using pre-existing accounting standards (i.e., Opinion 25 or the minimum value method of Statement 123). Refer to Q&A 83-1 for an illustration of the prospective application method.

Nonpublic companies that have used the fair-value based method (i.e., Statement 123) to account for their equity-based awards for either financial reporting or disclosure purposes are required to use the same methods of transition available to public companies. Refer to Q&A 71-1 for the methods of transition available to public companies. Fair value does not include the use of the minimum value method. Most nonpublic companies have used the minimum value method for their pro forma disclosures required under Statement 123. These companies are not required to follow the same transition methods as public companies.

Statement 123(R)

73. Early adoption of this Statement for interim or annual periods for which financial statements or interim reports have not been issued is encouraged.[32]

Footnote 32 — If an entity early adopts this Statement pursuant to paragraph 73, then the *required effective date* would be the first date in the initial period of adoption.

73-1: Early Adoption

Question

Will companies be able to early adopt Statement 123(R)?

Answer

Yes. Early adoption of Statement 123(R) is encouraged provided that the financial statements (interim or annual) for the period have not been issued. Therefore, a calendar year-end company may adopt Statement 123(R) as early as the beginning of the fourth quarter ended December 31, 2004, provided its financial statements have not been issued for that period. Alternatively, a company may elect to early adopt the provisions of Statement 123(R) effective January 1, 2005, for interim and annual reporting purposes. Regardless of the effective date selected (i.e., early adoption or the required effective date), companies are required to follow the transition methods outlined in Q&As 71-1, *Methods of Transition — Public Companies* and 72-1, *Methods of Transition — Nonpublic Companies*.

Transition — Modified Prospective Application Method

Statement 123(R)

74. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, shall adopt this Statement using a modified version of prospective application (*modified prospective application*). Under modified prospective application, this Statement applies to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the required effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated for either recognition or pro forma disclosures under Statement 123. Changes to the grant-date fair value of equity awards granted before the required effective date of this Statement are precluded.[33] The compensation cost for those earlier awards shall be attributed to periods beginning on or after the required effective date of this Statement using the attribution method that was used under Statement 123, except that the method of recognizing forfeitures only as they occur shall not be continued (paragraph 80). Any unearned or deferred compensation (contra-equity accounts) related to those earlier awards shall be eliminated against the appropriate equity accounts.

Footnote 33 — The prohibition in paragraphs 74 and 76 of changes to the grant-date fair value of equity awards granted before the required effective date of this Statement does not apply if the entity needs to correct an error.

74-1: Illustration — Modified Prospective Application Method

Company A (A), an SEC registrant and calendar year-end company, uses the modified prospective application method for transition. On January 1, 2004, A grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $9. In addition, on January 1, 2006, A grants 2,000 "at-the-money" employee share options, each with a grant-date fair value of $12. All awards vest at the end of the third year of service (cliff-vesting). Company A adopts Statement 123(R) on January 1, 2006,[11] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purposes.

Question

How much compensation cost does the company record in each year assuming these are the only awards outstanding?

[11] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

Illustration

Year Ended	Compensation Cost*	Comments
December 31, 2004	$ —	No compensation cost is recorded as the company was following the provisions of Opinion 25.
December 31, 2005	$ —	No compensation cost is recorded as the company was following the provisions of Opinion 25.
December 31, 2006	$ 11,000	The company records twelve months of compensation cost for the award issued on January 1, 2004 (1,000 awards × $9 fair value × 33% services rendered† = $3,000), **and** twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2007	$ 8,000	The company records no compensation cost for the award issued January 1, 2004, as that award becomes fully vested on December 31, 2006. The company records twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2008	$ 8,000	The company records no compensation cost for the award issued January 1, 2004, as that award becomes fully vested on December 31, 2006. The company records twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).

* For simplicity purposes, the effects of forfeitures and income taxes have been ignored.
† Thirty-three percent represents the employee providing one of three years of service.

74-2: Transition — Calculation of Grant-Date Fair Value for Awards Granted Prior to Adoption

Question

A company has historically used the Black-Scholes-Merton formula in valuing employee stock options for purposes of providing the required pro forma disclosures under Statement 123. Upon adoption of Statement 123(R) the company decided to value future grants using a binomial approach. Is it acceptable for the company to recalculate the grant-date fair value for previously issued awards that remain outstanding at the initial date of adoption of Statement 123(R)?

Answer

No. Companies **will not be allowed** to recalculate the grant-date fair value for previously issued awards that remain outstanding at the date of adoption. Under either the modified prospective application or the modified retrospective application methods available, companies are **precluded** from recalculating an award's grant-date fair value. For awards granted prior to the adoption of Statement 123(R), companies should continue to use the values previously calculated pursuant to Statement 123 for recognition or pro forma disclosure purposes in calculating the amount of compensation cost to be recognized in the financial statements under the provisions of Statement 123(R). Refer to Q&As 74-1 and 76-1 for illustrations of the modified prospective application and the modified retrospective application methods.

74-3: Modification of an Award After the Adoption of Statement 123(R) — Modified Prospective Application Method

Question

Under the modified prospective application method, what is the accounting consequence of modifying the terms of an award that was issued before the effective date of Statement 123(R), but was modified after the standard's effective date?

Answer

The modification should be accounted for following the modification guidance in Statement 123(R). However, the accounting for the modification will depend on whether the award is vested, at the date of modification. Absent the modification, awards that are fully vested prior to the effective date of Statement 123(R) will have no compensation cost associated with them after the effective date. Refer to Q&A 71-1 for a discussion of the modified prospective application method. Therefore, the only accounting consequence of a fully vested award results from the incremental value conveyed to the employee as part of the modification. The company records the incremental value: the difference, if any, between the fair value of the modified award immediately after the modification and the fair value of the original award immediately before the modification, as compensation cost in the period in which the modification occurred.

Alternatively, an award that was not fully vested at the date of modification has an accounting consequence for **both** the unvested portion of the original award **and** the incremental value conveyed to the employee as part of the modification. The company continues to record the compensation cost associated with the unvested portion of the original award over the remaining service period. In addition, the company records the incremental value conveyed to the employee as part of the modification as compensation cost over the remaining service period.

Example 1

On January 1, 2002, Company A (A), an SEC registrant and calendar year-end company, grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $9. The awards vest at the end of the third year of service (cliff-vesting) and have an exercise price of $30. Company A adopts Statement 123(R) on January 1, 2006,[12] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purposes. Company A's stock price has fallen significantly below the $30 exercise price and on April 1, 2006, A reduces the exercise price of the aforementioned stock options to $10. When the options are re-priced on April 1, 2006, the incremental fair value resulting from the modification was $4.

Because the awards were fully vested at the date A adopted Statement 123(R), there is no compensation cost recorded for the original award (following the modified prospective application method). However, A needs to record the entire $4,000 ($4 incremental fair value × 1,000 share options) of incremental compensation cost on the date of modification (April 1, 2006).

Example 2

Alternatively, assume all the same facts as above, except that the awards were issued on January 1, 2005. On January 1, 2006 (the effective date of Statement 123(R)),[13] A began recording the unvested portion of compensation cost (1,000 awards × $9 grant-date fair value × 66 2/3% services to be rendered[14] = $6,000) over the remaining service period (two years) as required by the modified prospective application method. In addition, on April 1, 2006, A has

[12] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

[13] See footnote 12 above.

[14] Sixty-six and two-thirds percent represents the remaining two of three years of service to be rendered.

to record the $4,000 of incremental compensation cost, resulting from the modification, over the remaining service period.

74-4: Accounting for Variable Awards Upon Adoption of Statement 123(R) — Modified Prospective Application Method

Question

How will awards that were previously accounted for as variable awards under Opinion 25 transition to Statement 123(R) if the modified prospective application method is used?

Answer

The accounting depends upon whether the award is considered to be a liability award or an equity award under the provisions of Statement 123(R).

Liability Awards

Certain awards are accounted for as variable awards under Opinion 25 because of a requirement to settle the awards in cash (e.g., cash settled share appreciation rights). These awards are considered liability awards under Statement 123(R). Statement 123(R) maintained the notion of variable accounting for liability awards; however, instead of the compensation cost for these awards being measured and recorded at their intrinsic value each reporting period, the awards will now be measured and recorded at their fair value (or calculated or intrinsic value for a nonpublic company following the modified prospective application method). The change from intrinsic value to fair value requires a cumulative effect adjustment for a change in accounting principle upon adoption of Statement 123(R). Refer to Q&As 79-1 and 79-2 for a discussion and illustration of the cumulative effect adjustment.

Equity Awards

Other awards are considered to be variable awards under Opinion 25 even though the awards do not result in the employer incurring a liability (e.g., an award that is accounted for as variable because of a re-pricing). Upon adoption of Statement 123(R) a company should cease applying variable accounting for Opinion 25 variable awards that are not considered to be liabilities. If the awards are not fully vested as of the effective date of Statement 123(R), companies will cease applying variable accounting and begin recording compensation cost for the unvested portion of the awards based on their grant-date fair value. The grant-date fair value used should be the amount previously calculated and disclosed in the company's pro forma footnote disclosure. This is consistent with the requirement of the modified prospective application method, which requires compensation cost to be recorded for the unvested portion of previously issued awards that remain outstanding at the date of adoption.

Alternatively, if the awards are fully vested as of the effective date of Statement 123(R), but continue to be accounted for as a variable award (i.e., measurement date has not occurred), companies should cease recording compensation cost for these awards and no further compensation cost is recorded. The modified prospective application method requires companies to record compensation cost for the portion of the outstanding award for which the requisite service has not been rendered. In this example, since all the requisite services have been rendered, the company records no additional compensation cost upon adoption of Statement 123(R).

Example

On January 1, 2004, Company A (A) grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $15. The awards vest at the end of the third year of service (cliff-vesting). Assume A adopts Statement

123(R) on January 1, 2006,[15] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purpose. The awards were issued with a performance condition and therefore were accorded variable accounting treatment under Opinion 25.

Regardless of whether the awards are vested or unvested, A ceases to apply variable accounting on the date it adopts Statement 123(R). However since the awards are not fully vested as of the effective date of Statement 123(R), A begins recording compensation cost based on the award's grant-date fair value. Company A records $5,000 (1,000 awards × $15 grant-date fair value × 33% services rendered[16]) of compensation cost over the remaining service period (one year).

74-5: Capitalization of Compensation Cost (e.g., in Inventory)

In applying the provisions of Statement 123 to compute the fair value of compensation cost reported in the pro forma footnote disclosures, a company did not adjust the pro forma amounts for the impact related to capitalization of compensation cost as part of the cost to acquire or construct an asset (such as inventory).

Question

If a company previously did not contemplate the impact of capitalization of stock-based compensation cost for internally constructed assets in applying the provisions of Statement 123 (e.g., because the impact was insignificant), and subsequent to the adoption of Statement 123(R) the company concludes that capitalization of stock-based compensation cost is appropriate, can the company adjust the beginning inventory balance to reflect the impact of this policy on a retroactive basis?

Answer

No. If a company previously has not reported the impact of capitalization of Statement 123 compensation cost, it is not permitted to adjust prior periods or beginning inventory to reflect the impact of applying such a policy retroactively. That is, upon adoption of Statement 123(R) companies that begin to account for the impact of stock-based compensation cost as part of the cost to acquire or construct an asset must do so prospectively. While Statement 123(R) provides for the ability to "restate" prior years, the retrospective application method allows companies to recognize in their prior period financial statements the exact amount of compensation cost that previously was disclosed in their pro forma footnote disclosures. Since the company did not reflect the impact of capitalization of stock-based compensation cost in reported Statement 123 pro forma amounts, a change to the compensation amounts as they previously were presented in a company's pro forma footnote disclosure is not permitted. However, as indicated in footnote 33 of Statement 123(R), the prohibition against adjusting previously reported amounts does not apply if there is a material error in the previously reported amounts.

74-6: Nonpublic Companies That Become Public Companies Before the Adoption of Statement 123(R) — The Accounting for Awards Granted Prior to an IPO When Adopting Statement 123(R) — Modified Prospective Application Method

On January 1, 20X5, a calendar year-end nonpublic company issues 1,000 "at-the-money" employee stock options each with a minimum value of $2. The awards vest at the end of the fourth year of service (cliff-vesting). The company is currently applying the provisions of Opinion 25 for recognition purposes and the minimum value method of Statement 123 for disclosure purposes. On April 1, 20X5, the company files the necessary registration statement

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[15] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

[16] Thirty-three percent represents the employee providing one of three years of service.

to become a public company. Based on part (b) of the definition of a public company in Appendix E in Statement 123(R) (reproduced herein as Appendix A), the company is considered to be a public company when it files the registration statement. After the change in status (from nonpublic to public), the company begins disclosing the fair value of any newly issued employee stock options in its footnote disclosures. On May 1, 20X5, the company grants an additional 1,000 "at-the-money" employee stock options each with a grant-date fair value of $4 and a four-year service period (cliff-vesting).

Question

How does a company that becomes or became a public company prior to the effective date of Statement 123(R) apply the modified prospective application method to awards granted to employees prior to the company becoming a public company?

Answer

Since the company is a public company at the date it adopts Statement 123(R), it is required to adopt the standard using the transition requirements for a public company (i.e., the modified prospective application method rather than the prospective method). In applying the modified prospective application method, the company only records compensation cost for the unvested portion of the awards issued after becoming a public company (the May 1, 20X5, awards in the above example). The company continues to record compensation cost, if any, on the awards issued on January 1, 20X5, following the provisions of Opinion 25 (i.e., the prospective method for the awards granted while not a public company). This is in keeping with the concept of paragraph 83 of Statement 123(R), which states, in part:

> Nonpublic entities, including those that become public entities after June 15, 2005, that used the minimum value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 shall apply this Statement prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date.

This is also consistent with the application of the modified retrospective application method to prior periods when a company was using the "minimum value" method of Statement 123. Footnote 34 of Statement 123(R) states:

> A nonpublic entity shall apply this method [modified retrospective application method] to all prior years for which Statement 123's fair-value-based method was adopted for recognition or pro forma disclosures if that date is later than when Statement 123 was first effective.

Based on informal discussions, the FASB staff has confirmed that the modified prospective application method is only applied to awards issued while a company was a public company. For awards issued prior to becoming a public company, applying the prospective method is appropriate.

Statement 123(R)
75. An entity that does not choose modified retrospective application (paragraphs 76–78 of this Statement) shall apply the amendments to Statement 95 in paragraph 68 of this Statement only for the interim or annual periods for which this Statement is adopted.

Transition — Modified Retrospective Application Method

Statement 123(R)

76. All public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, may apply a modified version of retrospective application (*modified retrospective application*) to periods before the required effective date. Modified retrospective application may be applied either (a) to all prior years for which Statement 123 was effective[34] or (b) only to prior interim periods in the year of initial adoption if the required effective date of this Statement does not coincide with the beginning of the entity's fiscal year. An entity that chooses to apply the modified retrospective method to all prior years for which Statement 123 was effective shall adjust financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods by Statement 123, as amended by FASB Statement No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*,[35] and by paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*. Accordingly, compensation cost and the related tax effects will be recognized in those financial statements as though they had been accounted for under Statement 123.[36] Changes to amounts as originally measured on a pro forma basis are precluded.

Footnote 34 — A nonpublic entity shall apply this method to all prior years for which Statement 123's fair-value-based method was adopted for recognition or pro forma disclosures if that date is later than when Statement 123 was first effective.

Footnote 35 — For convenience, the remaining discussion in this Statement refers only to Statement 123. Those references should be understood as referring to Statement 123, as amended by Statement 148.

Footnote 36 — This provision applies to all awards regardless of whether they were accounted for as fixed or variable under Opinion 25.

76-1: Illustration — Modified Retrospective Application Method

Assume Company A (A), an SEC registrant and calendar year-end company, elects to use the modified retrospective application method for transition for all prior periods for which Statement 123 was effective. On January 1, 2004, A grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $9. In addition, on July 1, 2005, A grants 2,000 employee share options, each with a grant-date fair value of $12. All awards vest at the end of the third year of service (cliff-vesting). Prior to the adoption of Statement 123(R), A applied the provisions of Opinion 25 for recognition and Statement 123, for pro forma disclosure purposes. Following the existing guidance of Statement 123 the company reported $3,000 of compensation cost (assuming no tax effects) for the year ended December 31, 2004, in its pro forma footnote disclosure.

Question

How much compensation cost does the company record in each year assuming these are the only awards outstanding?

