

Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

INTRODUCTION

C1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

WHY THE BOARD UNDERTOOK A PROJECT TO AMEND STATEMENT 123

Statement 123's Provisions on Cost Recognition for Share-Based Payment Arrangements

C2. FASB Statement No. 123, *Accounting for Stock-Based Compensation*, was issued in 1995 and was effective for financial statement share-based compensation transactions in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123¹ established a fair-value-based method of accounting for share-based compensation awarded to employees and encouraged, but did not require, entities to adopt it. The Board's decision at that time was based on practical rather than conceptual considerations. Paragraphs 60 and 61 of Statement 123 state:

The debate on accounting for stock-based compensation unfortunately became so divisive that it threatened the Board's future working relationship with some of its constituents. Eventually, the nature of the debate threatened the future of accounting standards setting in the private sector.

The Board continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments. The Board also believes that financial reporting would be improved if all equity instruments granted to employees, including instruments with variable features such as options with performance criteria for vesting, were accounted for on a consistent basis. However, in December 1994, the Board decided that the extent of improvement in financial reporting that was envisioned when this project was added to its technical agenda and when the Exposure Draft was issued was not attainable because the

¹Unless the text indicates otherwise, all references to Statement 123 in this appendix are to that Statement as originally issued, that is, before the effects of this amendment.

deliberate, logical consideration of issues that usually leads to improvement in financial reporting was no longer present. Therefore, the Board decided to specify as preferable and to encourage but not to require recognition of compensation cost for all stock-based employee compensation, with required disclosure of the pro forma effects of such recognition by entities that continue to apply Opinion 25.

C3. Statement 123 required awards under share-based payment arrangements with suppliers other than employees to be accounted for based on their fair value. That Statement also established the fair-value-based method as preferable for awards to employees but did not require entities to adopt that preferable method. Rather, Statement 123 allowed entities to continue accounting for share-based compensation arrangements with employees according to the intrinsic value method in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, under which no compensation cost was recognized for employee share options that met specified criteria. Public entities that continued to use the intrinsic value method were required to disclose pro forma measures of net income and earnings per share as if they had used the fair-value-based method. Nonpublic entities that continued to use Opinion 25's intrinsic value method were required to make pro forma disclosures as if they had used the minimum value method.

Pertinent Events during the First Eight Years Statement 123 Was Applicable

C4. Before 2002, most entities chose to continue to apply the provisions of Opinion 25 rather than to adopt the fair-value-based method to account for share-based compensation arrangements with employees. The serious financial reporting failures and allegations of misconduct by executives that came to light beginning in 2001 caused the attention of investors, regulators, members of the U.S. Congress, and the media to focus on accounting and financial reporting issues. Many of the Board's constituents who use financial information said that the failure to recognize compensation cost for most employee share options had obscured important aspects of reported performance and impaired the transparency of financial statements.

C5. The increased focus on high-quality, transparent financial reporting stemming from the financial reporting failures in the early years of the 21st century created a growing demand for entities to recognize compensation cost for employee share options and similar instruments—a demand to which entities began to respond. As of March 2003, when the Board added this project to its agenda, 179 public companies had adopted or announced their intention to adopt the fair-value-based accounting method in Statement 123. By May 2003, that number had grown to 276, of which 93 were companies included in the Standard & Poor's (S&P) 500 Index; those companies represented 36 percent of the index based on market capitalization.² By February 2004, the number had increased to 483 companies, 113 of which represented 41 percent of the S&P 500 index based on market capitalization.

²Refer to Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Stock Options Using the Fair Value Method," Bear Stearns (May 23, 2003) and Bear Stearns update (February 12, 2004).

C6. The increased focus on financial reporting issues, including accounting for share-based compensation arrangements with employees, was accompanied by numerous requests from investors, regulators, and others for the Board to reconsider the cost recognition provisions of Statement 123. Although an increasing number of entities were voluntarily adopting the fair-value-based accounting method in Statement 123, it did not appear likely that voluntary adoption would extend to all entities, at least not in the foreseeable future. Voluntary adoption of Statement 123's fair-value-based accounting method by increasing numbers of entities provided improved information about the effects of share-based payment arrangements with employees on those entities and their shareholders. However, that voluntary adoption also resulted in less comparability across entities because of the alternative accounting methods Statement 123 continued to permit.

C7. The existence of alternative accounting methods for share-based compensation arrangements with employees, coupled with the failure of Opinion 25 to provide much general guidance on applying its intrinsic value method, had resulted in voluminous accounting guidance that constituents said was disjointed, rule-based, and form-driven.³ Both the Board and the Emerging Issues Task Force (EITF) had responded to requests for guidance on a large number of implementation issues. For example, FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, addressed 20 implementation questions, many of which had 1 or more subquestions. The EITF addressed an additional 51 implementation issues in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44." Constituents asked the Board to simplify the existing accounting guidance on accounting for share-based payment arrangements, and some of those constituents noted that eliminating the alternative to continue using Opinion 25's accounting method would be the best way to achieve that simplification.

