

## Appendix F

### CLEAN COPY OF STATEMENT 123 (AS AMENDED BY THIS STATEMENT)

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## Appendix F

### CLEAN COPY OF STATEMENT 123 (AS AMENDED BY THIS STATEMENT)

#### INTRODUCTION

F1. This appendix consists of a clean copy of paragraphs 1–50 of Statement 123 as amended by this Statement. As noted in paragraph 2, this Statement does not substantively change Statement 123’s original requirements for transactions with nonemployees. The Board expects to reconsider the accounting for share-based payment arrangements with nonemployees in a later phase of its project on equity-based compensation. However, some paragraphs of Statement 123 that deal with transactions with nonemployees are included both for completeness and because of the need to revise certain terminology and to make other conforming changes.\*

F2. The term *this Statement* throughout the following clean copy refers to Statement 123 as amended by this Statement.

### CLEAN COPY OF AMENDED STATEMENT 123

#### Statement of Financial Accounting Standards No. 123

##### Share-Based Payment

#### INTRODUCTION

1. This Statement requires that the cost resulting from all **share-based payment transactions**<sup>1</sup> be recognized in the financial statements. This Statement establishes a fair-value-based method of accounting for **share-based payment arrangements** and requires **public entities** to apply that method in accounting for share-based payment transactions with **employees** (except for **employee stock ownership plans**). This Statement also establishes the fair-value-based method of accounting as preferable for **nonpublic entities**, but it permits those entities to account for their **share options** and similar instruments at **intrinsic value** remeasured at each reporting date until exercise or other manner of **settlement**.

2. This Statement also establishes **fair value** as the measurement basis 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 or not.

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\*Refer to footnote 1 of this Statement.

<sup>1</sup>Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

3. APB Opinion No. 25, *Accounting for Stock Issued to Employees*, issued in 1972, required compensation cost<sup>2</sup> for share-based employee compensation arrangements to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Opinion 25 specified different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award<sup>3</sup> were fixed or variable, as those terms were defined in Opinion 25.

4. Since 1972, share options and other forms of share-based payment arrangements with employees have become increasingly common. Also, option-pricing models have become widely used for measuring the value of share options and similar instruments. Opinion 25 was criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of share-based payment arrangements with employees. Several FASB Interpretations and Technical Bulletins have dealt with specific kinds of arrangements and other issues, and the Emerging Issues Task Force (EITF) has considered numerous related issues.

5. Because of the deficiencies in Opinion 25, early in the 1980s the AICPA's Accounting Standards Executive Committee (AcSEC), the staff of the Securities and Exchange Commission (SEC), most of the larger accounting firms, industry representatives, and others asked the Board to reconsider the accounting specified in Opinion 25. Statement 123, as originally issued, resulted from that reconsideration and established an accounting method based on the fair value of equity instruments awarded to employees as compensation that mitigates the deficiencies in Opinion 25. This Statement results from the Board's further reconsideration of those issues.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Scope

6. This Statement applies to all share-based payment transactions in which an entity acquires goods or services by **issuing**<sup>4</sup> its shares or other equity instruments (except for

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<sup>2</sup>This Statement refers to recognizing *compensation cost* rather than *compensation expense* because part of the amount recognized in a period may be capitalized as part of the cost to acquire an asset, such as inventory.

<sup>3</sup>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.

<sup>4</sup>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 for it 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, such as cash, an enforceable right to receive cash, other financial instruments, goods, or services, agreed to by the parties to the transaction. For that reason, this Statement does not use the term *issued* for the grant of equity share options or other equity instruments subject to various conditions.

equity instruments held by an employee stock ownership plan)<sup>5</sup> or by incurring liabilities to the supplier (a) in amounts based, at least in part, 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. Therefore, it applies to all transactions in which an entity grants shares of its common stock, share options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan.