Illustration

Year Ended	Compensation Cost*	Comments
December 31, 2004	$ 3,000	The company records the exact amount of compensation cost for each prior period presented as it reflected in its pro forma footnote disclosure.
December 31, 2005	$ 7,000	The company records twelve months of compensation cost for the award issued on January 1, 2004 (1,000 awards × $9 fair value × 33% services rendered† = $3,000), **and** six months of compensation cost for the award issued on July 1, 2005 (2,000 awards × $12 fair value × 33% services rendered† × 50% = $4,000).
December 31, 2006	$ 11,000	The company records twelve months of compensation cost for the award issued on January 1, 2004 (1,000 awards × $9 fair value × 33% services rendered† = $3,000), **and** twelve months of compensation cost for the award issued on July 1, 2005 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2007	$ 8,000	The company records no compensation cost for the award issued January 1, 2004, as that award becomes fully vested on December 31, 2006. The company records twelve months of compensation cost for the award issued on July 1, 2005 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2008	$ 4,000	The company records six months of compensation cost for the award issued on July 1, 2005 (2,000 awards × $12 fair value × 33% services rendered† × 50% = $4,000).

* For simplicity purposes, the effects of forfeitures and income taxes have been ignored.
† Thirty-three percent represents the employee providing one of three years of service.

76-2: Transition — Recognition of Prior Period Income Tax Benefits

A company currently follows the disclosure guidance of Statement 123. That guidance requires companies to disclose in the footnotes to the financial statements the compensation cost, **net of related tax effects**, that would have been included in net income if the fair value based method had been used for their share-based payment awards.

Question

If a company elects to adopt Statement 123(R) using the modified retrospective application method, how should the company report the related tax impacts?

Answer

Applying the modified retrospective application method requires a company to recognize the **exact** amount of compensation cost that was reported in its pro forma footnote disclosures in its prior period income statements.

Therefore, the amount of income tax benefit that previously was reported in the company's pro forma footnote disclosure should be the **exact** amount of income tax benefit recognized in its adjusted prior period income statements and related balance sheet accounts. Changes to the amounts as they were originally disclosed in prior periods are precluded unless a company needs to correct an error.

Statement 123(R)

77. If an entity applies the modified retrospective application method to all prior years for which Statement 123 was effective and does not present all of those years in comparative financial statements, the beginning balances of paid-in capital, deferred taxes, and retained earnings for the earliest year presented shall be adjusted to reflect the results of modified retrospective application to those prior years not presented. The effects of any such adjustments shall be disclosed in the year of adoption. If an entity applies the modified retrospective application method only to prior interim periods in the year of initial adoption, there would be no adjustment to the beginning balances of paid-in capital, deferred taxes, or retained earnings for the year of initial adoption.

77-1: Adjustments to Beginning Balances — Modified Retrospective Application Method

Question

If the modified retrospective application method is used, will adjustments to the beginning balance of additional paid-in capital, deferred taxes, and retained earnings always be required?

Answer

It depends on the periods the modified retrospective application method is applied to.

Companies applying the modified retrospective application method to all prior periods

If a company applies the modified retrospective application method to all prior years for which Statement 123 was effective, it would be required to record a cumulative adjustment to the beginning balance of paid-in capital, deferred taxes, and retained earnings to the earliest period presented in the financial statements. The adjustment would reflect the amount of compensation cost that a company would have recorded had it been applying the provisions of Statement 123 since its effective date (annual periods beginning after December 15, 1994).

Companies applying the modified retrospective application method to interim periods of the year of adoption

Alternatively, if a company applies the modified retrospective application method to only the prior interim periods of the initial year of adoption, no adjustment to the beginning balances of paid-in capital, deferred taxes, and retained earnings is allowed.

Statement 123(R)

78. The amendments to Statement 95 in paragraph 68 of this Statement shall be applied to the same periods for which the modified retrospective application method is applied.

Transition — Other

Statement 123(R)
79. Transition as of the required effective date for instruments that are liabilities under the provisions of this Statement shall be as follows: a. For an instrument that had been classified as equity but is classified as a liability under this Statement, recognize a liability at its fair value (or portion thereof, if the requisite service has not been rendered). If (1) the fair value (or portion thereof) of the liability is greater or less than (2) previously recognized compensation cost for the instrument, the liability shall be recognized first, by reducing equity (generally, paid-in capital) to the extent of such previously recognized cost and second, by recognizing the difference (that is, the difference between items (1) and (2)) in the income statement, net of any related tax effect, as the cumulative effect of a change in accounting principle. b. For an outstanding instrument that previously was classified as a liability and measured at intrinsic value, recognize the effect of initially measuring the liability at its fair value, net of any related tax effect, as the cumulative effect of a change in accounting principle.[37] Footnote 37 — If share-based compensation cost has been previously capitalized as part of another asset, an entity should consider whether the carrying amount of that asset should be adjusted to reflect amounts calculated pursuant to paragraphs 79(a) and 79(b).

79-1: Transition — Cumulative Effect Adjustments

Question

In what circumstances will a company[17] have to record an adjustment for a cumulative effect of a change in accounting principle related to the adoption of Statement 123(R)?

Answer

Liability Awards

Under the recognition provisions of both Opinion 25 and Statement 123, liability awards have been recorded at their intrinsic value remeasured each reporting period until the date of settlement. However, the recognition provisions of Statement 123(R) require liability awards to be accounted for at their fair value, remeasured each reporting period until the date of settlement. Therefore, all public companies (and nonpublic companies that elect to account for their liability awards at fair value) must record an adjustment for the cumulative effect of a change in an accounting principle to record liabilities currently recorded at intrinsic value at fair value. The adjustment is computed as the difference between the amount currently recorded as a liability (i.e., intrinsic value) and the fair value, or portion thereof if unvested, of the liability award on the date of adoption of Statement 123(R), net of any related tax effects. Refer to Q&A 79-2 for an illustration of the cumulative effect adjustment resulting from a company recording its liability awards at fair value versus intrinsic value.

Equity Awards

There may be circumstances in which a company has classified an award as equity under existing standards (i.e., Opinion 25 or Statement 123) and will now be required to record that award as a liability under Statement 123(R). In

[17] This Q&A does not apply to nonpublic companies that adopt Statement 123(R) using the prospective method.

these cases, all public companies (and nonpublic companies that elect to account for their liability awards at fair value) must record an adjustment for the cumulative effect of a change in accounting principle to record their current equity awards as liabilities at current fair value. The adjustment is computed as the difference between the amount previously recognized as compensation cost (i.e., under the intrinsic value method) and the current fair value, or portion thereof if unvested, of the liability award net of any related tax effects. Refer to Q&A 79-3 for an illustration of the cumulative effect adjustment resulting from a company reclassifying its equity awards as liability awards and recording them at fair value versus intrinsic value.

Forfeitures

Previously, under Statement 123 companies were allowed either to estimate forfeitures on the date of grant, and adjust those earlier estimates when actual experiences differed from previous estimates, or recognize forfeitures as they actually occurred. Statement 123(R) requires companies to estimate forfeitures on the date of grant and thereafter. As of the effective date companies that

(1) have been following the recognition provisions of Statement 123 or have recognized compensation cost in the income statement under Opinion 25 (e.g., nonvested shares), and

(2) have been basing their recognition of compensation cost on forfeitures only as they occurred

will record an adjustment for the cumulative effect of a change in accounting principle.

The adjustment will be based on the difference between the compensation cost that a company has previously recorded and the amount of compensation cost the company would have recorded had it been estimating forfeitures since the date of grant. Refer to Q&As 80-1 and 80-2 for an illustration of the cumulative effect adjustment resulting from a company recording its forfeitures based on estimates at the date of grant and thereafter rather than actual experiences.

79-2: Illustration — Cumulative Effect Adjustments for Liability Awards

Illustration

On January 1, 2005, Company A (A) grants to its employees 1,000 “at-the-money” cash-settled stock appreciation rights. The awards vest at the end of the fourth year of service (cliff-vesting) and have an exercise price of $10. The company’s combined statutory tax rate is 40 percent. Assume A adopts Statement 123(R) on January 1, 2006,[18] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosures. Since the award requires cash settlement, it was recorded as a liability under Opinion 25.

On December 31, 2005, following the recognition provision of Opinion 25, A records the award at its then current intrinsic value. Assume on December 31, 2005, the company’s stock price is $15 and therefore the intrinsic value is $5 per option. Since the award is 25 percent vested (one of four service years has lapsed), A records a $1,250 share-based liability and a $500 deferred tax asset.

[18] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

On January 1, 2006, the date of adoption of Statement 123(R), the fair value of the liability award is $8. In keeping with the transition provisions of Statement 123(R), A records this award based upon its fair value ($8) rather than its intrinsic value ($5). The difference would be recorded as a cumulative effect of a change in accounting principle. Refer to the journal entries below.

Journal Entries		Debit		Credit
Cumulative effect of a change in accounting principle	$	750		
Share-based liability			$	750
To record the cumulative effect of a change in accounting principle to recognize the share-based liability at fair value rather than intrinsic value				
Deferred tax asset		300		
Cumulative effect of a change in accounting principle				300
To record the tax effect of the cumulative effect of a change in accounting principle to recognize the share-based liability at fair value rather than intrinsic value				

79-3: Illustration — Cumulative Effect Adjustments for Equity Awards Reclassified as Liability Awards

Illustration

On January 1, 2005, Company A (A) grants 1,000 "at-the-money" employee share options that have an exercise price that is indexed to the consumer price index (CPI). As the CPI fluctuates so too does the exercise price of the awards. The awards vest at the end of the fourth year of service (cliff-vesting) and have an exercise price of $10. The company's combined statutory tax rate is 40 percent. Assume A adopts Statement 123(R) on January 1, 2006,[19] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purpose. Even though the award has been indexed to something other than the company's own stock, Opinion 25 would still consider the award an equity award. However, the options would be recorded at their intrinsic value remeasured each reporting period, since a measurement date has not been established.

On December 31, 2005, the date prior to adoption, A records the award at its then current intrinsic value following the recognition provision of Opinion 25. Assume on December 31, 2005, the award has an intrinsic value of $5 per option. Since the award is 25 percent vested (one of four service years has lapsed), A would have recorded $1,250 in additional paid-in capital and a $500 deferred tax asset.

On January 1, 2006, the date of adoption of Statement 123(R), the fair value of the award is $8. However, now that A has adopted Statement 123(R), the award meets the definition of a liability and therefore would cease to be recorded as equity and would commence being reported as a liability. In following the recognition provisions for a liability award, A would have to remeasure this award at its fair value ($8) rather than at its intrinsic value ($5). The difference will be recorded as a cumulative effect of a change in accounting principle. Refer to the journal entries below.

[19] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

Journal Entries	Debit	Credit
Cumulative effect of a change in accounting principle	$ 750	
Additional paid-in capital	1,250	
Share-based liability		$ 2,000
To record the cumulative effect of a change in accounting principle to recognize the award as a share-based liability and record the award at fair value rather than intrinsic value		
Deferred tax asset	300	
Cumulative effect of a change in accounting principle		300
To record the tax effect of the cumulative effect of a change in accounting principle to recognize the award as a share-based liability and record the award at fair value rather than intrinsic value		

Statement 123(R)

80. As of the required effective date, an entity that had a policy of recognizing the effect of forfeitures only as they occurred shall estimate the number of outstanding instruments for which the requisite service is not expected to be rendered. Balance sheet amounts related to any compensation cost (excluding nonrefundable dividend payments), net of related tax effects, for those instruments previously recognized in income because of that policy for periods before the effective date of this Statement shall be eliminated and recognized in income as the cumulative effect of a change in accounting principle as of the required effective date.

80-1: Illustration — Cumulative Effect Adjustments for Estimating Forfeitures (Company Previously Applied Statement 123)

Illustration

On January 1, 2005, Company A (A) grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $10. The awards vest at the end of the fourth year of service (cliff-vesting). The company's combined statutory tax rate is 40 percent. Assume A adopts Statement 123(R) on January 1, 2006,[20] and previously was applying the provisions of Statement 123 for recognition purposes. At the date of grant A elected to account for forfeitures as they occurred. As of December 31, 2005, 30 options (or three percent) have been forfeited due to employee terminations. As a result of the terminations, A has recognized cumulative compensation cost of $2,425 [(1,000 options granted – 30 forfeitures) × $10 grant-date fair value × 25% services rendered[21]] for this award.

However, upon adoption, the provisions of Statement 123(R) require A to estimate the number of remaining forfeitures for this award. On January 1, 2006, A believes an additional 70 options will be forfeited prior to vesting. As a result, A records an adjustment for the difference ($175) in the amount of compensation cost the company did record [(1,000 options granted – 100 forfeitures) × $10 grant-date fair value × 25% services rendered[22]=$2,425] based on actual forfeitures of three percent and the amount it would have recorded ($2,250) had it been estimating forfeitures from the beginning. Refer to the journal entries below.

[20] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

[21] Twenty-five percent represents the employee providing one of four years of service.

[22] See footnote 21 above.

Journal Entries	Debit	Credit
Additional paid-in capital	$ 175	
Cumulative effect of a change in accounting principle		$ 175
To record the cumulative effect of a change in accounting principle to recognize estimated forfeitures rather than actual forfeitures		
Cumulative effect of a change in accounting principle	70	
Deferred tax asset		70
To record the tax effects of the cumulative effect of a change in accounting principle to recognize estimated forfeitures rather than actual forfeitures		

80-2: Illustration — Cumulative Effect Adjustments for Estimating Forfeitures (Company Previously Applied Opinion 25)

Illustration

On January 1, 2005, Company A (A) grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $20. The awards vest at the end of the fourth year of service (cliff-vesting). The company's combined statutory tax rate is 40 percent. Assume A adopts Statement 123(R) on January 1, 2006,[23] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purposes. Since compensation cost has not been recognized in the financial statements A does not record an adjustment for a cumulative effect of a change in accounting principle.

Alternatively, on January 1, 2005, A grants 1,000 nonvested shares, each with a grant-date fair value of $20 (the company's current stock price). The awards vest at the end of the fourth year of service (cliff-vesting). The company's combined statutory tax rate is 40 percent. Assume A adopts Statement 123(R) on January 1, 2006,[24] and previously was applying the provisions of Opinion 25 for recognition purposes and Statement 123 for pro forma disclosure purposes. At the date of grant A assumed no forfeitures and had subsequently recorded forfeitures based on their actual occurrence. As of December 31, 2005, 30 nonvested shares (or three percent) have been forfeited due to employee terminations. As a result of the terminations, A has recognized cumulative compensation cost of $4,850 [(1,000 nonvested shares granted – 30 forfeitures) × $20 grant-date fair value × 25% service rendered[25]] for this award.

However, upon adoption, the provisions of Statement 123(R) require A to estimate the number of remaining expected forfeitures for this award. On January 1, 2006, A believes an additional 70 nonvested shares will be forfeited prior to vesting. As a result, A records an adjustment for the difference ($350) in the amount of compensation cost the company did record ($4,850) based on actual forfeitures of three percent and the amount it would have recorded [(1,000 nonvested shares granted – 100 forfeitures) × $20 grant-date fair value × 25% services rendered[26]=$4,500] had it been estimating forfeitures from the beginning. Refer to the journal entries below.

[23] Pursuant to SEC Rule Release No. 33-8568, each registrant that is not a small business issuer is required to prepare financial statements in accordance with Statement 123(R) beginning with the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. This rule effectively delays the required effective date of Statement 123(R) for a calendar year-end company for six months from the date prescribed in the standard. A calendar year-end public company would begin applying Statement 123(R) on January 1, 2006.

[24] See footnote 23 above.

[25] Twenty-five percent represents the employee providing one of four years of service.

[26] See footnote 25 above.

Journal Entry		Debit		Credit
Additional paid-in capital	$	350		
Cumulative effect of a change in accounting principle			$	350
To record the cumulative effect of recording estimated forfeitures rather than actual forfeitures				
Cumulative effect of a change in accounting principle		140		
Deferred tax asset				140
To record the tax effects of the cumulative effect of a change in accounting principle to recognize estimated forfeitures				

Statement 123(R)

81. Except as required by paragraph 80, no transition adjustment as of the required effective date shall be made for any deferred tax assets associated with outstanding equity instruments that continue to be accounted for as equity instruments under this Statement. For purposes of calculating the available excess tax benefits if deferred tax assets need to be written off in subsequent periods, an entity shall include as available for offset only the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994. In determining that amount, an entity shall exclude excess tax benefits that have not been realized pursuant to Statement 109 (paragraph A94, footnote 82, of this Statement). An entity that previously has recognized deferred tax assets for excess tax benefits prior to their realization shall discontinue that practice prospectively and shall follow the guidance in this Statement and in Statement 109.
82. Outstanding equity instruments that are measured at intrinsic value under Statement 123 at the required effective date because it was not possible to reasonably estimate their grant-date fair value shall continue to be measured at intrinsic value until they are settled.