C8. In November 2002, the IASB issued an Exposure Draft, *Share-based Payment*, (ED2) that proposed a single, fair-value method to be used to account for all share-based compensation arrangements. Although the method that the IASB proposed in ED2 shared some important features of the fair value method in Statement 123, it also differed in certain significant respects. Many of the differences involved secondary implementation issues rather than primary issues of fundamental principles.

C9. In November 2002, shortly after the IASB issued ED2, the FASB issued an Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment*. The Invitation to Comment explained both the primary and secondary differences between the requirements of Statement 123 and the method proposed by the IASB. Most users of financial statements who responded to the Invitation to Comment urged the Board to undertake a project to require that entities account for share-based payment arrangements

³That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards. (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*, March 25, 2003 [www.sec.gov].)

with employees using a fair-value-based method. The majority of the preparers who responded did not support such a requirement. However, some of those preparers asked for additional guidance on applying the fair-value-based method in Statement 123.

C10. To maximize the opportunity for international convergence, the FASB concluded that it needed to reconsider the U.S. accounting requirements for share-based payment arrangements concurrently with the IASB's consideration of responses to ED2.⁴

Summary of Reasons for Undertaking This Project

C11. After considering the factors discussed in paragraphs C4–C10, in March 2003, the Board added to its agenda a project to reconsider the existing guidance on accounting for share-based payment arrangements. This Statement is a result of that project. By requiring recognition of compensation cost for share-based payment arrangements with employees, this Statement responds to:

- a. Requests from investors and others to improve the transparency, relevance, and comparability of information about the effects of share-based payment arrangements with employees on entities and their shareholders
- b. The need to simplify the existing accounting guidance on share-based payment arrangements with employees
- c. The Board's commitment to accelerate convergence to a set of high-quality, compatible accounting standards that can be used for both domestic and cross-border financial reporting.

REDELIBERATION OF KEY ISSUES

C12. The Board began this project by redeliberating the key issues in Statement 123. The results of those redeliberations are discussed in the following paragraphs, together with references to the paragraphs in Statement 123's basis for conclusions in which the same issues are discussed.

Employee Services Exchanged for Equity Instruments Give Rise to Compensation Cost As Those Services Are Used

C13. The Board reaffirmed the conclusion discussed in paragraphs 74–91 of Statement 123 that compensation cost should be recognized for employee services received in exchange for valuable equity instruments, including equity share options. That cost should be recognized as the employee services received in exchange for the instruments are used in the issuing entity's operations. Some opponents of required recognition of compensation for equity share options assert that because an award of equity share options results in neither an outflow of assets nor the incurrence of a liability, that award should not result in a recognizable cost. However, the Board

⁴The International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment*, in February 2004. Refer to paragraphs C48 and C49 of this appendix for an indication of differences between this Statement and IFRS 2.

believes that an entity receives assets—employee services—in exchange for equity share options. Because an entity cannot store services, they qualify as assets only momentarily unless those services are capitalized as part of another asset (as permitted by U.S. GAAP). An entity’s use of an asset results in an expense, regardless of whether the asset is cash or another financial instrument, goods, or services.⁵

C14. Some opponents of required cost recognition also contend that the issuance of an employee share option is a transaction directly between the recipient and the preexisting shareholders. The Board disagrees. Employees provide services to the entity—not directly to individual shareholders—as consideration for their options. Carried to its logical conclusion, that view would imply that the issuance of virtually any equity instrument for goods or services, rather than for cash or other financial instruments, should not affect the issuer’s financial statements. For example, no asset or related cost would be reported if shares of stock were issued to acquire legal or consulting services, tangible assets, or an entire business in a business combination. Moreover, it is a long-established practice that, even if a stockholder directly pays part of an employee’s cash compensation (or other corporate expenses), the transaction and the related costs are reflected in the entity’s financial statements, together with the stockholder’s contribution to paid-in capital. To omit such costs would give a misleading picture of the entity’s financial performance.

C15. To summarize, accounting for assets received (and the related expenses when consumed) has long been fundamental to the accounting for all freestanding equity instruments except one—fixed equity share options that have no intrinsic value at the grant date and are accounted for under the requirements of Opinion 25. This Statement remedies that exception.