7. The accounting for all share-based payment arrangements with employees or others shall reflect the rights conveyed to the holder and the obligations imposed on the issuer, regardless of how those arrangements are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for consideration of 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 grant of equity share options. The **terms** of a share-based payment arrangement affect the fair value of the liability or equity instruments granted and shall be appropriately reflected in determining that value. For example, whether an employee who is granted an implicit option structured as the exchange of equity shares for a nonrecourse note is required to pay nonrefundable interest on the note affects the fair value of the implicit option. Assessment of both the rights and obligations in a share-based payment arrangement and how the arrangement's terms affect the fair value of the related awards will require the exercise of judgment based on consideration of the relevant facts and circumstances.

### **Accounting for Share-Based Payment Transactions with Other Than Employees**

8. Except for transactions with employees as defined in this Statement,<sup>5a</sup> all transactions in which goods or services are the consideration received for the issuance of equity instruments shall be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The fair value of goods or services received from suppliers other than employees frequently is reliably measurable and therefore indicates the fair value of the equity instruments issued. The fair value of the equity instruments issued shall be used to

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<sup>5</sup>AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, specifies the accounting by employers for employee stock ownership plans. The Board expects to reconsider accounting for employee stock ownership plans in a later phase of its project on equity-based compensation.

<sup>5a</sup>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. (Refer to Illustration 1, paragraphs B50 and B51, of Appendix B.)

measure the transaction if that value is more reliably measurable than the fair value of the consideration received.<sup>6</sup>

9. [Paragraph 9 is replaced by the following:]

This Statement uses the term *fair value* with the same meaning as in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. That definition refers explicitly only to assets and liabilities, but the concept of *value in a current exchange* embodied in it applies equally to the equity instruments subject to this Statement.

10. If the fair value of the goods or services received is not reliably measurable, paragraph 8 of this Statement requires that the measure of the cost of goods or services acquired in a transaction with other than an employee be based on the fair value of the equity shares or other equity instruments issued. However, this Statement does not prescribe the **measurement date**, that is, the date of the share price on which the fair value of equity shares or other equity instruments is based, for a transaction with a nonemployee.<sup>6a</sup>

### **Accounting for Share-Based Payment Transactions with Employees**

10A. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize as an expense in the income statement the cost to the entity of services received (and consumed) in exchange for equity instruments issued, or liabilities incurred.

11. [Paragraph 11 is replaced by the following and footnote 7 is deleted.]

Except as indicated in paragraphs 20, 22, and 25B, an entity shall measure and recognize compensation cost from share-based payment transactions with employees based on the fair value of the shares or other equity instruments issued, or the liabilities incurred, in accordance with the fair-value-based method set forth in paragraphs 16–44 of this Statement. That is, the cost of services received from employees in exchange for awards of share-based compensation shall be measured based on the fair value of the equity instruments issued (based on the share price and other pertinent factors at the grant date) or the liabilities incurred (remeasured at the end of each reporting period until settlement).

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<sup>6</sup>The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include intangible 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.

<sup>6a</sup>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 shares or other equity instruments issued in share-based payment transactions with other than employees.

12. [Paragraph 12 is deleted.]
13. [Paragraph 13 is deleted.]
14. [Paragraph 14 and footnote 8 are deleted.]

#### **Certain Transactions with Related Parties and Other Economic Interest Holders**

15. Equity shares or other equity instruments of the reporting entity granted or otherwise transferred to an employee by a **related party** or other holder of an **economic interest** in that entity are share-based employee compensation to be accounted for by that entity under this Statement, unless the transfer clearly is for a purpose other than compensation. The substance of a transaction in which a related party or other economic interest holder directly transfers equity instruments to an employee as compensation is that the economic interest holder makes a capital contribution to the entity and the entity awards equity instruments to its employee. An example of a situation in which a direct transfer of equity instruments from an economic interest holder to an employee is not compensation is a transfer to settle an obligation of the economic interest holder that is unrelated to employment by the entity.

[Footnote 9 is deleted.]