Transition — Prospective Method

Statement 123(R)
83. Nonpublic entities, including those that become public entities after June 15, 2005, that used the minimum value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 shall apply this Statement prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (either the minimum value method under Statement 123 or the provisions of Opinion 25 and its related interpretive guidance).

83-1: Illustration — Prospective Method

On January 1, 2005, Company A (A), a nonpublic calendar year-end company, grants 1,000 "at-the-money" employee share options, each with a grant-date fair value of $9. In addition, on January 1, 2006, A grants 2,000 "at-the-money" employee share options, each with a grant-date fair value of $12. All awards vest at the end of the third year of service (cliff-vesting). Prior to the adoption of Statement 123(R), A applied the provisions of Opinion 25 for recognition and Statement 123 using the minimum value method for pro forma disclosure purposes.

Question

How much compensation cost does the company record in each year assuming these are the only awards outstanding?

Illustration

Year Ended	Compensation Cost*	Comments
December 31, 2005	$ —	No compensation cost is recorded, as the company was following the provisions of Opinion 25.
December 31, 2006	$ 8,000	The company continues to account for awards prior to adoption following the provisions of Opinion 25 and, accordingly, records **no compensation cost** for the fixed awards (in this example) issued January 1, 2005. The company records twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2007	$ 8,000	The company records **no compensation cost** for the award issued January 1, 2005. The company records twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).
December 31, 2008	$ 8,000	The company records twelve months of compensation cost for the award issued on January 1, 2006 (2,000 awards × $12 fair value × 33% services rendered† = $8,000).

* For simplicity purposes, the effects of forfeitures and income taxes have been ignored.

† Thirty-three percent represents the employee providing one of three years of service.

83-2: Accounting for Awards Issued by Nonpublic Companies Upon Adoption of Statement 123(R) — Prospective Method

Question

How will awards issued by nonpublic companies that were either previously accounted for as variable awards under Opinion 25, or accounted for using the minimum value method under Statement 123, transition to Statement 123(R) if the prospective method is used?

Answer

These awards, whether vested or unvested, continue to be accounted for in the same manner as before. For an award that was previously issued and remains outstanding as of the date of adoption, a nonpublic company should continue to follow its existing accounting treatment under Opinion 25 or the minimum value method of Statement 123.

Transition — Disclosures in the Initial Period of Adoption

Statement 123(R)

84. In the period that this Statement is adopted, an entity shall disclose the effect of the change from applying the original provisions of Statement 123[38] on income from continuing operations, income before income taxes, net income, cash flow from operations, cash flow from financing activities, and basic and diluted earnings per share. In addition, if awards under share-based payment arrangements with employees are accounted for under the intrinsic value method of Opinion 25 for any reporting period for which an income statement is presented, all public entities shall continue to provide the tabular presentation of the following information that was required by paragraph 45 of Statement 123 for all those periods:

   a. Net income and basic and diluted earnings per share as reported
   b. The share-based employee compensation cost, net of related tax effects, included in net income as reported
   c. The share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards[39]
   d. Pro forma net income as if the fair-value-based method had been applied to all awards
   e. Pro forma basic and diluted earnings per share as if the fair-value-based method had been applied to all awards.

   The required pro forma amounts shall reflect the difference in share-based employee compensation cost, if any, included in net income and the total cost measured by the fair-value-based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair-value-based method had been applied to all awards. The required pro forma per-share amounts shall reflect the change in the denominator of the diluted earnings per share calculation as if the assumed proceeds under the treasury stock method, including measured but unrecognized compensation cost and any excess tax benefits credited to additional paid-in capital, were determined under the fair-value-based method.

Footnote 38 — The effect of the change for the period in which this Statement is adopted will differ depending on whether a public entity had previously adopted the fair-value-based method (or a nonpublic entity had adopted the minimum value method) of Statement 123 or had continued to use the intrinsic value method in Opinion 25.

Footnote 39 — For paragraphs 84(c)–84(e), *all awards* refers to awards granted, modified, or settled in cash in fiscal periods beginning after December 15, 1994.

84-1: Reporting Pro Forma Information — Public Companies

Question

Upon adoption of Statement 123(R), are public companies required to continue reporting the pro forma effect of fair value accounting for prior periods presented?

Answer

It depends on the method of transition that the company elects. Public companies will continue reporting the pro forma effects of fair value accounting for any period presented in which the company has applied the provisions of Opinion 25.

For example, if a calendar year-end public company elects to adopt Statement 123(R) using the modified retrospective application method for all prior periods presented, the company does not need to disclose the pro forma effects of fair value accounting for any period presented. Refer to Q&A 76-1 for an illustration of the modified retrospective application method. Calendar year-end companies utilizing only the modified prospective application method are required to present in their financial statements (in the initial year of adoption) the pro forma effects of fair value accounting for the prior two calendar years. Refer to Q&A 74-1 for an illustration of the modified prospective application method.

84-2: Presentation of Stock-Based Compensation on the Face of the Statement of Operations

With the adoption of Statement 123(R), companies are required to record compensation cost in connection with the issue of their share-based payment awards. Registrants may question whether it is acceptable to present a separate line item on the face of the statement of operations for stock-based compensation, a non-cash charge. This separate line item may be identified as "non-cash compensation expense" or "equity related charges." For example, the face of the statement of operations may present a line item for "selling, general, and administrative expense (excluding $XXX of stock-based compensation)" followed by a line item for "stock-based compensation."

Question

Is it acceptable for SEC registrants to report stock-based compensation expense in the manner described above?

Answer

The SEC staff (the "staff") discussed the presentation of stock-based compensation expense at the 1999 and 2000 AICPA National Conference on Current SEC Developments.

The SEC staff believes that these non-cash expenses should be classified in the same manner as other similar expenses and that the presentation should not be driven by the form of consideration paid. The amount of stock-based compensation attributable to cost of sales, research and development, selling and administrative expenses, etc., should be included in those line items on the face of the statement of operations and not separately presented in a single stock-based compensation line item. The staff believes that the presentation of separate line items solely for the purpose of emphasizing that a particular expense did not involve a cash outlay is most effectively presented within the statement of cash flows, which may be further highlighted in the financial statement footnotes and Management's Discussion and Analysis (MD&A) rather than on the face of the statement of operations.

The SEC staff reiterated their view in SEC Staff Accounting Bulletin Topic 14.F, "Classification of Compensation Expense Associated With Share-Based Payment Arrangements" (SAB 107). It states:

> **Question:** How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?
>
> **Interpretive Response:** The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. [Footnote omitted] The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements.
>
> Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

Notwithstanding the staff's belief, the staff has not objected to the separate stock-based compensation line item presentation as long as the attribution of non-cash charges to the appropriate functional expense line item (Example 2) is transparent from the disclosures on the face of the statement of operations and is fair and balanced. However, any presentation that allows for the measurement of gross margin must include all deductions for cost of sales, regardless of the form of consideration paid. For example, it is not appropriate to have a line item "cost of sales (excluding $XXX of stock-based compensation)." In addition, when stock-based compensation is excluded from line items, such as in Example 2 (below), the discussion of the fluctuations in the line items in MD&A should be based on amounts that include the stock-based compensation attributable to each appropriate line item.

If a registrant continues to believe a separate line item presentation for stock compensation is appropriate, the staff provided examples of how it could be displayed:

Example 1	
Revenue	$ 100
Cost of sales (including non-cash compensation expense of $10)	40
Gross profit	60
Selling expense (including non-cash compensation expense of $5)	20
General & Administrative expense (including non-cash compensation expense of $5)	25
Total operating expenses	45
Income from operations	$ 15

Example 2		
Revenue		$ 100
Cost of sales:		
Non-cash compensation	$ 10	
Other cost of sales	30	40
Gross Profit		60
Selling expense:		
Non-cash compensation	5	
Other selling expenses	15	20
General & Administrative expense:		
Non-cash compensation	5	
Other G&A expenses	20	25
Total operating expenses		45
Income from operations		$ 15

Statement 123(R)

85. A nonpublic entity that used the minimum value method for pro forma disclosure purposes under the original provisions of Statement 123 shall not continue to provide those pro forma disclosures for outstanding awards accounted for under the intrinsic value method of Opinion 25.

85-1: Reporting Pro Forma Information — Nonpublic Companies

Question

Upon adoption of Statement 123(R), are nonpublic companies required to continue reporting the pro forma effect of fair value accounting for prior periods presented?

Answer

Generally, no. Nonpublic companies that used the minimum value method to comply with the disclosure provisions of Statement 123 are not allowed to continue providing those disclosures after the required effective date of Statement 123(R).

However, if a nonpublic company applied the fair value provisions of Statement 123 for disclosure purposes, it would continue to disclose the pro forma effects of fair value accounting for any period presented in which the company has applied the provisions of Opinion 25 for recognition purposes.

Roadmap to Applying Statement 123(R):

Appendix A —
Glossary of Statement 123(R) Terms

Statement 123(R), Appendix E

E1. This appendix contains definitions of certain terms or phrases used in this Statement.

Blackout period

A period of time during which exercise of an equity share option is contractually or legally prohibited.

Broker-assisted cashless exercise

The simultaneous exercise by an employee of a share option and sale of the shares through a broker (commonly referred to as a *broker-assisted exercise*).

Generally, under this method of exercise:

a. The employee authorizes the exercise of an option and the immediate sale of the option shares in the open market.
b. On the same day, the entity notifies the broker of the sale order.
c. The broker executes the sale and notifies the entity of the sales price.
d. The entity determines the minimum statutory tax-withholding requirements.
e. By the settlement day (generally three days later), the entity delivers the stock certificates to the broker.
f. On the settlement day, the broker makes payment to the entity for the exercise price and the minimum statutory withholding taxes and remits the balance of the net sales proceeds to the employee.

Calculated value

A measure of the value of a share option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option-pricing model.

Closed-form model

A valuation model that uses an equation to produce an estimated fair value. The Black-Scholes-Merton formula is a closed-form model. In the context of option valuation, both closed-form models and lattice models are based on risk-neutral valuation and a contingent claims framework. The payoff of a contingent claim, and thus its value, depends on the value(s) of one or more other assets. The contingent claims framework is a valuation methodology that explicitly recognizes that dependency and values the contingent claim as a function of the value of the underlying asset(s). One application of that methodology is risk-neutral valuation in which the contingent claim can be replicated by a combination of the underlying asset and a risk-free bond. If that replication is possible, the value of the contingent claim can be determined without estimating the expected returns on the underlying asset. The Black-Scholes-Merton formula is a special case of that replication.

Statement 123(R), Appendix E

Combination award

An award with two or more separate components, each of which can be separately exercised. Each component of the award is actually a separate award, and compensation cost is measured and recognized for each component.

Cross-volatility

A measure of the relationship between the volatilities of the prices of two assets taking into account the correlation between movements in the prices of the assets. (Refer to the definition of **volatility**.)

Derived service period

A service period for an award with a market condition that is inferred from the application of certain valuation techniques used to estimate fair value. For example, the derived service period for an award of share options that the employee can exercise only if the share price increases by 25 percent at any time during a 5-year period can be inferred from certain valuation techniques. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of satisfaction (as inferred from the valuation technique). If the derived service period is three years, the estimated requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition was satisfied at an earlier date.[170] Further, award of fully vested, deep out-of-the-money share options has a derived service period that must be determined from the valuation techniques used to estimate fair value. (Refer to the definitions of **explicit service period**, **implicit service period**, and **requisite service period**.)

Economic interest in an entity

Any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses.

Footnote 170 — Compensation cost would not be recognized beyond three years even if after the grant date the entity determines that it is not probable that the market condition will be satisfied within that period.

Statement 123(R), Appendix E

Employee

An individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service Revenue Ruling 87-41.[171] Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies a grantee potentially subject to U.S. payroll taxes as an employee for purposes of applying this Statement also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee for purposes of this Statement solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee for purposes of this Statement because the grantee also must be an employee of the grantor under common law.

A leased individual is deemed to be an employee of the lessee for purposes of this Statement if all of the following requirements are met:

a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.

b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:

   1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
   2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
   3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
   4. The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
   5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.

A nonemployee director does not satisfy this definition of employee. Nevertheless, for purposes of this Statement, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees for purposes of this Statement.

Footnote 171 — A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction.

Statement 123(R), Appendix E

Employee share ownership plan

An employee benefit plan that is described by the Employment Retirement Income Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

Equity restructuring

A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

Excess tax benefit

The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the **measurement date** for financial reporting) of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes.

Explicit service period

A service period that is explicitly stated in the terms of a share-based payment award. For example, an award stating that it vests after three years of continuous employee service from a given date (usually the grant date) has an explicit service period of three years. (Refer to **derived service period**, **implicit service period**, and **requisite service period**.)

Fair value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Freestanding financial instrument

A financial instrument that is entered into separately and apart from any of the entity's other financial instruments or equity transactions or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Grant date

The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory), for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. (Refer to the definition of **service inception date**.)

Statement 123(R), Appendix E

Implicit service period

A service period that is not explicitly stated in the terms of a share-based payment award but that may be inferred from an analysis of those terms and other facts and circumstances. For instance, if an award of share options vests upon the completion of a new product design and it is probable that the design will be completed in 18 months, the implicit service period is 18 months. (Refer to **derived service period**, **explicit service period**, and **requisite service period**.)

Intrinsic value

The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.)

Issued, issuance, or **issuing** of an equity instrument

An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to vesting conditions.

Lattice model

A model that produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument. In this context, a lattice model is based on risk-neutral valuation and a contingent claims framework. (Refer to **closed-form model** for an explanation of the terms *risk-neutral valuation* and *contingent claims framework*.)

Market condition

A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar[172] (or index of similar) equity security (securities).

Footnote 172 — The term similar as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

Statement 123(R), Appendix E

Measurement date

The date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed.

Modification

A change in any of the terms or conditions of a share-based payment award.

Nonpublic entity

Any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity for purposes of this Statement.

Nonvested shares

Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

Performance condition

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for purposes of this Statement. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee.

Public entity

An entity (a) with equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). That is, a subsidiary of a public entity is itself a public entity. An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is not a public entity for purposes of this Statement.

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Related party

An affiliate of the reporting entity; another entity for which the reporting entity's investment is accounted for by the equity method; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners and management of the entity; members of the immediate families of principal owners of the entity and its management; and other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. This definition is the same as the definition of related parties in paragraph 24 of FASB Statement No.57, *Related Party Disclosures*.

Reload feature and **reload option**

A reload feature provides for automatic grants of additional options whenever an employee exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price. At the time of exercise using shares, the employee is automatically granted a new option, called a *reload option*, for the shares used to exercise the previous option.

Replacement award

An award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

Requisite service period (and **requisite service)**

The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the *requisite service*. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

Statement 123(R), Appendix E

Restricted share

A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed *nonvested shares* because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. This Statement uses the term restricted shares to refer only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.[173] (Refer to the definition of nonvested shares.)

Restriction

A contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time.

Service condition

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition.

Service inception date

The date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date (refer to Illustration 3, paragraphs A79–A85).

Settle, settled, or **settlement** of an award

An action or event that irrevocably extinguishes the issuing entity's obligation under a share-based payment award. Transactions and events that constitute settlements include (a) exercise of a share option or lapse of an option at the end of its contractual term, (b) vesting of shares, (c) forfeiture of shares or share options due to failure to satisfy a vesting condition, and (d) an entity's repurchase of instruments in exchange for assets or for fully vested and transferable equity instruments. The vesting of a share option is not a settlement as that term is used in this Statement because the entity remains obligated to issue shares upon exercise of the option.

Footnote 173 — Vested equity instruments that are transferable to an employee's immediate family members or to a trust that benefits only those family members are restricted if the transferred instruments retain the same prohibition on sale to third parties.

Statement 123(R), Appendix E

Share option

A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options.

Share unit

A contract under which the holder has the right to convert each unit into a specified number of shares of the issuing entity.

Share-based payment (or **compensation) arrangement**

An arrangement under which (a) one or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments or (b) the entity incurs liabilities to suppliers (1) in amounts based, at least in part,[174] on the price of the entity's shares or other equity instruments or (2) that require or may require settlement by issuance of the entity's shares. For purposes of this Statement, the term *shares* includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. *Equity shares* refers only to shares that are accounted for as equity.

Share-based payment (or **compensation) transaction**

A transaction under a share-based payment arrangement, including a transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity awards a share-based payment to an employee or other supplier of goods or services for the entity's benefit.

Short-term inducement

An offer by the entity that would result in modification or settlement of an award to which an award holder may subscribe for a limited period of time.

Small business issuer

A public entity that is an SEC registrant that files as a small business issuer under the Securities Act of 1933 or the Securities Exchange Act of 1934. At the date this Statement was issued, a *small business issuer* was defined as an entity that meets all of the following criteria:

a. It has revenues of less than $25 million.
b. It is a U.S. or Canadian issuer.
c. It is not an investment company.
d. If the entity is a majority-owned subsidiary, the parent company also is a small business issuer.