Why Fair Value Is the Relevant Measurement Attribute

C16. The Board also reaffirmed the conclusion discussed in paragraphs 143–153 of Statement 123 that the fair value of equity share options granted to employees is the

⁵FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 81, footnote 43, notes that, in concept, most expenses decrease assets rather than increase liabilities. However, if receipt of an asset, such as services, and its use occur virtually simultaneously, the asset often is not recognized because it would be derecognized immediately. For ease of discussion, this appendix also generally omits references to the interim step of recognizing an asset and uses shorthand phrases such as *the compensation cost resulting from awards of share-based compensation*.

appropriate basis for measuring the related compensation cost.⁶ Other equity instruments and the consideration the issuing entity receives in exchange for them are recognized based on their fair values at the date the instruments are issued. For example, the initial recognition of debt issued with detachable stock purchase warrants is based on the relative fair values of the debt and the warrants at the date of issuance—not on either the intrinsic value or a calculated minimum value of the warrants. Similarly, a share or a share option issued in exchange for an asset other than employee services, such as a piece of equipment or legal services, and the related cost would be measured at either the fair value of the asset received or the equity instrument issued, whichever is more reliably measurable. The Board concluded that it is not feasible to measure directly the fair value of employee services received in exchange for employee share options or other equity instruments, that is, the amount for which the services would be exchanged in the marketplace. Thus, the amount of the related compensation cost must be based on the fair value of the instruments issued as compensation for those services. That is consistent with the measurement basis for other forms of employee compensation, including cash, other assets, pension benefits, and the like, which initially are measured at the fair value of the asset transferred or the liability incurred. The Board sees no reason to measure compensation paid in share options or other equity instruments on a different basis.

C17. Various valuation techniques are available for estimating the fair value of employee share options. But virtually any option-pricing model that takes into account the minimum factors that determine fair value (listed in paragraph 19 of Appendix A) and is applied appropriately in accordance with the fair value objective discussed in paragraphs B2, B3, and B5 will result in an estimate of fair value that will be a better basis for recognition of compensation cost than either the intrinsic value or the minimum value of the options at the grant date. The grant-date intrinsic value method in Opinion 25 not only fails to recognize any compensation cost for most employee share options (because they are granted at-the-money), but also omits most of the factors that make an option valuable and thus understates the value at the grant date of those options for which Opinion 25's method does result in recognition of compensation cost. That is, the grant-date intrinsic value of an option fails to reflect the value of the holder's ability to benefit from appreciation in the underlying stock for the option's contractual term while limiting exposure to loss to the amount paid (in cash or services) for the option. Minimum value reflects some, but not all, of the key factors listed in paragraph 19 of Appendix A that give a share option value. By omitting the effect of the expected volatility of the underlying share, minimum value does not result in a measure of the amount of cash an

⁶This Statement permits a nonpublic entity to measure its share options at their intrinsic value, remeasured at each reporting date until the options are settled. That method also is required for equity instruments of a public entity if that entity concludes that it is not possible to reasonably estimate the fair value at the grant date. The Board made those exceptions mainly for practical rather than conceptual reasons. However, some Board members believe that if an entity cannot reasonably estimate fair value at the grant date, yet the company enters into an arrangement in the form of a share option that allows an employee to purchase shares at a discount in the future, then the best measure of that discount at any reporting date would be the intrinsic value of the share option at that date. The exceptions for measuring at intrinsic value do not alter the conclusion that fair value is the appropriate measurement attribute for equity instruments awarded to employees as compensation.

entity forgoes by granting share options to employees rather than issuing similar options to third parties, that is, the fair value of the options.

C18. Even a three-month option will command a non-zero price in the marketplace. And the market price of a 6-month option with intrinsic value of \$20 at the date it is written will be more than \$20. No rational individual would write a 3-month option, much less a 10-year one, for a price equal to either its intrinsic value or its minimum value.

C19. Even though measures of the grant-date intrinsic value of share options made by different entities presumably are comparable, the resulting financial statements are not necessarily comparable. For example, assume that in 2005 Entity A grants 500,000 share options with a total fair value of \$1.5 million and an intrinsic value of zero. In the same year, Entity B, which is in the same industry, grants only 50,000 options with a fair value of \$200,000 and an intrinsic value of zero. If the compensation cost for employee share options is recognized based on their intrinsic value at grant date, compensation cost reported by Entity A is understated by \$1.5 million, while Entity B's is understated by only \$200,000.

Why Is Compensation Cost Recognized for Vested Employee Share Options That Expire Worthless?