#### **Measurement Basis**

16. Part or all of the consideration received for liabilities incurred or equity instruments issued to employees under a share-based payment arrangement is past or future employee services. The cost of the services received by the entity as consideration for those liability or equity instruments shall be measured and recognized based on the fair value of the liability settled or equity instruments issued. The portion of the fair value of an instrument attributed to employee services is net of the amount of cash or other assets, if any, that employees pay (or become obligated to pay) for the instrument when it is granted. Paragraphs 17–25B of this Statement provide guidance on how to measure the fair value of instruments issued under share-based payment arrangements with employees. Paragraphs 25E–33 provide guidance on how to attribute compensation cost to the periods in which employees render the related services. Appendix B, which is an integral part of this Statement, provides related implementation guidance.

#### **Measurement Objective and Measurement Date for Equity Instruments**

17. The objective of the measurement process for equity instruments awarded to employees is to estimate the fair value of the equity instruments to which employees become entitled when they 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 or to sell shares). That estimate is based on the share price (and other pertinent factors, such as expected volatility) at the **grant date**. **Restrictions** that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer **vested** employee share options to third parties or the inability to sell vested shares for a period of time, affect the value of the

instruments issued at the vesting date and therefore are reflected in estimating the fair value of the instruments at the grant date. However, restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested option or to sell **nonvested shares**, do not affect the fair value of the instruments issued at the vesting date and therefore are not reflected in estimating their fair value at the grant date. The effect of those restrictions is taken into account by recognizing compensation cost only for instruments for which the requisite service has been rendered. That is, no compensation cost is recognized for instruments that employees forfeit because a **service condition** or a **performance condition** is not satisfied (paragraph 26D). Illustrations 4 (paragraphs B59–B75), 5 (paragraphs B76–B81), and 11 (paragraphs B108–B114) of Appendix B provide examples of how compensation cost is recognized for awards with service and performance conditions.

## Measurement Methods

### *Awards Classified as Equity Instruments*

18. 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. Nonvested shares granted to employees usually are referred to as **restricted shares**, but this Statement reserves that term for shares whose sale is contractually or governmentally prohibited after the shares are vested. A restricted share 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 is issued to nonemployees. Illustration 10(a) (paragraphs B99–B101) of Appendix B provides an example of accounting for an award of nonvested shares.

19. The fair value of a share option (or its equivalent) granted by a public entity shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (paragraphs B4 and B5). Otherwise, the fair value of an employee share option or similar instrument shall be estimated using an option-pricing model that takes into account as of the grant date the following factors, at a minimum (paragraph B13):

- a. The exercise price of the option
- b. The expected term of the option, taking into account both the contractual term of the option and the effects of employees' expected exercise and expected post-vesting employment termination behavior
- c. The current price of the underlying share
- d. The expected **volatility** of the price of the underlying share
- e. The expected dividends on the underlying share (except as provided in paragraphs 32 and 33)
- f. The risk-free interest rate(s) for the expected term of the option.

The fair value of a share option or similar instrument estimated at the grant date shall not be subsequently remeasured for changes in the price of the underlying share or other

pertinent factors incorporated in the estimated fair value of the option at the grant date. Paragraphs B2–B30 provide additional guidance on estimating the fair value of share options and other equity instruments.

***Equity Share Options Granted by a Nonpublic Entity***

20. [Paragraph 20 is replaced by the following:]

A nonpublic entity shall choose whether to account for its equity share options and similar instruments based on (a) their fair value at the date they are granted as determined in accordance with this Statement or (b) their intrinsic value, remeasured at each reporting date through the date they are exercised or otherwise **settled**.<sup>9a</sup> 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;<sup>9b</sup> an equity share does not.<sup>9c</sup> Changes in the intrinsic value of a share option or similar instrument accounted for by the intrinsic value method shall be recognized in the same manner as required by paragraph 25B for changes in the fair value (or intrinsic value) of a liability. Illustration 10 (paragraphs B98–B107) of Appendix B further explains and illustrates the measurement requirements for equity instruments granted to employees by a nonpublic entity that elects to use the intrinsic value method of accounting.

20A. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*,<sup>9d</sup> and a nonpublic entity's election to use that method shall not be reversed. A nonpublic entity that changes to the fair-value-based method—either voluntarily or because it becomes a public entity—shall continue to account for awards outstanding at that date under the intrinsic value method until those awards are settled. Illustration 21 (paragraph B183) of Appendix B provides further guidance with respect to such a change. A nonpublic entity's election to use the fair-value-based or intrinsic value method shall be consistent for equity share options (and similar instruments) and liability instruments (paragraph 25B).