Footnote 174 — The phrase *at least in part* is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.

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However, regardless of whether it satisfies those criteria, an entity is not a small business issuer if the aggregate market value of its outstanding securities held by nonaffiliates is $25 million or more. The definition of a small business issuer is a matter of U.S. federal securities law and is subject to change. The effective date provisions of this Statement for a small business issuer apply only to an entity that files as a small business issuer under the related definition at that date.

Tandem award

An award with two (or more) components in which exercise of one part cancels the other(s).

Terms of a share-based payment award

The contractual provisions that determine the nature and scope of a share-based payment award. For example, the exercise price of share options is one of the terms of an award of share options. As indicated in paragraph 34 of this Statement, the written terms of a share-based payment award and its related arrangement, if any, usually provide the best evidence of its terms. However, an entity's past practice or other factors may indicate that some aspects of the substantive terms differ from the written terms. The substantive terms of a share-based payment award as those terms are mutually understood by the entity and a party (either an employee or a nonemployee) who receives the award provide the basis for determining the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the award and related arrangement, if any, are structured. Also refer to paragraph 6 of this Statement.

Time value of an option

The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5. If the fair value of that option is $7, the time value of the option is $2 ($7 – $5).

Vest, Vesting, or **Vested**

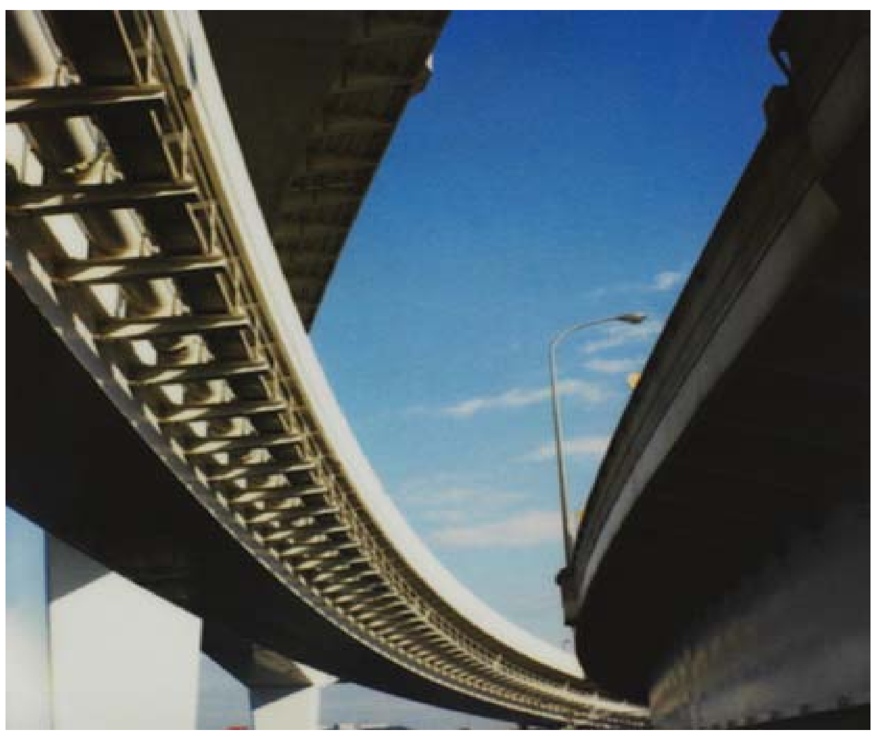
To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions for purposes of this Statement.

For convenience and because the terms are commonly used in practice, this Statement refers to *vested* or *nonvested* options, shares, awards, and the like, as well as *vesting date*. The stated vesting provisions of an award often establish the requisite service period, and an award that has reached the end of the requisite service period is vested. However, as indicated in the definition of *requisite service period*, the stated vesting period may differ from the requisite service period in certain circumstances. Thus, the more precise (but cumbersome) terms would be *options*, *shares*, or *awards for which the requisite service has been rendered and end of the requisite service period*.

Volatility

A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

Roadmap to Applying Statement 123(R): Appendix B — SAB Topic 14



Contents

The interpretations in this SAB express views of the staff regarding the interaction between Statement 123R and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. Statement 123R was issued by the Financial Accounting Standards Board ("FASB") on December 16, 2004. Statement 123R is based on the underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value.[1.] Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information.[2]

Statement 123R addresses a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

Statement 123R replaces Statement 123 and supersedes Opinion 25. Statement 123, as originally issued in 1995, established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of Statement 123R and enhance the information received by investors and other users of financial statements, thereby assisting them in making investment and other decisions. This SAB includes interpretive guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity[3] status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of Statement 123R in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of Statement 123R, the modification of employee share options prior to adoption of Statement 123R and disclosures in MD&A subsequent to adoption of Statement 123R.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement Statement 123R, and the interpretive guidance provided by this SAB, particularly during the period of the Statement's initial implementation. Thus, throughout this SAB the use of the terms "reasonable" and "reasonably" is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of Statement 123R and the interpretive guidance provided by this SAB in any given situation. In addition, as discussed in the Interpretive Response to Question 1 of Section C, Valuation Methods, estimates of fair value are not intended to predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made under Statement 123R. Over time, as issuers and accountants gain more experience in applying Statement 123R and the guidance provided in this SAB, the staff anticipates that particular approaches may begin to emerge as best practices and that the range of reasonable conduct, conclusions and methodologies will likely narrow.

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[1] Statement 123R, paragraph 1.

[2] Statement 123R, page iv.

[3] Defined in Statement 123R, Appendix E.

A. Share-Based Payment Transactions With Nonemployees

Question: Are share-based payment transactions with nonemployees included in the scope of Statement 123R?

Interpretive Response: Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by Statement 123R. Statement 123R explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments;[4] and
- Requires that an entity record the value of a transaction with a nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued.[5]

Statement 123R does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, Statement 123R does not specify the measurement date for sharebased payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued.[6] For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to Emerging Issues Task Force ("EITF") Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in Statement 123R would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in Statement 123R by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in Statement 123R would be inconsistent with the terms of the instrument issued to a nonemployee in a sharebased payment arrangement.[7] For example, the staff believes the guidance in Statement 123R on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

[4] Statement 123R, paragraph 7.

[5] Ibid.

[6] Statement 123R, paragraph 8.

[7] For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service termination, Statement 123R requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the option's expected term rather than the contractual term. If these features (i.e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.

B. Transition From Nonpublic to Public Entity Status

Facts: Company A is a nonpublic entity[8] that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8.[9] As a nonpublic entity, Company A had been assigning value to its share options[10] under the calculated value method prescribed by Statement 123R[11] and had elected to measure its liability awards based on intrinsic value. Company A is considered a public entity on January 2, 20X8 when it makes its initial filing with the SEC in preparation for the sale of its shares in a public market.

Question 1: How should Company A account for the share options that were granted to its employees prior to January 2, 20X8 for which the requisite service has not been rendered by January 2, 20X8?

Interpretive Response: Prior to becoming a public entity, Company A had been assigning value to its share options under the calculated value method. The staff believes that Company A should continue to follow that approach for those share options that were granted prior to January 2, 20X8, unless those share options are subsequently modified, repurchased or cancelled.[12] If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of Statement 123R. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under Statement 123R, paragraph 51(a), as the fair value of the modified share options over the fair value of the original share options measured immediately before the terms were modified.[13]

Question 2: How should Company A account for its liability awards granted to its employees prior to January 2, 20X8 which are fully vested but have not been settled by January 2, 20X8?

Interpretive Response: As a nonpublic entity, Company A had elected to measure its liability awards subject to Statement 123R at intrinsic value.[14] When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with Statement 123R.[15] In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under Statement 123R and intrinsic value. For example, assume the intrinsic value in the period ended December 31, 20X7 was $10 per award. At the end of the first reporting period ending after January 2, 20X8 (when Company A becomes a public entity), assume the intrinsic value of the award is $12 and the fair value as determined in accordance with Statement 123R is $15. The measured cost in the first reporting period after December 31, 20X7 would be $5.[16]

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[8] Defined in Statement 123R, Appendix E.

[9] For the purposes of these illustrations, assume all of Company A's equity-based awards granted to its employees were granted after the adoption of Statement 123R.

[10] For purposes of this staff accounting bulletin, the phrase "share options" is used to refer to "share options or similar instruments."

[11] Statement 123R, paragraph 23 requires a nonpublic entity to use the calculated value method when it is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. Statement 123R, paragraph A43 indicates that a nonpublic entity may be able to identify similar public entities for which share or option price information is available and may consider the historical, expected, or implied volatility of those entities' share prices in estimating expected volatility. The staff would expect an entity that becomes a public entity and had previously measured its share options under the calculated value method to be able to support its previous decision to use calculated value and to provide the disclosures required by paragraph A240(e)(2)(b) of Statement 123R.

[12] This view is consistent with the FASB's basis for rejecting full retrospective application of Statement 123R as described in Statement 123R, paragraph B251.

[13] Statement 123R, footnote 103. The staff believes that because Company A is a public entity as of the date of the modification, it would be inappropriate to use the calculated value method to measure the original share options immediately before the terms were modified.

[14] Statement 123R, paragraph 38.

[15] Statement 123R, paragraph 37.

[16] $15 fair value less $10 intrinsic value equals $5 of incremental cost.

Question 3: After becoming a public entity, may Company A retrospectively apply the fair-value-based method to its awards that were granted prior to the date Company A became a public entity?

Interpretive Response: No. Before becoming a public entity, Company A did not use the fair-value-based method for either its share options or its liability awards granted to the Company's employees. The staff does not believe it is appropriate for Company A to apply the fair-value-based method on a retrospective basis, because it would require the entity to make estimates of a prior period, which, due to hindsight, may vary significantly from estimates that would have been made contemporaneously in prior periods.[17]

Question 4: Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by Statement 123R?[18]

Interpretive Response: In the registration statement filed on January 2, 20X8, Company A should clearly describe in MD&A the change in accounting policy that will be required by Statement 123R in subsequent periods and the reasonably likely material future effects.[19] In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition, Company A should consider the applicability of SEC Release No. FR-60[20] and Section V, "Critical Accounting Estimates," in SEC Release No. FR-72[21] regarding critical accounting policies and estimates in MD&A.

[17] This view is consistent with the FASB's basis for rejecting full retrospective application of Statement 123R as described in Statement 123R, paragraph B251.

[18] Statement 123R disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242.

[19] See generally SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

[20] SEC Release No. FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

[21] SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

C. Valuation Methods

Statement 123R, paragraph 16, indicates that the measurement objective for equity instruments awarded to employees is to estimate at the grant date the fair value of the equity instruments the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. The Statement also states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement for equity and liability instruments awarded in a share-based payment transaction with employees.[22] However, if observable market prices of identical or similar equity or liability instruments are not available, the fair value shall be estimated by using a valuation technique or model that complies with the measurement objective, as described in Statement 123R.[23]

Question 1: If a valuation technique or model is used to estimate fair value, to what extent will the staff consider a company's estimates of fair value to be materially misleading because the estimates of fair value do not correspond to the value ultimately realized by the employees who received the share options?

Interpretive Response: The staff understands that estimates of fair value of employee share options, while derived from expected value calculations, cannot predict actual future events.[24] The estimate of fair value represents the measurement of the cost of the employee services to the company. The estimate of fair value should reflect the assumptions marketplace participants would use in determining how much to pay for an instrument on the date of the measurement (generally the grant date for equity awards). For example, valuation techniques used in estimating the fair value of employee share options may consider information about a large number of possible share price paths, while, of course, only one share price path will ultimately emerge. If a company makes a good faith fair value estimate in accordance with the provisions of Statement 123R in a way that is designed to take into account the assumptions that underlie the instrument's value that marketplace participants would reasonably make, then subsequent future events that affect the instrument's value do not provide meaningful information about the quality of the original fair value estimate. As long as the share options were originally so measured, changes in an employee share option's value, no matter how significant, subsequent to its grant date do not call into question the reasonableness of the grant date fair value estimate.

Question 2: In order to meet the fair value measurement objective in Statement 123R, are certain valuation techniques preferred over others?

Interpretive Response: Statement 123R, paragraph A14, clarifies that the Statement does not specify a preference for a particular valuation technique or model. As stated in Statement 123R, paragraph A8, in order to meet the fair value measurement objective, a company should select a valuation technique or model that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of Statement 123R, (b) is based on established principles of financial economic theory and generally applied in that field and (c) reflects all substantive characteristics of the instrument.

The chosen valuation technique or model must meet all three of the requirements stated above. In valuing a particular instrument, certain techniques or models may meet the first and second criteria but may not meet the third criterion because the techniques or models are not designed to reflect certain characteristics contained in the instrument. For example, for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton closed-form model would not generally be an appropriate

[22] Statement 123R, paragraph A7.

[23] Statement 123R, paragraph A8.

[24] Statement 123R, paragraph A12, states "The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future."

valuation model because, while it meets both the first and second criteria, it is not designed to take into account that type of market condition.[25]

Further, the staff understands that a company may consider multiple techniques or models that meet the fair value measurement objective before making its selection as to the appropriate technique or model. The staff would not object to a company's choice of a technique or model as long as the technique or model meets the fair value measurement objective. For example, a company is not required to use a lattice model simply because that model was the most complex of the models the company considered.

Question 3: In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?[26]

Interpretive Response: As long as the new technique or model meets the fair value measurement objective in Statement 123R as described in Question 2 above, the staff would not object to a company changing its valuation technique or model.[27] A change in the valuation technique or model used to meet the fair value measurement objective would not be considered a change in accounting principle. As such, a company would not be required to file a preferability letter from its independent accountants as described in Rule 10-01(b)(6) of Regulation S-X when it changes valuation techniques or models.[28] However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. Disclosure in the footnotes of the basis for any change in technique or model would be appropriate.[29]

Question 4: Must every company that issues share options or similar instruments hire an outside third party to assist in determining the fair value of the share options?

Interpretive Response: No. However, the valuation of a company's share options or similar instruments should be performed by a person with the requisite expertise.

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[25] See Statement 123R, paragraphs A13–17.

[26] Statement 123R, paragraph A14 and footnote 49, indicate that an entity may use different valuation techniques or models for instruments with different characteristics.

[27] The staff believes that a company should take into account the reason for the change in technique or model in determining whether the new technique or model meets the fair value measurement objective. For example, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of the Statement.

[28] Statement 123R, paragraph A23.

[29] See generally Statement 123R, paragraph 64c.

D. Certain Assumptions Used in Valuation Methods

Statement 123R's fair value measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments.[30] In order to meet this fair value measurement objective, management will be required to develop estimates regarding the expected volatility of its company's share price and the exercise behavior of its employees. The staff is providing guidance in the following sections related to the expected volatility and expected term assumptions to assist public entities in applying those requirements.

The staff understands that companies may refine their estimates of expected volatility and expected term as a result of the guidance provided in Statement 123R and in sections (1) and (2) below. Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes.[31]

1. Expected Volatility

Statement 123R, paragraph A31, states, "Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require an estimate of expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the share can be expected to vary — up or down. Because an option's value is unaffected by expected negative returns on the shares, other things [being] equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility."

Facts: Company B is a public entity whose common shares have been publicly traded for over twenty years. Company B also has multiple options on its shares outstanding that are traded on an exchange ("traded options"). Company B grants share options on January 2, 20X6.

Question 1: What should Company B consider when estimating expected volatility for purposes of measuring the fair value of its share options?

Interpretive Response: Statement 123R does not specify a particular method of estimating expected volatility. However, the Statement does clarify that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option.[32] Statement 123R provides a list of factors entities should consider in estimating expected volatility.[33] Company B may begin its process of estimating expected volatility by considering its historical volatility.[34] However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility.[35] Implied volatility[36] can be useful in estimating expected volatility because it is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility.

[30] Statement 123R, paragraph A2.

[31] Statement 123R, paragraph A240(e).

[32] Statement 123R, paragraph B86.

[33] Statement 123R, paragraph A32.

[34] Statement 123R, paragraph A34.

[35] Statement 123R, paragraph A34.

[36] Implied volatility is the volatility assumption inherent in the market prices of a company's traded options or other financial instruments that have option-like features. Implied volatility is derived by entering the market price of the traded financial instrument, along with assumptions specific to the financial options being valued, into a model based on a constant volatility estimate (e.g., the Black-Scholes-Merton closed form model) and solving for the unknown assumption of volatility.

The staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility. The staff believes companies that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. The extent of the ultimate reliance on implied volatility will depend on a company's facts and circumstances; however, the staff believes that a company with actively traded options or other financial instruments with embedded options[37] generally could place greater (or even exclusive) reliance on implied volatility. (See the Interpretive Responses to Questions 3 and 4 next page.)

The process used to gather and review available information to estimate expected volatility should be applied consistently from period to period. When circumstances indicate the availability of new or different information that would be useful in estimating expected volatility, a company should incorporate that information.

Question 2: What should Company B consider if computing historical volatility?[38]

Interpretive Response: The following should be considered in the computation of historical volatility:

1. Method of Computing Historical Volatility — The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B's expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term[39] of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B's historical volatility much more heavily than earlier periods.[40] For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history.[41]

2. Amount of Historical Data — Statement 123R, paragraph A32(a), indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

3. Frequency of Price Observations — Statement 123R, paragraph A32(d), indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility

[37] The staff believes implied volatility derived from embedded options can be utilized in determining expected volatility if, in deriving the implied volatility, the company considers all relevant features of the instruments (e.g., value of the host instrument, value of the option, etc.). The staff believes the derivation of implied volatility from other than simple instruments (e.g., a simple convertible bond) can, in some cases, be impracticable due to the complexity of multiple features.

[38] See Statement 123R, paragraph A32.

[39] For purposes of this staff accounting bulletin, the phrase "expected or contractual term, as applicable" has the same meaning as the phrase "expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of an employee share option."

[40] Statement 123R, paragraph A32(a), states that entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. Accordingly, the staff believes methods that place extreme emphasis on the most recent periods may be inconsistent with this guidance.

[41] Generalized Autoregressive Conditional Heteroskedasticity ("GARCH") is an example of a method that demonstrates this characteristic.

if the history provides enough data points on which to base the estimate.[42] Company B should select a consistent point in time within each interval when selecting data points.[43]

4. Consideration of Future Events — The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option.[44] Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

5. Exclusion of Periods of Historical Data — In some instances, due to a company's particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility.[45] In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff believes these situations would be rare.

Question 3: What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

Interpretive Response: To achieve the objective of estimating expected volatility as stated in paragraph B86 of Statement 123R, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and 4) the similarity of the length of the term of the traded and employee share options.[46]

1. Volume of Market Activity — The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect a marketplace participant's expectations regarding expected volatility.

2. Synchronization of the Variables — Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

[42] Further, if shares of a company are thinly traded the staff believes the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations. The volatility calculation using daily observations for such shares could be artificially inflated due to a larger spread between the bid and asked quotes and lack of consistent trading in the market.

[43] Statement 123R, paragraph A34, states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, Statement 123R, paragraph A23, indicates that assumptions used to estimate the fair value of instruments granted to employees should be determined in a consistent manner from period to period.

[44] Technical Bulletin 90-1, paragraph 4.

[45] Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FIN 45, subject to a scope exception from the initial recognition and measurement provisions.

[46] See generally Options, Futures, and Other Derivatives by John C. Hull (Prentice Hall, 5th Edition, 2003).

3. Similarity of the Exercise Prices — The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant.[47] If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.[48]

4. Similarity of Length of Terms — The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share option's contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater.[49] However, when using traded options with a term of less than one year[50] the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option.

The staff believes Company B's evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the market's expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.

Question 4: Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?

Interpretive Response: As stated above, Statement 123R does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity's estimate of expected volatility be reasonable and supportable.[51] Many of the factors listed in Statement 123R are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in Statement 123R, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option.[52] The staff believes that a company, after considering the factors listed in Statement 123R, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

The staff would not object to Company B placing exclusive reliance on implied volatility when the following factors are present, as long as the methodology is consistently applied:

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[47] Implied volatilities of options differ systematically over the "moneyness" of the option. This pattern of implied volatilities across exercise prices is known as the "volatility smile" or "volatility skew." Studies such as "Implied Volatility" by Stewart Mayhew, Financial Analysts Journal, July-August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

[48] The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of $52, but the only traded options available have exercise prices of $50 and $55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of $55 and 60% weight on the option with an exercise price of $50.

[49] The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.

[50] The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.

[51] Statement 123R, paragraphs A31–A32.

[52] Statement 123R, paragraph B86.

- Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options;[53]
- The implied volatility is derived from options that are actively traded;
- The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;
- The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options; [54] and
- The remaining maturities of the traded options on which the estimate is based are at least one year.

The staff would not object to Company B placing exclusive reliance on historical volatility when the following factors are present, so long as the methodology is consistently applied:

- Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past;[55]
- The computation of historical volatility uses a simple average calculation method;
- A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and
- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.56

Question 5: What disclosures would the staff expect Company B to include in its financial statements and MD&A regarding its assumption of expected volatility?

Interpretive Response: Statement 123R, paragraph A240, prescribes the minimum information needed to achieve the Statement's disclosure objectives.[57] Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it.[58] Accordingly, the staff expects that at a minimum Company B would disclose in a footnote to its financial statements how it determined the expected volatility assumption for purposes of determining the fair value of its share options in accordance with Statement 123R. For example, at a minimum, the staff would expect Company B to disclose whether it used only implied volatility, historical volatility, or a combination of both.

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[53] Statement 123R, paragraphs A15 and A33, discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the option's contractual term should consider the factors listed in Statement 123R, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.

[54] When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.

[55] See Statement 123R, paragraph B87. A change in a company's business model that results in a material alteration to the company's risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company's business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.

[56] If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.

[57] Statement 123R disclosure requirements are included in paragraphs 64, 65, A240, A241, and A242.

[58] Statement 123R, paragraph A240(e)(2)(b).

In addition, Company B should consider the applicability of SEC Release No. FR 60 and Section V, "Critical Accounting Estimates," in SEC Release No. FR-72 regarding critical accounting policies and estimates in MD&A. The staff would expect such disclosures to include an explanation of the method used to estimate the expected volatility of its share price. This explanation generally should include a discussion of the basis for the company's conclusions regarding the extent to which it used historical volatility, implied volatility or a combination of both. A company could consider summarizing its evaluation of the factors listed in Questions 2 and 3 of this section as part of these disclosures in MD&A.

Facts: Company C is a newly public entity with limited historical data on the price of its publicly traded shares and no other traded financial instruments. Company C believes that it does not have sufficient company specific information regarding the volatility of its share price on which to base an estimate of expected volatility

Question 6: What other sources of information should Company C consider in order to estimate the expected volatility of its share price?

Interpretive Response: Statement 123R provides guidance on estimating expected volatility for newly public and nonpublic entities that do not have company specific historical or implied volatility information available.[59] Company C may base its estimate of expected volatility on the historical, expected or implied volatility of similar entities whose share or option prices are publicly available. In making its determination as to similarity, Company C would likely consider the industry, stage of life cycle, size and financial leverage of such other entities.[60]

The staff would not object to Company C looking to an industry sector index (e.g., NASDAQ Computer Index) that is representative of Company C's industry, and possibly its size, to identify one or more similar entities.[61] Once Company C has identified similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its share price as an assumption in its valuation model.[62] Because of the effects of diversification that are present in an industry sector index, Company C should not substitute the volatility of an index for the expected volatility of its share price as an assumption in its valuation model.[63]

After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to Company C. Until Company C has sufficient information available, the staff would not object to Company C basing its estimate of expected volatility on the volatility of similar entities for those periods for which it does not have sufficient information available.[64] Until Company C has either a sufficient amount of historical information regarding the volatility of its share price or other traded financial instruments are available to derive an implied volatility to support an estimate of expected volatility, it should consistently apply a process as described above to estimate expected volatility based on the volatilities of similar entities.[65]

[59] Statement 123R, paragraphs A22 and A43.

[60] Statement 123R, paragraph A22.

[61] If a company operates in a number of different industries, it could look to several industry indices. However, when considering the volatilities of multiple companies, each operating only in a single industry, the staff believes a company should take into account its own leverage, the leverages of each of the entities, and the correlation of the entities' stock returns.

[62] Statement 123R, paragraph A45.

[63] Statement 123R, paragraph A22.

[64] Statement 123R, paragraph A32(c). The staff believes that at least two years of daily or weekly historical data could provide a reasonable basis on which to base an estimate of expected volatility if a company has no reason to believe that its future volatility will differ materially during the expected or contractual term, as applicable, from the volatility calculated from this past information. If the expected or contractual term, as applicable, of a share option is shorter than two years, the staff believes a company should use daily or weekly historical data for at least the length of that applicable term.

[65] Statement 123R, paragraph A34.

2. Expected Term

Statement 123R, paragraph A26, states "The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to the holder to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable [or tradable] share options in that employees cannot sell (or hedge) their share options — they can only exercise them; because of this, employees generally exercise their options before the end of the options' contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the option's value [compared to a transferable option] because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value." Accordingly, Statement 123R requires that when valuing an employee share option under the Black-Scholes-Merton framework the fair value of employee share options be based on the share options' expected term rather than the contractual term.

The staff believes the estimate of expected term should be based on the facts and circumstances available in each particular case. Consistent with our guidance regarding reasonableness immediately preceding Topic 14.A, the fact that other possible estimates are later determined to have more accurately reflected the term does not necessarily mean that the particular choice was unreasonable. The staff reminds registrants of the expected term disclosure requirements described in Statement 123R, paragraph A240(e)(2)(a).

Facts: Company D utilizes the Black-Scholes-Merton closed-form model to value its share options for the purposes of determining the fair value of the options under Statement 123R. Company D recently granted share options to its employees. Based on its review of various factors, Company D determines that the expected term of the options is six years, which is less than the contractual term of ten years.

Question 1: When determining the fair value of the share options in accordance with Statement 123R, should Company D consider an additional discount for nonhedgability and nontransferability?

Interpretive Response: No. Statement 123R, paragraphs A26 and B82, indicates that nonhedgability and nontransferability have the effect of increasing the likelihood that an employee share option will be exercised before the end of its contractual term. Nonhedgability and nontransferability therefore factor into the expected term assumption (in this case reducing the term assumption from ten years to six years), and the expected term reasonably adjusts for the effect of these factors. Accordingly, the staff believes that no additional reduction in the term assumption or other discount to the estimated fair value is appropriate for these particular factors.[66]

Question 2: Should forfeitures or terms that stem from forfeitability be factored into the determination of expected term?

Interpretive Response: No. Statement 123R indicates that the expected term that is utilized as an assumption in a closed-form option-pricing model or a resulting output of a lattice option pricing model when determining the fair value of the share options should not incorporate restrictions or other terms that stem from the pre-vesting forfeitability of the instruments. Under Statement 123R, these prevesting restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for which employees render the requisite service.[67]

[66] The staff notes the existence of academic literature that supports the assertion that the Black-Scholes-Merton closed-form model, with expected term as an input, can produce reasonable estimates of fair value. Such literature includes J. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial Economics, May 1998, pp.127–158; C. Marquardt, "The Cost of Employee Stock Option Grants: An Empirical Analysis," Journal of Accounting Research, September 2002, p. 1191–1217); and J. Bettis, J. Bizjak and M. Lemmon, "Exercise behavior, valuation, and the incentive effect of employee stock options," Journal of Financial Economics, forthcoming, 2005.

[67] Statement 123R, paragraph 18.

Question 3: Can a company's estimate of expected term ever be shorter than the vesting period?

Interpretive Response: No. The vesting period forms the lower bound of the estimate of expected term.[68]

Question 4: Statement 123R, paragraph A30, indicates that an entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term, regardless of the valuation technique or model used to estimate the fair value. How many groupings are typically considered sufficient?

Interpretive Response: As it relates to employee groupings, the staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.[69]

Question 5: What approaches could a company use to estimate the expected term of its employee share options?

Interpretive Response: A company should use an approach that is reasonable and supportable under Statement 123R's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in determining an exchange price for the share options.[70] If, in developing its estimate of expected term, a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the staff will not object to the use of the historical share option exercise experience to estimate expected term.[71]

A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants,[72] or a lack of variety of price paths that the company may have experienced.[73]

Statement 123R describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model.[74] In addition, Statement 123R, paragraph A29, states "…expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research." For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative information may not be widely available

[68] Statement 123R, paragraph A28a.

[69] The staff believes the focus should be on groups of employees with significantly different expected exercise behavior. Academic research suggests two such groups might be executives and non-executives. A study by S. Huddart found executives and other senior managers to be significantly more patient in their exercise behavior than more junior employees. (Employee rank was proxied for by the number of options issued to that employee.) See S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115–142. See also S. Huddart and M. Lang, "Employee stock option exercises: An empirical analysis," Journal of Accounting and Economics, 1996, pp. 5–43.

[70] Statement 123R, paragraph A10.

[71] Historical share option exercise experience encompasses data related to share option exercise, postvesting termination, and share option contractual term expiration.

[72] For example, if a company had historically granted share options that were always in-the-money, and will grant at-the-money options prospectively, the exercise behavior related to the in-the-money options may not be sufficient as the sole basis to form the estimate of expected term for the at-the-money grants.

[73] For example, if a company had a history of previous equity-based share option grants and exercises only in periods in which the company's share price was rising, the exercise behavior related to those options may not be sufficient as the sole basis to form the estimate of expected term for current option grants.

[74] Statement 123R, paragraph A27.

at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data.

Facts: Company E grants equity share options to its employees that have the following basic characteristics:[75]

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;[76]
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
- The share options are nontransferable and nonhedgeable.

Company E utilizes the Black-Scholes-Merton closed-form model for valuing its employee share options.

Question 6: As share options with these "plain-vanilla" characteristics have been granted in significant quantities by many companies in the past, is the staff aware of any "simple" methodologies that can be used to estimate expected term?

Interpretive Response: As noted above, the staff understands that an entity that chooses not to rely on its historical exercise data may find that certain alternative information, such as exercise data relating to employees of other companies, is not easily obtainable. As such, in the short term, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, the staff will accept the following "simplified" method for "plain vanilla" options consistent with those in the fact set above: expected term = ((vesting term + original contractual term) / 2). Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years.[77]

Academic research on the exercise of options issued to executives provides some general support for outcomes that would be produced by the application of this method.[78] If a company elects to use this method, it should be applied consistently to all "plain vanilla" employee share options, and the company should disclose the use of the method in the notes to its financial statements. Companies that have the information (from whatever source) to make more refined estimates of expected term may choose not to apply this simplified method. In addition, this simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

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[75] Employee share options with these features are sometimes referred to as "plain-vanilla" options.

[76] In this fact pattern, the requisite service period equals the vesting period.

[77] Calculated as [[[1 year vesting term (for the first 25% vested) plus 2 year vesting term (for the second 25% vested) plus 3 year vesting term (for the third 25% vested) plus 4 year vesting term (for the last 25% vested)] divided by 4 total years of vesting] plus 10 year contractual life] divided by 2; that is, (((1+2+3+4)/4) + 10) /2 = 6.25 years.

[78] J.N. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial Economics, 1998, pp.127–158 studies a sample of 40 NYSE and AMEX firms over the period 1979–1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The "mean time to exercise" is shorter than expected term since the study's sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bizjak; and Michael L. Lemmon, "Exercise behavior, valuation, and the incentive effects of employee stock options," forthcoming in the Journal of Financial Economics. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115–142.

Also, as noted above, the staff believes that more detailed information about exercise behavior will, over time, become readily available to companies. As such, the staff does not expect that such a simplified method would be used for share option grants after December 31, 2007, as more detailed information should be widely available by then.

E. Statement 123R and Certain Redeemable Financial Instruments

Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer.[79] Statement 123R provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as liabilities; however, some redeemable instruments will qualify for equity classification.[80] SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks,"*[81] ("ASR 268") and related guidance[82] address the classification and measurement of certain redeemable equity instruments.

Facts: Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder's option, but only after six months from the date of share issuance (as defined in Statement 123R). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of Statement 123R. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e.g., redemption at the option of the holder) that are outside the control of the issuer.

Question 1: While the instruments are subject to Statement 123R,[83] is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under Statements 123R?

Interpretive Response: Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under Statement 123R result in the need to present certain amounts outside of permanent equity (also referred to as being presented in "temporary equity") in accordance with ASR 268 and related guidance.[84]

When an instrument ceases to be subject to Statement 123R and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

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[79] The terminology "outside the control of the issuer" is used to refer to any of the three redemption conditions described in Rule 5-02.28 of Regulation S-X that would require classification outside permanent equity. That rule requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer.

[80] Statement 123R, paragraphs 28–35 and A225–A232.

[81] ASR 268, July 27, 1979, Rule 5-02.28 of Regulation S-X.

[82] Related guidance includes EITF Abstracts Topic No. D-98, Classification and Measurement of Redeemable Securities ("Topic D-98").

[83] Statement 123R, paragraph A231, states that an instrument ceases to be subject to Statement 123R when "the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service)."