C20. Some have questioned why compensation cost should be recognized for an award of share options that vests but that is not exercised and subsequently expires worthless. The Board reaffirmed the conclusions on grant-date accounting discussed in paragraphs 149–154 of Statement 123. The premise of grant-date accounting is that on the grant date, (a) the employer and the employee come to a mutual understanding of the terms of a share-based payment arrangement and (b) the employer gives a conditional promise to issue equity instruments to the employee in exchange for services. As discussed in paragraph C16, equity instruments and the consideration the issuing entity receives in exchange for them are recognized based on their fair values at the date the instruments are issued. For equity instruments awarded to employees, this Statement requires that the estimate of fair value be based on the share price (and other pertinent factors) at the grant date.⁷ That estimate is not subsequently adjusted for either increases or decreases in the share price. After an employee share option (or other equity instrument) vests, the employer has benefited from the services received. Both the benefit and the risk of subsequent price changes are the employee's. No additional compensation cost is recognized subsequent to vesting because the exchange transaction has been consummated; the requisite service has been rendered by the employee and equity instruments have been issued by the entity—the exchange transaction is complete. The effect is similar to a warrant issued by a company for cash that expires worthless; the company retains the premium received (in this case, services) and an increase in paid-in capital, even though no shares ultimately were issued.

⁷Refer to paragraph B2 for discussion of the fair value measurement objective under the modified grant-date method required by this Statement. This Statement provides two exceptions to grant-date measurement under which equity share options are measured at their intrinsic value until exercise or other settlement—those exceptions mainly are based on practical considerations.

Is the Fair Value of Employee Share Options Measurable with Sufficient Reliability for Recognition in Financial Statements?

C21. Some of the opposition to required recognition of compensation cost for employee services received in exchange for share options and similar equity instruments has focused on measurement considerations. Critics generally assert that the Black-Scholes-Merton formula and similar closed-form models do not adequately take account of unique features of employee share options. They also point out that closed-form models may not be the best way to estimate the fair values of long-term options, even those without the unique features of employee share options, because those models are limited to single weighted-average assumptions for volatilities and dividends. Some recommend deferring required recognition of compensation cost from employee share options until a better valuation technique for those instruments is developed. They contend that recognizing compensation cost based on a fair value estimated using currently available valuation techniques would add an unacceptable level of measurement error to financial statements and impair their comparability and credibility.

C22. The Board did not find persuasive assertions that the estimated fair value of employee share options based on currently available valuation techniques would be so unreliable as to impair the credibility and comparability of financial statements. To the contrary, the Board believes that use of the intrinsic value method has and would continue to impair not only the relevance and reliability, but also the credibility, of financial statements by omitting a potentially significant component of the total cost of employee services. Uncertainties inherent in estimates of the fair value of share based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations. For those items, as well as in many other items in accounting involving the use of estimates, companies are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements.⁸ Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing no amounts.

⁸U.S. GAAP and generally accepted auditing standards currently address many circumstances in which entities use estimates. For example, APB Opinion No. 20, *Accounting Changes*, requires disclosure about changes in estimates. AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires general disclosure in the notes to financial statements that the preparation of financial statements requires the use of estimates. AICPA Auditing Standards AU Section 380, “Communication with Audit Committees,” addresses communicating certain estimates to the audit committee. In addition, the SEC has provided cautionary advice about public companies’ disclosure of critical accounting policies used in financial statements (Cautionary Advice Regarding Disclosure about Critical Accounting Policies, Releases No. 33-8040, 34-45149; FR-60 [December 12, 2001]). Those required disclosures identify methods, estimates, and judgments that companies use in applying those accounting policies that have a significant impact on the results reported.

Lattice Models versus Closed-Form Models

C23. As discussed in paragraphs B5–B12, closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options. A lattice model is preferable because such a model can accommodate the expected term structure of risk-free interest rates and volatilities, as well as expected changes in dividends over an option’s contractual term. A lattice model also can accommodate estimates of employees’ option exercise patterns and post-vesting employment termination during the option’s contractual term, and thereby can result in an adjustment for the nontransferability of employee share options that is more accurate than the adjustment resulting from a closed-form model using a single weighted-average expected life of the options. A lattice model therefore offers greater flexibility to reflect the characteristics of employee share options and similar instruments.

C24. Based on information provided by its Option Valuation Group (refer to paragraph C37) and by the responses of software providers to a questionnaire posted to the FASB’s website in November 2003, the Board concluded that lattice models adapted to take account of the characteristics of employee share options can be made commercially available within the near term. However, the Board understands that entities may not have available in a usable format information about employees’ exercise patterns (and perhaps other factors) needed to provide appropriate input to those models. The Board therefore decided to designate lattice models as preferable but not to require their use at this time.

C25. Having decided not to require the use of a lattice model, the Board considered whether the use of the Black-Scholes-Merton formula (or other closed-form models) would provide an estimate of fair value that is sufficiently reliable for recognition in financial statements. Paragraphs B9–B12 discuss circumstances in which use of a closed-form model may provide an estimate of fair value that is sufficiently reliable for recognition in the financial statements. The Board notes that valuation techniques for financial instruments, including employee share options, continue to evolve, and that required recognition of compensation cost based on the fair value of employee share options may lead to the development of improved commercially available valuation techniques.