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<sup>9a</sup>APB Opinion No. 22, *Disclosure of Accounting Policies*, requires an entity to include a description of all significant accounting policies as an integral part of the financial statements. This Statement requires an entity to disclose the policy adopted pursuant to this paragraph (paragraph B191(a)).

<sup>9b</sup>This assumes that the SAR is not structured to be the equivalent of an equity share.

<sup>9c</sup>In certain circumstances, the time value of a share option may be such an insignificant portion of its fair value that the risks and rewards to the holder of the option are essentially the same at the grant date as the risks and rewards to the holder of a share, for example, a share option with an exercise price of \$0.20 on a share with a grant-date fair value of \$20. In that situation, the share option shall be accounted for the same as the underlying share for purposes of applying paragraph 20 of this Statement. On the other hand, if a share option with an exercise price of \$0.03 on a share with a fair value of \$0.05 is granted by an entity, the share option shall be accounted for as a share option, not as a share.

<sup>9d</sup>Opinion 20, paragraph 8, provides that initial adoption of an accounting principle for a transaction that the entity has not previously had to account for is not a change in accounting principle. The December 15, 2003, FASB Exposure Draft, *Accounting Changes and Error Corrections*, would retain that provision of Opinion 20.

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

21. 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 B illustrates techniques for estimating the fair values of several instruments with complicated features. However, in certain circumstances, the terms of an equity share option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted.

22. If it is not possible to reasonably estimate the fair value of a share option or other equity instrument at the grant date, 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 pro rata change, depending on the percentage of the requisite service that has been rendered at the reporting date) in intrinsic value of the instrument for each reporting period, based on the current share price and other pertinent factors at the reporting date. The entity shall continue to use that accounting method for those awards even if it subsequently concludes that it is possible to reasonably estimate their fair value—for example, if the terms of the award are modified or a new valuation technique is developed.

**Employee Share Purchase Plans**

23. [Paragraph 23 is replaced by the following:]

If the terms of an employee share purchase plan are no more favorable than those available to all holders of the same class of shares and substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis, the plan is not compensatory.<sup>9e</sup> Illustration 19 (paragraphs B177–B179) of Appendix B provides guidance on how to determine whether the terms of an employee share purchase plan are no more favorable than those available to all holders of the same class of shares and gives examples of limited employment qualifications.

24. [Paragraph 24 is deleted.]

**Awards Classified as Liabilities**

25. Some awards of share-based compensation result in the entity's incurring a liability either because employees can compel the entity to settle the award in cash or other assets or because criteria in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, under which an equity-settled instrument is a liability, are satisfied. For example, an entity may incur a liability

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<sup>9e</sup>A transaction subject to an employee share purchase plan involving 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. Illustration 20 (paragraphs B180–B182) of Appendix B provides guidance on making that determination.

to pay an employee either on demand or at a specified date an amount of cash or other assets to be determined by the increase in the entity's share price from a specified level. Such a liability generally is referred to as a cash share appreciation right (cash SAR).

#### *Liability Awards of Public Entities*

25A. A public entity shall measure a liability incurred under a share-based payment arrangement with employees at its fair value. The liability shall be remeasured at the end of each reporting period until settlement based on the current share price and other pertinent factors at the reporting or settlement date. Illustration 11 (paragraphs B108–B114) of Appendix B provides an example of accounting for an instrument classified as a liability.

#### *Liability Awards of Nonpublic Entities*

25B. A nonpublic entity shall make a policy decision of whether to measure its liabilities incurred under share-based payment arrangements with employees at fair value or at intrinsic value, remeasured at the end of each reporting period until settlement based on the current share price and other pertinent factors at the reporting date or settlement date. A nonpublic entity's election to use the fair-value-based or intrinsic value method shall be consistent for liability instruments and equity share options (and similar instruments) (paragraphs 20 and 20A). Illustrations 11 (paragraphs B108–B114) and 10(b) (paragraphs B102–B107) of Appendix B provide examples of accounting for an instrument classified as a liability using the fair-value-based method and an equity share option using the intrinsic value method (which results in similar accounting for an instrument classified as a liability and accounted for using the intrinsic value method).