[84] Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which paragraphs 14–18 of EITF Issue 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, would otherwise require the assumption of net cash settlement. See Statement 123R, footnote 152 to paragraph B121, which states, in part: "…Issue 00-19 specifies that events or actions necessary to deliver registered shares are not controlled by a company and, therefore, except under limited circumstances, such provisions would require a company to assume that the contract would be net-cash settled.…Thus, employee share options might be classified as substantive liabilities if they were subject to Issue 00-19; however, for purposes of this Statement, the Board does not believe that employee share options should be classified as liabilities based solely on that notion." See also Statement 123R, footnote 20.

Question 2: How should Company F apply ASR 268 and related guidance to the shares (or share options) granted under the share-based payment arrangements with employees that may be unvested at the date of grant?

***Interpretive Response*:** Under Statement 123R, when compensation cost is recognized for instruments classified as equity instruments, additional paid-incapital[85] is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuer's control but are classified as equity instruments under Statement 123R.

The staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under Statement 123R is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable stock that qualifies for equity classification under Statement 123R is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic[86] value of the option should be presented as temporary equity at that date.

Question 3: Would the methodology described for employee awards in the Interpretive Response to Question 2 above apply to nonemployee awards to be issued in exchange for goods or services with similar terms to those described above?

Interpretive Response: See Topic 14.A for a discussion of the application of the principles in Statement 123R to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

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[85] Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

[86] The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

F. Classification of Compensation Expense Associated With Share-Based Payment Arrangements

Facts: Company G utilizes both cash and share-based payment arrangements to compensate its employees and nonemployee service providers. Company G would like to emphasize in its income statement the amount of its compensation that did not involve a cash outlay.

Question: How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?

Interpretive Response: The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees.[87] The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements. Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

[87] Statement 123R does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

G. Non-GAAP Financial Measures

Facts: Company H, a calendar year company, adopts Statement 123R as of July 1, 2005. Company H has issued share options to its employees each year since issuing publicly traded stock twenty years ago. In the MD&A section of its 2005 Form 10-K, Company H believes it would be useful to investors to disclose what net income would be before considering the effect of accounting for share-based payment transactions in accordance with Statement 123R.

Question 1*:* Does the resulting measure, "Net Income Before Share-Based Payment Charge," or an equivalent measure, meet the definition of a non-GAAP measure in Regulation G and Item 10(e) of Regulation S-K?[88]

Interpretive Response: Yes. Because the financial measure Company H is considering excludes an amount (share-based payment expense) that is included in the most directly comparable measure calculated and presented in accordance with GAAP (net income), it would be considered a non-GAAP financial measure pursuant to the provisions of Regulation G and Item 10(e) of Regulation S-K.

Question 2: Is the measure "Net Income Before Share-Based Payment Charge," or an equivalent measure, a prohibited non-GAAP measure pursuant to Item 10(e) of Regulation S-K?

Interpretive Response: Item 10(e) prohibits the inclusion of certain non-GAAP financial measures and also mandates specific disclosures for registrants that include permitted non-GAAP financial measures in filings. Generally, under Item 10(e) of Regulation S-K, a company may not present a non-GAAP performance measure that removes an expense from net income by identifying that expense as non-recurring, infrequent, or unusual if it is reasonably likely that the expense will recur within two years or if the company had a similar expense within the prior two years. The staff issued Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003. Question 8 discusses whether it is appropriate to eliminate or smooth an item that is identified as recurring. The staff answered the question in part by stating "Companies should never use a non-GAAP financial measure in an attempt to smooth earnings. Further, while there is no per se prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance."

The staff believes that a measure used by the management of Company H that excludes share-based payments internally to evaluate performance may be relevant disclosure for investors. In these cases, if Company H determines that the non-GAAP financial measure "Net Income Before Share-Based Payment Charge" does not violate any of the prohibitions from inclusion in filings with the Commission outlined in Item 10(e) of Regulation S-K, Company H's management would be required to disclose, among other items, the following:

- The reasons that the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations; and

- To the extent material, the additional purposes, if any, for which the company's management uses the non-GAAP financial measure that are not otherwise disclosed.[89]

In addition, the staff's response to Question 8 included in Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003 notes that the inclusion of a non-GAAP financial measure may be misleading absent the following disclosures:

- The manner in which management uses the non-GAAP measure to conduct or evaluate its business;

[88] 17 CFR 229.10(e). All references to Item 10(e) of Regulation S-K also includes corresponding provisions of Item 10(h) of Regulation S-B with respect to small business issuers as well as US GAAP information of foreign private issuers under General Instruction C(e) of Form 20-F.

[89] 17 CFR 229.10(e)(1).

- The economic substance behind management's decision to use such a measure;
- The material limitations associated with use of the non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure;
- The manner in which management compensates for these limitations when using the non-GAAP financial measure; and
- The substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.

Question 3: How could Company H demonstrate the effect of accounting for share-based payment transactions in accordance with Statement 123R and Regulation G and Item 10(e) of Regulation S-K in its Form 10-K?

Interpretive Response: The staff believes that including a discussion in MD&A addressing significant trends and variability of a company's earnings and changes in the significant components of certain line items is important to assist an investor in understanding the company's performance. The staff also understands that expenses from share-based payments might vary in different ways and for different reasons than would other expenses. In particular, the staff believes Company H's investors would be well served by disclosure in MD&A that explains the components of the company's expenses, including, if material, identification of the amount of expense associated with share-based payment transactions and discussion of the reasons why such amounts have fluctuated from period to period.

Question 4: Would the staff object to Company H including a pro-forma income statement in its SEC filings that removes from net income the effects of accounting for share-based payment arrangements in accordance with Statement 123R?

Interpretive Response: Yes. Removal of the effects of accounting for sharebased payment arrangements in accordance with Statement 123R would not meet any of the conditions in Rule 11-01(a) of Regulation S-X for presentation of pro forma financial information. Further, the removal of the effects of accounting for share-based payment arrangements in accordance with Statement 123R would not meet any of the conditions in Rule 11-02(b)(6) of Regulation S-X to be reflected as a pro forma adjustment in circumstances where pro forma financial information is required under Rule 11-01(a) of Regulation S-X for other transactions such as recent or probable business combinations.

In addition, Item 10(e) of Regulation S-X prohibits presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X. Further, a company may not present non-GAAP financial measures on the face of the company's financial statements prepared in accordance with GAAP or in the accompanying notes.

H. First Time Adoption of Statement 123R in an Interim Period

Facts: Company I's fiscal year begins on January 1, 2005. Company I plans to adopt Statement 123R on July 1, 2005, which is the beginning of its first interim period following the effective date. Company I previously recognized share based payment compensation in accordance with Opinion 25.

Question 1: What disclosures are required in Company I's Form 10-Q for the third quarter of 2005?

Interpretive Response: The disclosures required by paragraphs 64–65, 84, and A240–242 of Statement 123R should be included in the Form 10-Q for the interim period when Statement 123R is first adopted. If Company I applies the modified retrospective method[90] in other than the first interim period of a fiscal year, the staff believes that the Form 10-Q for the period of adoption should include disclosure of the effects of the adoption of Statement 123R on previously reported interim periods.[91] If Company I applies the modified prospective method,[92] the financial statements for Company I's prior interim periods and fiscal years will not reflect any restated amounts. The staff believes that Company I should disclose this fact. Regardless of the transition method chosen, Company I should also provide the disclosures required by SAB Topic 11M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, in interim and annual financial statements preceding the adoption of Statement 123R.

Facts: Company J plans to adopt Statement 123R by applying the modified retrospective method only to the preceding interim periods of its current fiscal year. Company J anticipates recording an adjustment upon the adoption of Statement 123R to reflect the cumulative effect of reclassifying certain share based payment arrangements as liabilities.

Question 2: Would Company J be required to apply the cumulative effect adjustment to the beginning of the fiscal year and to reflect the change in classification from liabilities to equity to its interim periods preceding adoption in accordance with Statement 3,[93] paragraph 10?

Interpretive Response: No. Statement 123R, paragraph 76, limits retrospective application to recording compensation cost for unvested awards based on the amounts previously determined under Statement 123 for pro forma footnote disclosure. Any adjustments to be recorded as a cumulative effect of a change in accounting principle should be recorded as of the date of adoption of Statement 123R, which may occur after the beginning of the fiscal year. Therefore, based on the guidance in Statement 123R, paragraphs 79–82, registrants are not required to apply the provisions of Statement 3, paragraph 10.

[90] Statement 123R, paragraph 76.

[91] See Statement 123R, paragraph 77.

[92] Statement 123R, paragraph 74.

[93] Statement of Financial Accounting Standards No. 3, Reporting Accounting Changes in Interim Financial Statements ("Statement 3").

I. Capitalization of Compensation Cost Related to Share-Based Payment Arrangements

Facts: Company K is a manufacturing company that grants share options to its production employees. Company K has determined that the cost of the production employees' service is an inventoriable cost. As such, Company K is required to initially capitalize the cost of the share option grants to these production employees as inventory and later recognize the cost in the income statement when the inventory is consumed.[94]

Question: If Company K elects to adjust its period end inventory balance for the allocable amount of share-option cost through a period end adjustment to its financial statements, instead of incorporating the share-option cost through its inventory costing system, would this be considered a deficiency in internal controls?

Interpretive Response: No. Statement 123R does not prescribe the mechanism a company should use to incorporate a portion of share-option costs in an inventory-costing system. The staff believes Company K may accomplish this through a period end adjustment to its financial statements. Company K should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment. The fact that the entry is recorded as a period end adjustment, by itself, should not impact management's ability to determine that the internal control over financial reporting, as defined by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002,[95] is effective.

[94] Statement 123R, paragraph 5.

[95] Release No. 34-47986, June 5, 2003, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.

J. Accounting for Income Tax Effects of Share-Based Payment Arrangements Upon Adoption of Statement 123R

Facts: In accordance with Statement 123R, reporting entities will need to determine whether deductions reported on tax returns for share-based payment awards exceed or are less than the cumulative compensation cost recognized for financial reporting. If the deductions exceed the cumulative compensation cost recognized for financial reporting, the entity generally should record any resulting excess tax benefits as additional paid-in capital. If deductions are less than the cumulative compensation cost recognized for financial reporting, the entity should record the write-off of the deferred tax asset, net of the related valuation allowance, against any remaining additional paid-in capital from previous awards accounted for in accordance with the fair value method of Statement 123 or Statement 123R, as applicable. The remaining balance, if any, of the write-off of the deferred tax asset shall be recognized in the income statement.[96]

Company L is an entity that previously recognized employee share-based payment costs under the intrinsic value method of Opinion 25. In this situation, Statement 123R states that Company L "shall calculate the amount available for offset [in additional paid-in capital] as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method."[97]

Question: When is Company L required to calculate the additional paid-in capital from previous share-based payment awards that is available for offset against the write-off of a deferred tax asset?

Interpretive Response: Statement 123R will necessitate the tracking of tax attributes relating to share-based payment transactions with employees for a number of reasons, including the requirements related to any required write-off of excess deferred tax assets upon settlement of a share option. While it is important that appropriate detailed information be available when needed for consideration, the timing as to when such information actually affects financial reporting will vary from company to company. In preparation for the adoption of Statement 123R, Company L should evaluate the level of detail which may be required considering its particular facts and circumstances.

Statement 123R is silent as to when the additional paid-in capital available for offset should be calculated. However, the staff notes that Company L would not be required to calculate the additional paid-in capital available for offset by the date it adopts Statement 123R. In addition, the staff notes that Statement 123R does not require disclosure of the additional paid-in capital available for offset.[98] The staff believes that Company L need only calculate the additional paid-in capital available for offset if and when Company L faces a situation in which deductions reported on its tax return are less than the relevant deferred tax asset. In addition, Company L need only perform the calculations periodically to the extent necessary to conclude that sufficient paid-in capital is available for the offset of the deduction shortfall.

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[96] Statement 123R, paragraph 63.

[97] Ibid.

[98] Statement 123R's disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242.

K. Modification of Employee Share Options Prior to Adoption of Statement 123R

Facts: Company M is a public entity that historically applied the recognition provisions of Opinion 25 and intends to transition to Statement 123R under the modified prospective method of application.[99] In prior periods, Company M granted at-the-money share options to its employees in which the exercisability of the options is conditional only on performing service through the vesting date.[100] Since the time of grant, Company M's share price has fallen such that the share options are out-of-the-money. Prior to adoption of Statement 123R the share options are still unvested, and Company M intends to modify these unvested share options to accelerate the vesting. Company M has determined that the modification to accelerate vesting will not require recognition of compensation cost in its financial statements in the period of the modification under the provisions of Opinion 25.[101] However, Company M intends to reflect the compensation cost related to the modification in its fair value pro forma disclosures under Statement 123,[102] in the period the modification is made.

Question: Would the staff object to Company M reflecting the remaining compensation cost related to these share options in the fair value pro forma disclosures required under Statement 123 as a result of the modification in the period in which the modification was enacted?

Interpretive Response: No. The staff believes that an acceptable interpretation of Statement 123 is that the modification to accelerate the vesting of such share options would result in the recognition of the remaining amount of compensation cost in the period the modification is made, so long as the acceleration of vesting permits employees to exercise the share options in a circumstance when they would not otherwise have been able to do so absent the modification. The staff notes that the service period definition in Statement 123[103] indicates, "If the service period is not defined as an earlier or shorter period, it shall be presumed to be the vesting period." After the modification, Company M's share options will be vested pursuant to the awards' terms. Accordingly, under this interpretation, there is no remaining service period and any remaining unrecognized service cost for those share options should be recognized at the date of the modification. The staff believes that since the remaining unrecognized compensation cost is accelerated and recognized at the date of modification, no compensation cost would be recognized for these modified share options in the income statement in the periods after adoption of Statement 123R, absent any further modifications.

The staff reminds public entities that Statement 123, paragraph 47, indicates that for each year an income statement is provided, the terms of significant modifications of outstanding awards shall be disclosed. In order to inform investors about modification transactions and management's reasons for entering into those transactions, the staff believes that public entities should specifically disclose any modifications to accelerate the vesting of out-of-the-money share options in anticipation of adopting Statement 123R, including the reasons for modifying the option terms.

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[99] Statement 123R, paragraph 74.

[100] The terms of these share options do not define the service period as being other than the vesting period.

[101] See FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, paragraph 36, which requires the recognition of compensation expense under Opinion 25 due to a modification of a share-based payment award only if, absent the acceleration of vesting, the award would have otherwise been forfeited during the vesting period pursuant to its original terms.

[102] Statement 123, paragraph 45, as amended by Statement 148, Accounting for Stock-Based Compensation — Transition and Disclosure ("Statement 148").

[103] Statement 123, Appendix E.

L. Application of the Measurement Provisions of Statement 123R to Foreign Private Issuers[104]

Question: Does the staff believe there are differences in the measurement provisions for share-based payment arrangements with employees under International Accounting Standards Board International Financial Reporting Standard 2, Share-based Payment ("IFRS 2") and Statement 123R that would result in a reconciling item under Item 17 or 18 of Form 20-F?

Interpretive Response: The staff believes that application of the guidance provided by IFRS 2 regarding the measurement of employee share options would generally result in a fair value measurement that is consistent with the fair value objective stated in Statement 123R.[105] Accordingly, the staff believes that application of Statement 123R's measurement guidance would not generally result in a reconciling item required to be reported under Item 17 or 18 of Form 20-F for a foreign private issuer that has complied with the provisions of IFRS 2 for share-based payment transactions with employees. However, the staff reminds foreign private issuers that there are certain differences between the guidance in IFRS 2 and Statement 123R that may result in reconciling items.[106]

[104] As defined in Regulation C §230.405.

[105] Statement 123R, paragraph A2.

[106] Statement 123R, paragraphs B258-B269, identify the more significant differences between IFRS 2 and Statement 123R.

M. Disclosures in MD&A Subsequent to Adoption of Statement 123R

Question: What disclosures should companies consider including in MD&A to highlight the effects of 1) differences between the accounting for share-based payment arrangements before and after the adoption of Statement 123R and 2) changes to share-based payment arrangements?

Interpretive Response: As stated in SEC Release FR-72, the principal objectives of MD&A are to give readers a view of a company through the eyes of management, to provide the context within which financial information should be analyzed and to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. The adoption of Statement 123R may result in significant differences between the financial statements of periods before and after the adoption, especially for companies with significant share-based compensation programs that have followed the recognition provisions of Opinion 25 or that adopted the fair-value based method for financial statement recognition in accordance with Statement 123 using the prospective method permitted by Statement 148. Furthermore, the staff understands that companies may refine their estimates of assumptions as a result of implementing Statement 123R and the interpretive guidance provided in this SAB. In addition, the staff understands that many companies are evaluating their share-based payment arrangements and making changes to those arrangements.