Disclosure versus Recognition

C26. Having reaffirmed the conclusion that compensation cost from awards of equity instruments to employees, measured on a fair value basis, qualifies for recognition in the financial statements, the Board considered whether to eliminate the alternative to disclose, on a pro forma basis, the effects of that accounting in lieu of applying it for recognition purposes. Some respondents to the Invitation to Comment said that the pro forma disclosures required by Statement 123 provide adequate financial information about share-based payment arrangements with employees. Similar comments were made in various public venues during the Board’s work leading to the issuance of this Statement. Some of those commentators asserted that whether information is disclosed in

the notes or recognized in the financial statement is not important—either way, sophisticated users of financial information have access to the information they need.

Pro Forma Disclosure Is Not an Acceptable Substitute for Recognition

C27. The Board reaffirmed the conclusion in Statement 123 that pro forma disclosures are not an adequate substitute for recognition in the financial statements of compensation cost resulting from share-based payment arrangements with employees. The reasons for that conclusion, which are discussed in paragraphs C28–C30 of this Statement, are essentially the same as the reasons given in paragraphs 102–106 of Statement 123. However, new information made available since issuance of Statement 123 has provided additional support for the Board’s reasoning.

C28. Paragraph 9 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses recognition and disclosure:

Since recognition means depiction of an item in both words and numbers, with the amount included in the totals of the financial statements, disclosure by other means is *not* recognition. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria.

C29. Most of the users of financial statements who responded to either the Invitation to Comment or ED2 (or both) or to the Exposure Draft that led to the issuance of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*, strongly supported recognition of the cost of employee services received in exchange for equity instruments. Although the pro forma disclosures required by Statement 123 helped to mitigate the problems of nonrecognition of compensation cost, many financial statement users said that the failure of most entities to recognize that cost impaired the transparency, relevance, and comparability, as well as the credibility, of financial statements. In agreeing with those respondents, the Board noted that if disclosure and recognition were equal alternatives, the arguments for only disclosing the amount of compensation cost from share-based compensation arrangements with employees would apply equally to other costs incurred during a period, such as warranties, pensions, and other postretirement benefits. Disclosing but not recognizing those costs in the period in which they are incurred would cause reported net income to misrepresent the results of current operations.

C30. In addition to responses to the Invitation to Comment, ED2, and the Exposure Draft that led to the issuance of Statement 148, the Board’s conclusion that many users of financial statements support recognition of the cost of employee services received in exchange for share options and similar equity instruments was confirmed in a number of ways, including:

- a. Numerous requests from users for the Board to add a project to its agenda to reconsider accounting for share-based payment arrangements with employees.
- b. Responses to a survey of analysts and fund managers in 2001 by the Association for Investment Management and Research⁹ in which 83 percent of respondents favored recognition of compensation cost for share-based payment arrangements with employees.
- c. Responses to a recent survey¹⁰ of 30 institutional investors in technology companies in which more than 90 percent supported recognition of compensation cost for employee share options. Approximately 70 percent of those analysts and portfolio managers also said that an analysis of an entity's share options is significant to their valuation of the entity and has the potential to influence their investment decisions.
- d. Public comments made by various users of financial statements during the course of the Board's project on share-based payment.

The Cost of Compensation That Is Paid in Employee Equity Share Options Is Not Recognized in Earnings per Share

C31. Some respondents to the Invitation to Comment said that mandatory recognition of the cost of employee services received in exchange for employee share options would inappropriately “double count” the effect of granting share options. They note that the dilutive effect of in-the-money share options is included in the denominator of diluted earnings per share. To reduce net income (the numerator) by recognizing compensation expense based on fair value would, in their view, create an inappropriate dual effect on diluted earnings per share; this argument often is stated as “earnings per share would be hit twice.”

C32. Earnings per share is a metric—no expense (cost), revenue, or other element of financial statements is “recognized” by including its effect only in earnings per share. A transaction that results in an expense and also increases the number of common shares outstanding properly affects both the numerator and the denominator of earnings per share. (An equity share option potentially affects only dilutive common equivalent shares outstanding and thus affects only diluted earnings per share.) If an entity issues shares, share options, or share purchase warrants for cash and uses the cash received to pay employee salaries, earnings are reduced and more actual or potential common shares are outstanding. Moreover, if an entity issues common shares in exchange for a depreciable asset, both the resulting depreciation expense and the increase in common shares outstanding reduce basic earnings per share. Recognition of compensation cost that is associated with granting employee share options is no different from the accounting treatment accorded other transactions in which use of the consideration received (cash, other tangible assets, or services) for issuing equity instruments reduces reported earnings, and the dilutive effect of the related equity instruments increase either actual or potential common shares outstanding.