#### **Cashless Exercises and Minimum Statutory Withholding Requirements**

25C. A provision for employees to effect a **cashless exercise** of their share options through a broker that is not a related party of the entity does not result in liability classification for instruments that otherwise would be classified as equity as long as (a) the cashless exercise requires a valid exercise of the share options and (b) the entity concludes that the employee is the legal owner of all the shares subject to the option (even though the employee has not paid the exercise price to the entity prior to the sale of the shares subject to the option).<sup>9f</sup> Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options to meet the employer's minimum statutory withholding requirements<sup>9g</sup> (related to the exercise) does not, by itself, result in liability classification of instruments that otherwise would be classified as equity.

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<sup>9f</sup>A broker that is a related party of the entity must sell the shares on the open market within three days for the award to qualify as equity.

<sup>9g</sup>Based on minimum statutory withholding rates for federal and state tax purposes, including payroll taxes, that are applicable to such supplemental taxable income.

## Evaluating the Terms of a Share-Based Payment Arrangement in Determining Whether It Qualifies as a Liability

25D. As indicated in paragraph 7, the accounting shall reflect the terms of a share-based payment arrangement—that is, the substantive terms as they are mutually understood by the employer and the employees who receive awards under the arrangement. Generally, the written arrangement provides the best evidence of its terms. However, an entity's past practice may indicate that the substantive terms of an arrangement differ from its written terms. For example, an entity that grants a **tandem award** consisting of either a stock option or a cash 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 predominantly settles in cash, or if the entity ordinarily settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. The substantive terms of the share-based payment arrangement shall be the basis for the accounting.

## Recognition of Compensation Cost for an Award Accounted for as an Equity Instrument

### *Recognition of Compensation Cost over the Requisite Service Period*

25E. The compensation cost for an award of share-based compensation accounted for as an equity instrument shall be recognized over the requisite employee service period by a charge to compensation cost and a corresponding credit to equity (paid-in capital). The **requisite service period** is the period of time over which employee service is rendered in exchange for the award, often the vesting period. That period is estimated based on an analysis of the terms of the share-based payment arrangement. The requisite service period may be explicitly stated or it may be implicit, being inferred from an analysis of other terms in the arrangement, including other explicit service or performance conditions. Further, the requisite service period for an award that contains a **market condition** may be derived from certain valuation techniques used to estimate that award's grant-date fair value (paragraphs B47–B49). 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.<sup>9h</sup> Paragraphs B37–B49 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. The **service inception date** is the beginning of the requisite service period.<sup>9i</sup>

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<sup>9h</sup>Certain awards, including an award with a graded vesting schedule, may have more than one requisite service period because the award's terms represent, in substance, multiple awards (paragraph 25F).

<sup>9i</sup>If both the service inception date and a reporting date occur before the grant date, for example, if the necessary approvals have not yet been obtained, 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.

Illustration 2 (paragraphs B52–B56) of Appendix B provides guidance on the concept of *service inception date* and how it should be applied. The service completion date is the end of the requisite service period.

25F. Compensation cost for each part of an award with a graded vesting schedule shall be measured separately and recognized over the requisite service period for that part of the award. Illustration 4 (paragraphs B59–B75) of Appendix B provides an example of the accounting for an award with a graded vesting schedule.

***Amount of Compensation Cost to Be Recognized over the Requisite Service Period***

26. The compensation cost recognized for an award of share-based compensation shall be based on the number of instruments for which the requisite service is rendered (that is, for which the requisite service period is 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 and shall revise that estimate if subsequent information indicates that the actual number of instruments for which the requisite service is expected to be rendered is likely to differ from initial estimates. The effect of a change in the estimated number of instruments for which the requisite service is expected to be rendered is a change in an estimate, and the cumulative effect of the change on current and prior periods shall be recognized in the period of the change.