Each of these situations may affect the comparability of financial statements. Accordingly, to assist investors and other users of financial statements in understanding the financial results of a company that has adopted Statement 123R, the staff believes that companies should consider including in MD&A material qualitative and quantitative information about any of the following, as well as other information that could affect comparability of financial statements from period to period:

- Transition method selected (e.g., modified prospective application or modified retrospective application) and the resulting financial statement impact in current and future reporting periods;
- Method utilized by the company to account for share-based payment arrangements in periods prior to the adoption of Statement 123R and the impact, or lack thereof, on the prior period financial statements;
- Modifications made to outstanding share options prior to the adoption of Statement 123R and the reason(s) for the modification;
- Differences in valuation methodologies or assumptions compared to those that were used in estimating the fair value of share options under Statement 123;
- Changes in the quantity or type of instruments used in share-based payment programs, such as a shift from share options to restricted shares;
- Changes in the terms of share-based payment arrangements, such as the addition of performance conditions;
- A discussion of the one-time effect, if any, of the adoption of Statement 123R, such as any cumulative adjustments recorded in the financial statements; and
- Total compensation cost related to nonvested awards not yet recognized and the weighted average period over which it is expected to be recognized

Roadmap to Applying Statement 123(R): Appendix C — Statement 123(R) Accounting and Disclosure Checklist

This checklist summarizes the accounting and disclosure requirements of Statement 123(R) and SEC Staff Accounting Bulletin No. 107 (SAB Topic 14). Although the checklist has been designed to assist you in considering compliance with those pronouncements, it is not a substitute for your understanding of them or for the exercise of your judgment.

You are presumed to have a thorough knowledge of the pronouncements and should refer to them as necessary in considering the application of particular items in this checklist. References in the checklist are to the applicable sections of Statement 123(R), EITF Issue 96-18, and SAB Topic 14.

Statement 123(R) Accounting and Disclosure Checklist

	Yes	No	NA
I. ACCOUNTING FOR SHARE-BASED PAYMENT AWARDS UNDER STATEMENT 123(R)			
A. Scope			
1. Have the provisions of Statement 123(R) been applied to all share-based payment awards issued, modified, repurchased, or cancelled after the required effective date (or adoption date, for companies that elect to early adopt) in which an entity [Statement 123(R) ¶4, ¶70]			
a. Acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments (except for equity instruments held by an employee share ownership plan) or	—	—	—
b. Incurs liabilities to an employee or other supplier that (i) are based, at least in part, on the price of the entity's shares or other equity instruments, or (ii) require or may require settlement by issuing the entity's equity shares or other equity instruments?	—	—	—
2. Have share-based payment awards issued to an employee of the reporting entity by a related party or other holder of an economic interest in the entity been accounted for as compensation for services provided to the entity under Statement 123(R)? [Statement 123(R) ¶11]	—	—	—
B. Award Classification			
3. Has the entity applied the classification criteria in paragraphs 8–14 of Statement 150 in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction (unless Questions 4–11 below require otherwise)? [Statement 123(R) ¶29]	—	—	—
4. In determining the classification of an instrument, has the company taken into account the deferrals contained in FSP FASB 150-3? [Statement 123(R) ¶30]	—	—	—
5. Has a puttable or callable share awarded to an employee as compensation been classified as a liability if either: [Statement 123(R) ¶31]			
a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time (six months or more) from the date the requisite service is rendered and the share is issued or	—	—	—
b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time (six months or more) from the date the share is issued?	—	—	—
6. If a puttable or callable share awarded to an employee as compensation does not meet either of the criteria listed in Question 5 above, has the award been classified as equity? [Statement 123(R) ¶31]	—	—	—

	Yes	No	NA
7. Have options or similar instruments on shares been classified as liabilities if: [Statement 123(R) ¶31–32]			
a. The underlying shares are classified as liabilities,	—	—	—
b. The company can be required under any circumstance to settle the option or similar instrument by transferring cash or other assets, or	—	—	—
c. The options are puttable or callable?	—	—	—
8. If an award is indexed to another factor in addition to the company's share price, and that factor is not a market, performance, or service condition, has the award been classified as a liability and the additional factor been reflected in estimating the fair value (or calculated value) of the award? [Statement 123(R) ¶33]	—	—	—
9. For awards of share-based payments in which the choice to settle the award in cash or shares is made by the company, have the following been considered in determining the appropriate classification of such awards: [Statement 123(R) ¶34]			
a. The company's past practice in settling awards with similar terms,	—	—	—
b. The company's ability to deliver the shares, and	—	—	—
c. Any requirements to pay cash upon the occurrence of contingent events?	—	—	—
10. If provisions in a share-based payment award permit the employee to effect a broker-assisted cashless exercise of part or all of an award of share options, has the award been classified in equity only if the following criteria have been met: [Statement 123(R) ¶35, fn. 21]			
a. The cashless exercise requires a valid exercise of the share options,	—	—	—
b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option), and	—	—	—
c. A broker that is also a related party has sold the shares in the open market within a normal settlement period, which is generally three days?	—	—	—
11. If there are provisions for either direct or indirect repurchase of shares issued upon exercise of options, with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, and an amount in excess of the minimum statutory requirements is withheld (or may be withheld at the employee's discretion), has the entire award been classified and accounted for as a liability? [Statement 123(R) ¶35]	—	—	—
C. Measurement			
12. For public entities, have liability awards under a share-based payment arrangement been measured based on the award's fair value and remeasured at each reporting date until the date of settlement? [Statement 123(R) ¶37]	—	—	—
13. For nonpublic entities with liability awards, have compensation costs been measured each period until settlement based on either the change in the fair value (or calculated value) or intrinsic value of the award from the previous reporting period? [NOTE: A nonpublic entity must make a policy decision of whether to measure all of its liabilities under share-based payment arrangements at fair value or intrinsic value. Nonpublic entities that cannot reasonably estimate fair value will use the calculated value.] [Statement 123(R) ¶38]	—	—	—

	Yes	No	NA
14. Have equity instruments awarded to employees been measured at the estimated fair value at the grant date of the equity award? [Statement 123(R) ¶16] [NOTE: Observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value, and if available, should be used as the basis for the measurement of equity and liability instruments awarded in share-based payment transactions with employees.] [Statement 123(R) ¶A7]	—	—	—
15. If observable market prices of identical or similar equity or liability instruments of the entity are not available, has the fair value of such awards been estimated using a valuation technique? [Statement 123(R) ¶A8]	—	—	—
16. Has the valuation technique referred to in Question 15 above been: [Statement 123(R) ¶A8]			
a. Applied in a manner consistent with the fair value measurement objective and other requirements of Statement 123(R);	—	—	—
b. Based on established principles of financial economic theory and generally applied in that field; and	—	—	—
c. Reflective of all substantive characteristics of the instrument, except for those explicitly excluded by Statement 123(R), such as vesting conditions and reload features?	—	—	—
17. Has the valuation technique in Question 15 above taken into account, at a minimum, the following assumptions: [Statement 123(R) ¶A18]			
a. The exercise price of the option;	—	—	—
b. The expected term of the option, taking into account both the contractual term and the effects of employees' expected exercise and post-vesting employment termination behavior, including any restrictions or conditions that continue after the company has issued instruments to employees, the effects of market conditions, etc.; [Statement 123(R) ¶17, ¶19]	—	—	—
c. The current price of the underlying share;	—	—	—
d. The expected volatility of the underlying share price for the expected term of the option;	—	—	—
e. The expected dividends for the expected term of the option; and	—	—	—
f. The risk-free interest rate(s) for the expected term of the option?	—	—	—
18. Have the assumptions described in Question 17 above been based on or determined from external data or derived from the company's own historical experience (i.e., the assumptions have not represented any bias of the company)? [Statement 123(R) ¶A10] [NOTE: See paragraphs A18–A42 of Statement 123(R) for additional guidance on selecting assumptions for use in an option-pricing model.]	—	—	—
19. Have restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right have been disregarded in estimating the fair value (or calculated value) of the related instruments at grant date? [NOTE: Those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.] [Statement 123(R) ¶18, ¶48]	—	—	—
20. Have nonvested equity shares or nonvested equity share units awarded to an employee been measured at fair value as if they were vested and issued on grant date? [Statement 123(R) ¶21]	—	—	—

	Yes	No	NA
21. Have restricted shares (i.e., shares that will be restricted after the employee has a vested righted to them) awarded to employees been measured at fair value (which is the same amount for which similarly restricted shares would be issued to third parties)? [Statement 123(R) ¶21]	—	—	—
22. In the rare circumstances when it has not been possible to reasonably estimate the fair value (or calculated value) of an equity instrument at the grant date, has the instrument been accounted for based on its intrinsic value and remeasured at each reporting date through the date of exercise or other settlement? [Statement 123(R) ¶25]	—	—	—
23. Has the fair value (or calculated value) of each award of equity instruments, including an award of options with a reload feature, been measured separately based on their terms, share price, and other pertinent factors at the grant date? [Statement 123(R) ¶26]	—	—	—
24. Has the effect of contingent features been disregarded in estimating the grant-date fair value (or calculated value) of an equity instrument, and have they instead been accounted for only if and when the contingent event occurs? [An example would be a clawback feature, which may cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than the fair value (or calculated value) on the date of transfer.] [Statement 123(R) ¶27]	—	—	—
D. Recognition			
25. Have employee share purchase plans that meet all of the following criteria been accounted for as noncompensatory plans: [Statement 123(R) ¶12]			
a. The terms of the plan are no more favorable than those available to all holders of the same class of shares, nor does any purchase discount from the market price exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering; [NOTE: A purchase discount of five percent or less from the market price shall be considered to comply with this condition without further justification.]	—	—	—
b. Substantially all of the employees that meet limited employment qualifications may participate on an equitable basis; and	—	—	—
c. The plan incorporates no option features other than (i) employees are permitted a short period of time after the purchase price has been fixed to enroll in the plan (not to exceed 31 days) or (ii) the purchase price is based solely on the market price of the shares at the date of the purchase and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid.	—	—	—
26. Have compensation costs not been recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied? [Statement 123(R) ¶19]	—	—	—
27. For public entities with liability awards, have compensation costs been recorded each period until settlement based on the change in the fair value of the award from the previous reporting period? [Statement 123(R) ¶37]	—	—	—
28. For nonpublic entities with liability awards, have compensation costs been recognized each period until settlement based on either the change in the fair value (or calculated value) or intrinsic value of the award from the previous reporting period? [NOTE: A nonpublic entity must make a policy decision of whether to measure all of its liabilities under share-based payment arrangements at fair value or intrinsic value. Nonpublic entities that cannot reasonably estimate fair value will use the calculated value.] [Statement 123(R) ¶38]	—	—	—

	Yes	No	NA
29. Has the compensation cost for an award of share-based employee compensation classified as equity been recognized over the requisite service period with a corresponding credit to equity (generally, paid-in capital)? [Statement 123(R) ¶39]	—	—	—
30. Has the requisite service period referred to in Question 29 above been estimated at the grant date as the period during which an employee is required to provide service in exchange for an award, based on an analysis of the terms of the share-based payment award? [NOTE: See paragraphs A59–A74 of Statement 123(R) for additional guidance in determining explicit, implicit, and derived service periods.] [Statement 123(R) ¶39]	—	—	—
31. If an award vests upon the satisfaction of a service condition or one or more performance conditions, has the requisite service period been estimated based on the probabilities of achieving each outcome? [Statement 123(R) ¶46, ¶A63–A64]	—	—	—
32. If an award contains a market condition and a performance or service condition and the initial estimate of the requisite service period is based on the market condition's derived service period, has the requisite service period not been revised unless the following conditions have been met: [Statement 123(R) ¶A65]			
a. The market condition is satisfied before the end of the derived service period and	—	—	—
b. Satisfying the market condition is no longer the basis for determining the requisite service period?	—	—	—
33. If the beginning of the requisite service period (the service inception date) precedes the grant date, has the company accrued compensation costs for periods before the grant date based on the fair value (or calculated value) of the award at the reporting date? [Statement 123(R) ¶41]	—	—	—
34. For situations described in Question 33 above, in the period in which the grant date occurs, has the company adjusted the cumulative compensation costs to reflect the cumulative effect of measuring compensation cost based on fair value (or calculated value) at the grant date rather than the fair value (or calculated value) previously used at the service inception date? [Statement 123(R) ¶41]	—	—	—
35. For an award with only service conditions that have a graded vesting schedule, has the amount of compensation cost recognized at any date been at least equal to the portion of the grant-date fair value (or calculated value) of the award that is vested at that date? [NOTE: The company must make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule on a straight-line basis over the requisite service period (a) for each separately vesting portion of the award as if the award was, in substance, multiple awards or (b) for the entire award.] [Statement 123(R) ¶42]	—	—	—
36. Have the initial accruals of compensation cost been based on the number of instruments for which the requisite service period is expected to be rendered? [Statement 123(R) ¶43]	—	—	—
37. Have the estimates in Question 36 above been revised if subsequent information indicates that the actual number of instruments is likely to be different from previous estimates? [Statement 123(R) ¶43]	—	—	—
38. Has the cumulative effect of a change in estimate made pursuant to Question 36 above been recognized as compensation cost in the period of change? [Statement 123(R) ¶43]	—	—	—
39. Has compensation cost related to awards with a performance condition been accrued only if it is probable that the performance condition will be achieved? For awards with multiple performance conditions, has the interrelationship of all performance conditions been assessed to determine the probability of satisfying the performance conditions? [Statement 123(R) ¶44]	—	—	—

	Yes	No	NA
40. In the event that an employee renders the requisite service for a share option or share unit, and the award expires unexercised or unconverted, has the company not reversed previously recognized compensation cost? [Statement 123(R) ¶45]	—	—	—
41. If an award requires satisfaction of one or more market, performance, or service conditions, has compensation cost been recognized only if the requisite service has been rendered? [Statement 123(R) ¶47]	—	—	—
42. For awards with market, performance, and service conditions (or any combination thereof), has the final measure of compensation cost been based on the amount estimated at the grant date (i.e., grant-date fair value, or calculated value) for the condition or outcome that is actually satisfied? [NOTE: Market, performance, or service conditions that affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors shall be considered in measuring the grant-date fair value (or calculated value).] [Statement 123(R) ¶49]	—	—	—
43. For awards classified as liabilities, has the company complied with the following recognition provisions? [Statement 123(R) ¶50]			
a. Have the changes in fair value (or calculated value) or intrinsic value of a liability award that occurred during the requisite service period been recognized as compensation cost over that period?	—	—	—
b. Has the percentage of fair value (or calculated value) or intrinsic value that is accrued as compensation cost at the end of each period been equal to the percentage of requisite service that has been rendered at that date?	—	—	—
c. Have the changes in fair value (or calculated value) or intrinsic value of a liability award that occurred after the end of the requisite service period been recognized as compensation cost in the period in which the changes occur?	—	—	—
d. Has any difference between the amount for which a liability award is settled and its fair value (or calculated value) or intrinsic value at the date of settlement been recognized as an adjustment of compensation cost in the period of settlement?	—	—	—
E. Modifications			
44. In general, modifications of the terms or conditions of equity awards are treated as an exchange of the original award for a new award. Have the effects of modifications been measured as follows: [Statement 123(R) ¶51]			
a. Has incremental compensation cost been measured as the excess of the fair value (or calculated value) of the modified award over the fair value (or calculated value) of the original award immediately before its terms were modified?	—	—	—
b. Has the effect of the modification on the number of instruments expected to vest also been reflected in determining incremental compensation cost? [This estimate should also be subsequently adjusted, if necessary, in accordance with Questions 36–40 above (¶A160–A170).]	—	—	—
c. Has the total compensation cost measured at the date of modification been equal to the sum of:			
(1) The portion of the grant-date fair value (or calculated value) of the original award for which the requisite service has already been rendered (or is expected to be rendered) at that date and	—	—	—
(2) The incremental cost resulting from the modification?	—	—	—
d. Has the change in compensation cost of an equity award measured at intrinsic value in accordance with Question 22 above been measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately prior to modification?	—	—	—