⁹Association for Investment Management and Research (AIMR), “Survey on Accounting for Stock Options,” (September 2001). Electronic survey sent to more than 18,000 AIMR members worldwide to assess their response to a proposed agenda topic of the IASB.

¹⁰Merrill Lynch, “Tech Stock Options: The Invisible Cash Flow Drain,” (February 3, 2004).

Potential Economic Consequences of Recognition of Compensation Cost

C33. Some opponents of required recognition of compensation cost based on the fair value of employee share options say that recognition may have undesirable economic consequences. They suggest that required recognition of compensation cost from share-based payment arrangements is likely to cause some entities to reduce, eliminate, or otherwise revise those arrangements. Some also contend that recognition of compensation cost for employee share options will raise the cost of capital for entities that make extensive use of those options. Those assertions seem to be based on the presumptions that (a) most, if not all, current share-based arrangements are inherently desirable regardless of their cost and (b) Opinion 25's accounting requirements have only desirable economic consequences. The Board considers neither presumption to be either supportable or relevant in establishing accounting standards for share-based payment arrangements.

C34. The Board's operating precepts require it to consider issues in an evenhanded manner, without attempting to encourage or to discourage specific actions. That does not imply that improved financial reporting should have no economic consequences. To the contrary, a change in accounting standards that results in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences. For example, required recognition of compensation cost based on the provisions of this Statement would result in comparable accounting for all forms of employee compensation. The Board believes that any decision to reassess and modify existing share-based payment arrangements would be based on information that better represents the costs and benefits of various forms of compensation.

C35. Some investors and others have noted the dramatic increase in the number of share options awarded to employees during recent years. The Board understands that the vast majority of share options awarded to employees are fixed, at-the-money options for which entities that continued to use the accounting requirements of Opinion 25 recognized no compensation expense. The accounting under Opinion 25 treats most fixed share options as though they were a "free good," which implies that the services received in exchange for those options are obtained without incurring a cost. But employee services received in exchange for share options are not free. Share options are valuable equity instruments for which valuable consideration is received—consideration that should be recognized regardless of whether it is in the form of cash, goods, or services from employees or other suppliers. Accounting for fixed, at-the-money employee share options as though they imposed no cost on the entity that issues them may encourage their substitution for other forms of compensation, such as share options or other instruments with performance or market conditions, that may be preferable in a particular situation. Requiring recognition of compensation cost based on fair value increases the neutrality of financial reporting and removes an accounting incentive for an entity to choose a form of incentive compensation—fixed, at-the-money share options—that may not be the most advantageous in its circumstances.

Conclusions on Requiring Recognition of Compensation Cost

C36. In summary, the Board reaffirmed the conclusions reflected in Statement 123 that:

- a. Employee services exchanged for share options and other equity instruments give rise to a cost that is properly recognized in financial statements.
- b. Disclosure is not an adequate substitute for recognition.
- c. Fair value is the appropriate measurement attribute for share-based compensation.
- d. The fair value of equity instruments issued to employees in share-based payment arrangements can be estimated with sufficient reliability for recognition in financial statements.

In light of those conclusions, which were considered in combination with recent events discussed in paragraphs C4–C10, the Board decided that in order to improve financial reporting it was necessary to require entities to recognize at fair value the compensation cost resulting from the consumption of employees services received in exchange for equity instruments.

OTHER BACKGROUND INFORMATION

C37. Shortly after adding this project to its agenda, the Board established an Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of share options. That group includes valuation experts from the compensation consulting, risk management, investment banking, and academic communities. The Board met formally with that group, and the staff also met formally with the group on another occasion and consulted frequently with its members.

C38. The Board received 302 letters of comment in response to the Invitation to Comment, many of which commented only on the issue of whether the FASB should require recognition at fair value of compensation cost for employee share options. Responses to other issues are discussed later in this appendix as appropriate. Additionally, the Board received 132 unsolicited letters of comment from various constituents during the deliberative process leading to this Statement. Those respondents commented on various aspects of share-based payment and this project.

C39. The Board discussed the issues in this project, including the information received in the letters of comment, at 38 public meetings from March 2003 through March 2004. One of those meetings, held in October 2003, was a joint meeting of the FASB and the IASB.

COST-BENEFIT CONSIDERATIONS

C40. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including

preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy. However, the value of that incremental improvement to financial reporting and most of the costs to achieve it are subjective and cannot be quantified.

C41. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

C42. Several procedures were conducted before the issuance of the Exposure Draft to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members and other valuation experts.

C43. The Board concluded that field visits were an appropriate means of gathering information about the perceived costs of the proposed changes to Statement 123. The Board noted that a field test was conducted before issuance of Statement 123 and that field tests are more important for standards that require new methods of accounting. That is not the situation with this Statement, which revises the fair-value-based method in Statement 123 rather than requiring an entirely new accounting method. Further, thousands of public entities have had several years of experience in developing fair value estimates for their share-based payment arrangements with employees—estimates that Statement 123 required for either recognition or pro forma disclosure purposes.