[Footnote 10 is deleted.]

26A. Accruals of compensation cost for an award with a performance condition shall be based on the probable<sup>10a</sup> outcome of that performance condition. If an award has multiple performance conditions (for example, the number of options or shares an employee earns varies depending on which condition is satisfied), accruals of compensation cost shall be based on which, if any, of the conditions is the most likely outcome. Illustration 5 (paragraphs B76–B81) of Appendix B provides an example of how to account for awards with multiple performance conditions.

26B. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) expires unexercised (or unconverted) if the entity has already received and consumed the services for which the option (or unit) was exchanged, that is, the requisite employee service has been rendered.

***Adjusting the Initial Estimate of Requisite Service Period***

26C. Awards with multiple market, performance, or service conditions may have multiple service periods because of each particular condition. An entity shall make its 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, if appropriate, consider that period in measuring the fair value of the instrument granted and shall base accruals of compensation cost on that period. If that initial best estimate is based on a performance

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<sup>10a</sup>*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).

or service condition, an entity shall revise that estimate if subsequent information indicates that additional service or performance is required to achieve the condition or another performance or service condition is the probable outcome. If that initial best estimate is based on a market condition, the requisite service period shall not be revised unless the market condition is satisfied prior to the end of that initially estimated period or another performance or service condition becomes probable of achievement prior to the end of that initially estimated period.

***Effect of Market, Performance, and Service Conditions on Recognition and Measurement of Compensation Cost***

**Market, performance, and service conditions that affect vesting or exercisability**

26D. 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 B31–B33 of Appendix B provide specific guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).

26E. Service and performance conditions that affect whether vesting occurs are not reflected in estimating the fair value of instruments at the grant date because they are restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right (paragraph 17). However, for purposes of this Statement, an award is not deemed forfeited solely because a market condition is not satisfied. For an award with a market condition, reversal of previously recognized compensation cost is not permitted, provided the requisite service has been rendered, regardless of when, if ever, the market condition is satisfied. Rather, the effect of a market condition shall be reflected in estimating the fair value of an award at the grant date.

**Market, performance, and service conditions that affect factors other than vesting or exercisability**

26F. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other pertinent factors (excluding vesting) that are relevant in measuring an award's fair value. All such conditions are reflected in estimating a grant-date fair value of instruments for each possible outcome. An award shall be classified and accounted for as a liability, if it includes conditions that are not market, performance, or service conditions that affect vesting, exercisability, or other pertinent factors that are relevant in measuring an award's fair value. Paragraphs B34 and B35 provide guidance on the effect of market, performance, and service conditions that affect factors other than vesting and exercisability. Illustrations 5 (paragraphs B76–B81), 6 (paragraphs B82–B84), and 8 (paragraphs B92–B95) of Appendix B provide examples of accounting for awards with such conditions.

27. [Paragraph 27 is deleted.]

28. [Paragraph 28 is incorporated into paragraph 26 and footnote 11 is deleted.]

29. [Paragraph 29 is incorporated into paragraph 26.]
30. [Paragraph 30 is renumbered as paragraph 25E.]
31. [Paragraph 31 is renumbered as paragraph 25F.]

***Effect of Dividends or Dividend Equivalents on Recognition and Measurement of Equity Awards***

32. 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. Dividends or dividend equivalents paid on instruments that do not vest shall be recognized as compensation cost if employees are not required to return those dividends or dividend equivalents when they forfeit the rights to the related instruments.<sup>11a</sup>

33. If employees receive only the dividends declared on the class of shares granted to them after the shares become vested, the value of the award at the grant date shall be reduced by the present value of dividends expected to be paid on the shares during the vesting period, discounted at the appropriate risk-free interest rate(s). The fair value of an award of share options on which dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant to antidilution provisions shall be estimated based on a dividend payment of zero (paragraph 19).

