

## Appendix E

### GLOSSARY

E1. This appendix contains definitions of certain terms or phrases used in this Statement.

#### 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*). Under this method of exercise:

- a. The employee authorizes the exercise of an option and the immediate sale of the option shares.
- b. On the same day, the company notifies the broker of the sale order.
- c. The broker executes the sale and notifies the company of the sales price.
- d. The company determines the minimum statutory tax-withholding requirements.
- e. By the settlement day (three days later), the company delivers the stock certificates to the broker.
- f. On the settlement day, the broker makes payment to the company for the exercise price and the minimum statutory withholding taxes and remits the balance of the net sales proceeds to the employee.

#### 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. 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.

#### Combination award

An award with two (or more) separate components, each of which can be separately exercised. Each part of the award is actually a separate grant, and compensation cost is measured and recognized for each grant.

## **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**.)

## **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.

## **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. 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.

### **Employee stock 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, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend that causes the per-share fair value of the shares underlying an option or similar award to change.

### **Excess tax benefit(s)**

The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the grant date) of deductible compensation cost reported on an employer's tax return for an individual employee's equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes.

### **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 one or more of its employees reach a mutual understanding of the key terms and conditions of a share-based payment arrangement. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to employees who fulfill vesting requirements. Awards made under a plan 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 plan. 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 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**.)

### **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 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 various 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 the definition of **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<sup>1</sup> (or index of similar) equity security (securities).

### **Measurement date**

The date at which the share price that enters into measurement of the fair value of an award of share-based payment is fixed.

### **Modification**

A change in any of the terms or conditions of an award of share-based compensation, including changes in quantity, exercise price, transferability, settlement provisions, and vesting conditions.

### **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).

### **Nonvested shares**

Shares that cannot currently be sold because the employee to whom the shares were granted has not yet satisfied one or more vesting conditions necessary to earn the right to the shares. 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 (or 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

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<sup>1</sup>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.

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**

Any 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 for this purpose. An entity that has only debt securities trading (or that has made a filing with a regulatory agency in preparation to trade only debt securities) in a public market is not a public entity for purposes of this Statement.

### **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.<sup>2</sup>

### **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

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<sup>2</sup>This definition is consistent with the definition of *related parties* in paragraph 24 of FASB Statement No. 57, *Related Party Disclosures*.

is automatically granted a new option, called a *reload option*, for the shares used to exercise the previous option. The number of reload options granted is the number of shares tendered, and the exercise price of the reload option is the market price of the stock on the date the reload option is granted. All other terms of the reload option, such as expiration date and vesting status, are the same as the terms of the original option.

### **Replacement award**

An award of share-based compensation that is granted concurrently with the cancellation of another award.

### **Requisite service period (and requisite service)**

The period or periods during which an employee is required to perform 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. For example, an entity that grants fully vested, deep out-of-the-money share options with an expected term of six years would be unable to presume that the vesting period is the requisite service period. An award that requires future service for vesting 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 arrangement (paragraph 25E of Appendix A). Paragraphs B38–B41 discuss requisite service periods that are explicit, implicit, or derived.

### **Restricted shares**

Shares for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed *nonvested stock* 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.<sup>3</sup> (Refer to the definition of **nonvested shares**.)

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<sup>3</sup>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.

**Restriction**

A contractual or governmental provision that prohibits sale (or substantive sale) of equity shares or other equity instruments for a specified period of time.

**Service condition**

A condition affecting the vesting (or 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. Generally, the service inception date is the grant date, but the service inception date may precede the grant date if, for example, service that will count toward vesting begins before the necessary shareholder approval for an award has been obtained.

**Settle, settled, or settlement of an award**

An action or event that irrevocably extinguishes the issuing entity's obligation under a share-based payment arrangement with an employee. 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 or a termination of service with vested options that are out of the money and not freely transferable, and (d) an employer's repurchase of instruments in exchange for cash (or other assets) or for fully vested and transferable equity instruments.

**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 of stock 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 equity shares of the issuing entity.

**Share-based payment (or compensation) arrangement**

An arrangement under which (a) one or more suppliers of goods or services receive awards of equity shares, share options, or other equity instruments or (b) the entity

incurs liabilities to suppliers (1) in amounts based, at least in part,<sup>4</sup> 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.

### **Share-based payment (or compensation) transaction**

A transaction under a share-based payment arrangement. A transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity transfer the entity's equity instruments to an employee for the entity's benefit also is a share-based payment transaction.

### **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.

### **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 arrangement and award**

The substantive terms and conditions 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 an award under the share-based payment arrangement. Although the written terms of a share-based payment arrangement usually provide the best evidence of its terms, 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 provide the basis for the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the arrangement is structured.

### **Time value**

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**

To earn the rights to, which is when an employee has rendered the requisite service. An employee's share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other equity instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a

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<sup>4</sup>This phrase refers to awards that are indexed to both shares of the entity and something other than either shares of the entity or a market, performance, or service condition.

performance condition. The terms *vest(s)*, *vested*, and *vesting* are used in this Statement in their traditional sense as indicated in the two preceding sentences. Market conditions are not vesting conditions for purposes of this Statement.

### **Volatility**

A measure of the amount by which a financial variable such as a 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.