C44. The field visit program included discussions with 18 enterprises selected to achieve broad coverage of constituent enterprises based on market capitalization, software used to value employee share options, filing status (public or nonpublic), industry membership, total number of employees, total awards outstanding, and types of awards outstanding. Field visit participants included preparers of financial statements, employee benefit consultants, and auditors. Before each field visit, participants received a package of materials, including a description of the proposed changes to Statement 123, a discussion of the type of information that could be incorporated into a lattice model, and questions for participants to consider.

C45. The Board also solicited information by means of a questionnaire survey of commercial software providers about the functionality of existing tracking and valuation software for employee share options and similar instruments. That survey asked about the functionality of existing software used to track grants of share-based compensation

and to estimate the fair value of the related instruments. The survey also asked about the estimated costs and timing of availability of software with the ability to estimate fair value using a lattice model that incorporated information about employees' expected early exercise and post-vesting employment termination behavior.

C46. Based on the findings of the cost-benefit procedures, the Board concluded that this Statement will sufficiently improve financial reporting to justify the costs it will impose. Most of the expected benefits of required recognition of the cost of share-based compensation arrangements with employees using the fair-value-based method have been discussed already. In addition, existing guidance on accounting for share-based employee compensation is simplified because this Statement eliminates Opinion 25 and the guidance necessary to implement it.

C47. Several of the Board's decisions are intended to mitigate the incremental costs of complying with this Statement. For example, a nonpublic entity is not required to estimate the fair value of its share options; instead, such an entity may elect to account for its share options and similar instruments at intrinsic value, remeasured at each reporting date until settlement. Also, transition costs have been minimized by requiring that compensation cost for the unvested portion of awards granted before the issuance of this Statement be based on the grant-date fair values previously estimated for recognition or pro forma disclosure purposes under Statement 123.

CONVERGENCE OF U.S. AND INTERNATIONAL ACCOUNTING STANDARDS ON ACCOUNTING FOR SHARE-BASED PAYMENT TRANSACTIONS

C48. As discussed in paragraphs C8–C10, one reason that the Board added this project to its agenda early in 2003 was to maximize the opportunity for convergence of U.S. and international accounting standards on accounting for share-based payment transactions. At that time, the comment period on the IASB's ED2 was nearing its end, and the IASB was preparing to redeliberate its conclusions based on the comments received. Although the FASB's and the IASB's projects were at different stages (the FASB was working toward an Exposure Draft at the same time the IASB was working toward a final Standard), both Boards considered it appropriate to cooperate to the extent feasible to minimize differences between their accounting standards for share-based payment arrangements. To a large extent, that objective was achieved. Accounting for share-based payment arrangements under this Statement and related accounting under International Financial Reporting Standard (IFRS) 2, *Share-based Payment*, have the potential to differ in only a few areas. Those differences may be further reduced as the FASB progresses with the next phase of its project on accounting for share-based payment arrangements (refer to paragraphs C50 and C51) as well as other convergence projects. In addition, the two Boards will consider undertaking a joint project to further converge their respective accounting standards when the FASB has completed its project on accounting for share-based payment arrangements and its current project on distinguishing between liabilities and equity.

C49. The more significant differences between this Statement and IFRS 2 are listed below, together with references to the paragraphs in this appendix in which they are discussed:

- a. Accounting for share-based payment arrangements with other than employees (paragraph C52)
- b. Measurement of share options granted by a nonpublic entity (paragraphs C73 and C74)
- c. Certain aspects of accounting for modifications of awards (paragraphs C106–C111)
- d. Classification of certain instruments as liabilities or equity (paragraphs C126 and C127)
- e. Certain aspects of accounting for the income tax effects of an award of equity instruments (paragraphs C133–C138).

SCOPE OF THIS STATEMENT

C50. The FASB project from which this Statement results encompasses reconsideration of all aspects of accounting for share-based payment arrangements. However, the Board decided to limit the scope of this Statement to accounting for share-based payment arrangements with employees, except for employee stock ownership plans currently accounted for under AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*.

C51. Most of the debate surrounding accounting for share-based payment has focused on arrangements with employees, and the Board concluded that mandating recognition of compensation cost measured at fair value for those arrangements was the most urgent aspect of this project. Moreover, cost is already recognized for share-based payment arrangements with nonemployees under Statement 123 and 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," albeit using a measurement date that may differ from the one this Statement prescribes for equity instruments issued to employees. Including guidance on share-based payment arrangements with nonemployees and guidance on accounting for shares held by employee stock ownership plans would have significantly delayed the issuance of this Statement. Additionally, existing U.S. GAAP already requires that compensation cost be recognized for those arrangements using a fair-value-based measurement. The Board expects to reconsider the existing accounting guidance for those types of arrangements in a later phase of this project. In the meantime, accounting for those arrangements continues to be governed by the provisions of Issue 96-18 and SOP 93-6, respectively.