**Recognition of Changes in the Fair Value or Intrinsic Value of Liabilities**

33A. The effects of changes in the fair value (or intrinsic value for a nonpublic entity that elects that method) of a liability 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 (intrinsic value) of a liability after 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 the fair value of the award at that date estimated in accordance with the provisions of this Statement is an adjustment of compensation cost in the period of settlement. Illustration 11 (paragraphs B108–B114) of Appendix B provides an example of accounting for a liability award from the grant date through its settlement.

**Reload Options**

34. The fair value of each award of equity instruments, including an award of **reload options**, shall be measured separately based on its terms and the current share price and other pertinent factors at the date the award is granted. That is, the effect of a reload provision in the terms of an award when it is granted shall not be included in estimating

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<sup>11a</sup>The estimate of compensation cost for dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity's estimates of forfeitures (paragraph 26).

the fair value. A subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

### **Modifications of Outstanding Awards**

35. A **modification** of the terms or conditions of an award that increases its fair value shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater fair value, incurring additional compensation cost for that incremental value. The effects of a modification shall be measured as follows:

- a. Incremental compensation 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. The effect of the modification on the number of instruments expected to vest also shall be reflected. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 26 of this Statement.
- b. Total recognized compensation cost for an award rarely will be less than 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 paragraph 26 of this Statement.
- c. A change in compensation cost from the modification of an award measured at intrinsic value in accordance with either paragraph 20A or paragraph 22 of this Statement shall be measured by comparing the intrinsic value of the modified award, if any, and the intrinsic value of the original award, if any, immediately before the modification.

Illustrations 12 (paragraphs B115–B121), 13 (paragraphs B122–B131), and 14 (paragraphs B132–B153) of Appendix B provide 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.

### ***Inducements***

35A. 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.

### *Cancellations and Replacements of Awards*

35B. Cancellation of an award accompanied by the concurrent grant of 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 for a cancellation and replacement 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 date the cancellation and replacement occur.

### *Equity Restructurings*

36. 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.<sup>11b</sup>

### **Repurchases or Cancellations of Awards of Equity Instruments**

37. An entity may repurchase equity shares or other equity instruments issued to employees after the employees have rendered the requisite service for them. An entity that settles an award for which the requisite service has not been rendered for cash or other assets has, in effect, vested the award (or made it exercisable), and the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the date of settlement. The amount of cash or other assets paid (or liabilities incurred) to repurchase an equity instrument shall be charged to equity, provided that the amount paid does not exceed the fair value of the instruments at the repurchase date. Any excess of the repurchase price over the fair value of the instruments shall be recognized as additional compensation cost.

37A. A cancellation of an award that is not accompanied by the concurrent grant of 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 date of the cancellation.

38. [Paragraph 38 is deleted.]

39. [Paragraph 39 is renumbered as paragraph 25D.]

### **Interaction of This Statement and Statement 150**

39A. Statement 150 establishes standards for determining whether certain **freestanding financial instruments** are classified as liabilities (or in some cases, assets). Statement 150 excludes from its scope instruments that are accounted for under this Statement. Nevertheless, 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

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<sup>11b</sup>Other aspects of accounting for share-based payment arrangements in a business combination are expected to be addressed as part of the current project on business combinations.

classify as a liability a freestanding financial instrument granted to an employee in a share-based payment transaction.<sup>11c</sup> On November 7, 2003, the Board directed its staff to issue FASB Staff Position (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 determining the classification of an instrument, an entity shall also take into account the deferrals contained in that FSP; furthermore, call options<sup>11d</sup> written on instruments that are classified as equity due to the deferrals in that FSP also shall be classified as equity while the deferral is in effect. Once the classification of an instrument is determined, the recognition and measurement provisions of this Statement shall be applied until the instrument ceases to be subject to this Statement in accordance with paragraph 40A.

40. [Paragraph 40 is deleted.]

#### ***Subsequent Accounting for Certain Freestanding Financial Instruments***

40A. A freestanding financial instrument ceases to be subject to this Statement and becomes subject to the recognition and measurement requirements of Statement 150 when an employee could terminate service and receive or retain the fair value of the instrument for the remaining contractual term of that instrument. In general, a share option or similar instrument remains subject to this Statement until it is exercised, forfeited, allowed to lapse at the end of its contractual term, or otherwise settled. In contrast, a vested share, as well as a vested share option whose contractual term is not affected by an employee’s termination, generally is subject to Statement 150. Illustration 22 (paragraph B184) of Appendix B provides guidance on when specific types of financial instruments cease to be subject to this Statement and become subject to Statement 150.