	Yes	No	NA
45. Have offers by the entity that would result in modification or settlement of an award to which an award holder may subscribe for a limited period of time (short-term inducements) been accounted for as a modification of the terms of only the awards of employees who accept the inducement? [Statement 123(R) ¶52]	—	—	—
46. Have all other inducements that do not meet the description of short-term inducements in Question 45 above been accounted for as modifications of the terms of all awards subject to the inducements? [Statement 123(R) ¶52]	—	—	—
47. Have exchanges of share options or other equity instruments, or changes to their terms in conjunction with an equity restructuring or business combination, been accounted for as modifications subject to the requirements of Question 44 above? [Statement 123(R) ¶53]	—	—	—
48. If an antidilution provision has been added, has it been accounted for as a modification only if it was added in contemplation of an equity restructuring? [Statement 123(R) ¶54; ¶A156]	—	—	—
49. For repurchases or cancellations of equity instrument awards, has the company: [Statement 123(R) ¶55]			
a. Charged to equity the amount of cash or other assets transferred (or liabilities incurred) to repurchase the equity award, to the extent that the amount does not exceed the fair value (or calculated value) of the equity instruments repurchased at the repurchase date;	—	—	—
b. Recognized any excess of the purchase price over the fair value (or calculated value) of the instruments repurchased as additional compensation cost on the repurchase date; and	—	—	—
c. Recognized at the repurchase date the amount of compensation cost measured at the grant date that has not yet been recognized for repurchases of awards for which the requisite service has not yet been rendered?	—	—	—
50. Have cancellations of awards accompanied by a concurrent grant of a replacement award or other valuable consideration been accounted for in the same manner as other modifications pursuant to Question 44 above? [Statement 123(R) ¶56]	—	—	—
51. Has the company recognized any previously unrecognized compensation cost at the cancellation date for cancellations of awards that are not accompanied by a concurrent grant of a replacement award? [Statement 123(R) ¶57]	—	—	—
F. Transactions With Nonemployees			
52. Have share-based payment transactions with nonemployees been measured using the fair value that is more reliably measurable (i.e., fair value of the goods or services received or the fair value of the equity instruments issued)? [Statement 123(R) ¶7]	—	—	—
53. For share-based payment transactions with nonemployees, has the measurement date been determined to be the earlier of the following: [Statement 123(R) ¶8; EITF Issue 96-18]			
a. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a "performance commitment") or	—	—	—
b. The date at which the counterparty's performance is complete?	—	—	—
[NOTE: A performance commitment is a commitment under which performance is probable because of a sufficiently large disincentive for nonperformance. Forfeiture of the equity instruments as the sole remedy, or the ability to sue for nonperformance, in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable.]	—	—	—

	Yes	No	NA
54. For share-based payment transactions with nonemployees, when it is appropriate for the issuer to recognize any cost of the transaction prior to the measurement date, have such costs been measured at their then-current fair value at each interim reporting date, with changes in fair value between reporting dates attributed in accordance with Interpretation 28? [EITF Issue 96-18]	—	—	—
G. Income Tax Effects			
55. Has the cumulative amount of compensation cost recognized (for financial reporting purposes) for share-based payment instruments (both liability and equity awards) that ordinarily would result in a future tax deduction under existing tax law been considered to be a deductible temporary difference? [Statement 123(R) ¶59–60]	—	—	—
56. Has the difference between the deductible temporary difference from Question 55 above and the tax deduction that would result based on the current fair value (or calculated value) of the entity's shares been disregarded in measuring the gross deferred tax asset or determining the need for a valuation allowance? [Statement 123(R) ¶61]	—	—	—
57. Have the excess tax benefits that stem from a change in the fair value (or calculated value) of the company's shares between the measurement date for accounting purposes and a later measurement date for tax purposes been recognized as additional paid-in capital? [NOTE: Excess tax benefits are the result of realized tax benefits that exceed previously recognized deferred tax assets.] [Statement 123(R) ¶62]	—	—	—
58. Have the excess tax benefits that stem from a reason other than a change in the fair value (or calculated value) of the company's shares between the measurement date for accounting purposes and a later measurement date for tax purposes been recognized in the income statement? [Statement 123(R) ¶62]	—	—	—
59. Has the write-off of a deferred tax asset resulting from excess recognized cumulative compensation cost (for financial reporting purposes) over the amount deductible on the company's tax return first been offset with any remaining additional paid-in capital from excess tax benefits from previous awards? [Statement 123(R) ¶63]	—	—	—
60. Has the remaining balance, if any, from the write-off of a deferred tax asset described in Question 58 above been recognized in the income statement? [Statement 123(R) ¶63]	—	—	—
61. For companies that continued to use Opinion 25's intrinsic value method as permitted by Statement 123, has the amount available for offset as discussed in Question 59 above been calculated as the net amount of excess tax benefits that would have qualified as such had the company adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method? [Statement 123(R) ¶63]	—	—	—
62. In calculating the amount in Question 61 above, has no distinction been made between the excess tax benefits attributable to different types of equity awards? [Statement 123(R) ¶63]	—	—	—
63. In calculating the amount in Question 61 above, has the company excluded from that amount both excess tax benefits from share-based payment arrangements that are outside the scope of Statement 123(R) and excess tax benefits that have not been realized pursuant to Statement 109? [Statement 123(R) ¶63]	—	—	—
64. In calculating available excess tax benefits if deferred tax assets need to be written off in periods subsequent to adoption, has the company included only the net excess tax benefits that would have qualified as such had the company adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994? [Statement 123(R) ¶81]	—	—	—

	Yes	No	NA
65. In determining the amount in Question 64 above, has the company excluded excess tax benefits that have not been realized pursuant to Statement 109? [NOTE: Companies that previously recognized deferred tax assets for excess tax benefits that have not been realized must discontinue such practice prospectively.] [Statement 123(R) ¶81]	—	—	—
H. Transition			
66. For public companies and nonpublic companies that used the fair-value-based method for either recognition or disclosure under Statement 123, has the modified prospective application transition method been applied as of the required effective date? [NOTE: Companies can elect to apply the modified retrospective application transition method to periods before the required effective date.] [Statement 123(R) ¶71]	—	—	—
67. For nonpublic companies that used the minimum value method in Statement 123 for either recognition or pro forma disclosure: [Statement 123(R) ¶72, ¶83]			
a. Have the provisions of Statement 123(R) been applied to new awards and to awards modified, repurchased, or cancelled after the required effective date (the prospective transition method)?	—	—	—
b. Has the company continued to account for any portion of awards outstanding at the date of adoption of Statement 123(R) using the accounting principles originally applied to those awards?	—	—	—
68. For companies that are following the modified prospective application method of transition: [Statement 123(R) ¶74]			
a. Has compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date been recognized as the requisite service is rendered on or after the required effective date?	—	—	—
b. Has the compensation cost for awards in Question 68(a) above been based on the grant-date fair value (or calculated value) of those awards as calculated for either recognition or pro forma disclosure purposes under Statement 123?	—	—	—
c. Have changes to the grant-date fair value (or calculated value) of equity awards granted before the required effective date been precluded, unless inclusion of such changes are for a correction of an error?	—	—	—
d. Has any unearned or deferred compensation related to awards that were outstanding as of the required effective date been eliminated against the appropriate equity accounts?	—	—	—
69. For companies following the modified retrospective application method of transition: [Statement 123(R) ¶76–77]			
a. If the company chooses to apply this method to all prior years for which Statement 123 was effective, has the company adjusted the financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods? [NOTE: Changes to the amounts as originally measured on a pro forma basis are precluded.]	—	—	—
b. If the company applies this method to all prior years for which Statement 123 was effective and not all prior years are presented in the comparative financial statements, have the beginning balances of paid-in capital, deferred taxes and retained earnings for the earliest year presented been adjusted to reflect the results of the modified retrospective application method to those prior years not presented?	—	—	—

	Yes	No	NA
c. If the company chooses to apply this method only to the prior interim periods in the year of initial adoption, have no adjustments been made to the beginning balances of paid-in capital, deferred taxes or retained earnings?	—	—	—
70. For an instrument that had been classified as equity but is classified as a liability under Statement 123(R), has the company recognized a liability at its fair value (or calculated value) or portion thereof, if the requisite service has not been rendered? [Statement 123(R) ¶79]	—	—	—
71. If the fair value (or calculated value, or portion thereof) of the liability in Question 68 above is greater or less than previously recognized compensation cost for the instrument, has the liability been recognized: [Statement 123(R) ¶79]			
a. By reducing equity (generally, paid-in capital) to the extent of such previously recognized cost, and then	—	—	—
b. By recognizing the difference between the fair value (or calculated value) and the previously recognized compensation cost in the income statement, net of any related tax effects?	—	—	—
72. Has the amount calculated in Question 71(b) above been shown as a cumulative effect of a change in accounting principle? [Statement 123(R) ¶79]	—	—	—
73. For an outstanding instrument that previously was classified as a liability and measured at intrinsic value, has the company recognized the effect of initially measuring the liability at its fair value (or calculated value), net of any related tax effects, as a cumulative effect of a change in accounting principle? [Statement 123(R) ¶79]	—	—	—
74. Upon adoption, if the company had a policy of recognizing the effect of forfeitures only as they occurred, has the company estimated the number of outstanding instruments for which the requisite service is not expected to be rendered? [Statement 123(R) ¶80]	—	—	—
75. Have the balance sheet amounts related to any compensation cost for those instruments previously recognized in income as a result of recognizing forfeitures as they occur been eliminated and recognized in income as a cumulative effect of a change in accounting principle as of the required effective date? [Statement 123(R) ¶80]	—	—	—
76. Has no transition adjustment been made, except as required in Question 75 above, for any deferred tax assets associated with outstanding equity instruments that continue to be accounted for as equity instruments under Statement 123(R)? [Statement 123(R) ¶81]	—	—	—
77. Have outstanding equity instruments that were measured at intrinsic value under Statement 123 at the required effective date because it was not possible to reasonably estimate their grant-date fair value (or calculated value) continued to be measured at intrinsic value until they are settled? [Statement 123(R) ¶82]	—	—	—
II. DISCLOSURES REQUIRED BY STATEMENT 123(R) AND SAB TOPIC 14			
A. Disclosures			
1. Has the company made the following minimum disclosures: [Statement 123(R) ¶A240]			
a. A description of the share-based payment arrangement(s), including the general terms of the awards, such as the requisite service period(s) and any other substantive conditions (including those related to vesting), the maximum contractual term of equity (or liability) share options or similar instruments, and the number of shares authorized for awards of equity share options or other equity instruments;	—	—	—

	Yes	No	NA
b. The method used for measuring compensation cost from share-based payment arrangements with employees;	—	—	—
c. For the most recent year in which an income statement is provided:			
(1) The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):			
(a) Those outstanding at the beginning of the year,	—	—	—
(b) Those outstanding at the end of the year,	—	—	—
(c) Those exercisable or convertible at the end of the year,	—	—	—
(d) Those granted during the year,	—	—	—
(e) Those exercised or converted during the year,	—	—	—
(f) Those forfeited during the year, and	—	—	—
(g) Those expired during the year.	—	—	—
(2) The number and weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards in which fair value cannot be reasonably estimated) of equity instruments not specified in Question 1(c)(1) above (e.g., shares of nonvested stock), for each of the following groups of equity instruments:			
(a) Those nonvested at the beginning of the year,	—	—	—
(b) Those nonvested at the end of the year,	—	—	—
(c) Those granted during the year,	—	—	—
(d) Those vested during the year, and	—	—	—
(e) Those forfeited during the year.	—	—	—
d. For each year for which an income statement is provided:			
(1) The weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards in which fair value can not be reasonably estimated) of equity options or other equity instruments granted during the year; and	—	—	—
(2) The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.	—	—	—
e. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position:			
(1) The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding; and	—	—	—
(2) The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic companies), and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).	—	—	—

	Yes	No	NA
f. For each year in which an income statement is presented: [NOTE: An entity that uses the intrinsic value method for awards in which the fair value can not be reasonably estimated is not required to disclose the following information for awards accounted for under that method.]			
(1) A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements; and	—	—	—
(2) A description of the significant assumptions used during the year to estimate fair value (or calculated value) of share-based compensation awards, including, if applicable:			
(a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and post-vesting employment termination behavior into the fair value (or calculated value) of the instrument;	—	—	—
(b) Expected volatility of the entity's shares and the method used to determine it, or for companies that use a method that employs different volatilities during the contractual term of the award, the range of expected volatilities used and the weighted-average expected volatility;	—	—	—
(c) For nonpublic companies that use the calculated method, the reasons why it is not practicable to estimate the expected volatility of the company's share price, the appropriate industry sector index the company has selected, the reasons for selecting that particular index, and how the company has calculated historical volatility using that index;	—	—	—
(d) Expected dividends, or for companies that use a method that employs different dividend rates during the contractual terms of the award, the range of expected dividends used and the weighted-average expected dividends;	—	—	—
(e) Risk-free rate(s), or for companies that use a method that employs different risk-free rates, the range of risk-free rates used; and	—	—	—
(f) Discount for post-vesting restrictions and the method for estimating it.	—	—	—
g. Have the disclosures required in Question 1a.–f. above been provided separately for each share-based payment arrangement in situations where the company grants equity or liability instruments under multiple share-based payment arrangements with employees to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the company's use of share-based compensation?	—	—	—
h. For each year in which an income statement is presented:			
(1) Total compensation cost for share-based payment arrangements recognized in income as well as the total recognized tax benefit related thereto;	—	—	—
(2) Total compensation cost capitalized as part of the cost of an asset; and	—	—	—
(3) A description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications.	—	—	—
i. As of the balance-sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized;	—	—	—

	Yes	No	NA
j. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period;	—	—	—
k. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements;	—	—	—
l. A description of the company's policy, if any, for issuing shares upon share option exercise (or unit share conversion) including the source of those shares (i.e., new shares or treasury shares);	—	—	—
m. An estimate of the amount or range of shares to be repurchased in the following annual period as a result of the policy described in Question 1(ℓ) above.	—	—	—
2. In the period in which Statement 123(R) is first adopted, has the company disclosed the effect of the change from applying the original provisions of Statement 123 on income from continuing operations, income before income taxes, net income, cash flow from operations, cash flow from financing activities, and basic and diluted earnings per share? [Statement 123(R) ¶84]	—	—	—
3. For public companies, if awards under share-based payment arrangements with employees are accounted for under the intrinsic value method of Opinion 25 for any period for which an income statement is presented, has the company continued to provide a tabular presentation of the following information for all of those periods: [Statement 123(R) ¶84]			
a. Net income and basic and diluted earnings per share as reported;	—	—	—
b. The share-based employee compensation cost, net of related tax effects, included in net income as reported;	—	—	—
c. The share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards;	—	—	—
d. Pro forma net income as if the fair-value-based method had been applied to all awards; and	—	—	—
e. Pro forma basic and diluted earnings per share as if the fair-value-based method had been applied to all awards.	—	—	—
4. For nonpublic companies that used the minimum value method for pro forma disclosure purposes under Statement 123, has the company no longer provided those pro forma disclosures for outstanding awards accounted for under the intrinsic value method of Opinion 25? [Statement 123(R) ¶85]	—	—	—
5. Has the company made disclosures similar to those described in Question 1 above when the company acquired goods or services other than employee services in share-based payment transactions to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements? [Statement 123(R) ¶65]	—	—	—
6. For companies that have applied the modified retrospective application method of transition to all prior years for which Statement 123 was effective, have the effects of the adjustments to the beginning balances of paid-in capital, deferred taxes, and retained earnings for the earliest year presented been disclosed in the financial statements in the year of adoption? [Statement 123(R) ¶77]	—	—	—
7. For public companies that have elected to use the "simplified" method of calculating expected term, has disclosure of the use of the method been made in the notes to their financial statements? [SAB Topic 14.D.2, Question 6]	—	—	—

	Yes	No	NA
8. For public companies that have share-based compensation expense, have these amounts been reflected in the same line or lines in the financial statements as cash compensation paid to the same employees? [SAB Topic 14.F]	—	—	—
9. For public companies, in the first interim period after adoption of Statement 123(R), has the company made the disclosures required by Questions 1–5 above? [SAB Topic 14.H, Question 1]	—	—	—
10. For public companies that apply the modified retrospective application method in other than the first interim period of a fiscal year, has the company disclosed the effects of the adoption of Statement 123R on previously reported interim periods? [SAB Topic 14.H, Question 1]	—	—	—
11. For public companies that apply the modified prospective application method, has the company disclosed that the financial statements of prior interim periods and fiscal years do not reflect any restated amounts? [SAB Topic 14.H, Question 1]	—	—	—
B. Cash Flows			
[NOTE: The guidance below related to the cash flow statement should be applied to the same periods in which the modified prospective and modified retrospective application methods are applied.]			
12. Has the company included in cash inflows from financing activities the cash retained as a result of the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements that are not included in the costs of goods or services that is recognizable for financial reporting purposes? [NOTE: Excess tax benefits shall be determined on an individual award basis, or a portion thereof, for this purpose.] [Statement 123(R) ¶68(a)]	—	—	—
13. Has the company included in cash outflows from operating activities, and disclosed separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services recognized for financial reporting purposes also had not been deductible in determining taxable income? [Statement 123(R) ¶68(b)]	—	—	—

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