40B. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Statement 150. Such a modification or settlement shall be accounted for under the provisions of this Statement unless it applies equally to all financial instruments of the same class regardless of

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<sup>11c</sup>The payoff to the employee from an award with a vesting condition is based on both the vesting condition and variations in the fair value of the entity’s shares. For example, a vesting condition that awards equity share options equal to .05 times the number of units sold in excess of 1,000 units would create a payoff that is based on both units sold and the fair value of the equity share options. That arrangement or an arrangement that conveys a fixed number of equity share options to an employee that vests (or becomes exercisable) based on the satisfaction of a market, performance, or service condition (or any combination thereof) is generally not a liability under Statement 150 (paragraph 12(b)) because, in most cases, the effect of the vesting condition on the monetary value of the conditional obligation to issue the equity share options is not predominant over the effect of variations in the fair value of the entity’s shares.

<sup>11d</sup>Refer to the definition of *share option* in Appendix E.

whether the holder is (or was) an employee (or an employee's beneficiary).<sup>11e</sup> Subsequently, the modified instrument shall continue to be accounted for under Statement 150.

### **Accounting for Tax Consequences of Instruments Awarded to Employees**

41. Income tax regulations specify allowable tax deductions for instruments awarded to employees under share-based payment arrangements in determining an entity's income tax liability. Compensation cost recognized under this Statement may be measured based on the fair value of an award. Under existing U.S. tax law, 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.

42. 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 fair value of the instruments recognized as compensation cost for financial reporting purposes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, as additional service is rendered and the related cost is recognized, shall be recognized in the income statement. 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 stock under existing U.S. tax law, 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.

42A. 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 fair value of the instruments recognized as compensation cost for financial reporting purposes.

43. 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. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity's stock shall not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under this Statement.

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<sup>11e</sup>A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Statement.

44. If changes in the fair value of an entity's shares after the grant date result in deductible compensation cost reported on the employer's tax return for an individual employee's equity instruments (received in exchange for the requisite service) that exceeds the 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 (that is, the **excess tax benefit**) shall be recognized as additional paid-in capital (paragraph 42). An excess of a tax benefit for an individual employee's equity instruments over the deferred tax asset for those instruments 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. If the amount deductible for an individual employee's equity instruments on the employer's tax return is less than the cumulative compensation cost recognized for those instruments for financial reporting purposes, the write-off of the portion of the deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall be recognized in the income statement. Illustrations 4 (paragraphs B67–B69), 10 (paragraphs B100 and B101), 11 (paragraphs B113 and B114), and 14 (paragraphs B139–B141) of Appendix B provide examples of accounting for the income tax effects of various awards.

## **Disclosures**

45. [Paragraph 45 is deleted.]

46. [Paragraph 46 is replaced by the following:]

An entity with one or more share-based payment arrangements with employees shall disclose information that enables users of the financial statements to understand:

- a. The nature and general terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders (for example, the transfer of value from existing shareholders to option holders upon option exercise)
- b. The effect of compensation cost arising from share-based employee 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, during the period
- d. The cash flow effects resulting from share-based payment arrangements.

Paragraphs B191–B193 indicate the minimum information needed to achieve those objectives and illustrate how the disclosure requirements might be satisfied.

47. [Paragraph 47 is replaced by the following:]

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 46 to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements. 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 B191 provides additional guidance on satisfying the requirements for multiple arrangements.

48. [Paragraph 48 is deleted.]

### **Earnings per Share Implications**

49. FASB Statement No. 128, *Earnings per Share*, requires that employee share options, nonvested stock, 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 is contingent upon factors other than continued service, 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 share options or other equity instruments are granted or forfeited during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

50. In applying the treasury stock method of Statement 128, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay, (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.