Difference between Scope of This Statement and Scope of IFRS 2

C52. The Board's decision not to reconsider the existing guidance for share-based payment arrangements with nonemployees in developing this Statement may result, at least temporarily, in different accounting for those arrangements under U.S. GAAP and IFRS 2. The scope of IFRS 2 includes accounting for all share-based payment

arrangements, regardless of whether the counterparty is an employee. All of those arrangements generally will be accounted for using the modified grant-date method that this Statement requires for share-based payment transactions with employees. However, for transactions with parties other than employees, in which it is not possible to reliably estimate the fair value of goods or services received, IFRS 2 requires that the fair value of those goods or services be measured by reference to the fair value of the equity instruments granted measured at the date those goods or services are received. In contrast, Issue 96-18 requires that grants of share options and other equity instruments to nonemployees be measured at the earlier of (a) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached or (b) the date at which the counterparty's performance is complete. For many grants, the measurement date under Issue 96-18 may be different than the measurement date prescribed by IFRS 2.

CONCLUSIONS REFLECTED IN STATEMENT 123 THAT THE BOARD REAFFIRMED IN THIS STATEMENT

C53. The Board's reconsideration of the provisions of Statement 123 and the reasons for them resulted in reaffirming many of those conclusions for essentially the same reasons discussed in the basis for conclusions of Statement 123. Certain of those reaffirmed conclusions have already been discussed. The others are listed below, together with references to the relevant paragraphs in Statement 123's basis for conclusions. This Statement does not discuss further the following reaffirmed conclusions:

- a. The appropriate measurement date for compensation cost from equity instruments awarded to employees is the grant date (paragraphs 119–134 and 149–152).
- b. The effect of restrictions that apply only during the vesting period should be reflected by recognizing compensation cost only for awards that actually vest.¹¹ In contrast, restrictions that continue in effect after an award is fully vested, such as the inability to transfer vested options to a third party, are to be included in estimating the fair value of the instruments granted (paragraphs 155–160).
- c. The effect of employees' inability to transfer their vested options to third parties is to increase the likelihood that the options will be exercised before the end of their contractual terms. Thus, the option term that is used in estimating the fair value of an award of options should reflect employees' expected early exercise and post-vesting employment termination behaviors (paragraphs 169–173). Paragraphs C64 and C65 of this Statement explain revisions to Statement 123's guidance on how to determine an option's expected term.
- d. Compensation cost for awards of share-based compensation should be recognized over the related requisite service period (paragraphs 196–200).

¹¹Paragraph E1 of this Statement defines *vest* as follows: "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 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."

- e. A reload option should be accounted for as a new grant, that is, the effect of a reload feature should not affect an award's grant-date fair value (paragraphs 182–186).
- f. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests should be charged to retained earnings. Any dividends or dividend equivalents that employees do not forfeit even though the related shares do not vest should be recognized as additional compensation cost. If employees do not receive the dividends declared on the class of shares granted to them during the vesting period, the fair value of the award at the grant date should be measured based on the fair value of a dividend-paying share reduced by the present value of dividends expected to be paid on the stock 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 should be estimated based on a dividend payment of zero (paragraphs 204–207).

C54. The reasons for the revisions this Statement makes to Statement 123 are discussed in the remainder of this appendix.

TRANSFERS OF EQUITY INSTRUMENTS TO EMPLOYEES BY ECONOMIC INTEREST HOLDERS

C55. Statement 123 required that an entity recognize compensation cost for equity instruments granted or otherwise transferred to an employee by a *principal stockholder* of the entity unless the transfer clearly was for a purpose other than compensation. The Board concluded at that time that the substance of such a transaction is that the principal stockholder makes a capital contribution to the entity, which the entity uses to grant share-based compensation to the employee who receives the equity instruments. Statement 123 defined a principal stockholder as

One who either owns 10 percent or more of an entity's common stock or has the ability, directly or indirectly, to control or significantly influence the entity. [paragraph 395]

An example of a situation in which a direct transfer of equity instruments to an employee from a principal stockholder is not compensation cost is a transfer to settle an obligation of the principal stockholder unrelated to employment by the reporting entity.

C56. ED2 contained a similar provision, except that a direct transfer of equity instruments from any shareholder, not only a principal shareholder, to an employee as payment for services received by the reporting entity was to be recognized as share-based compensation. Most respondents to the Invitation to Comment and to ED2 who addressed this issue supported ED2's proposed requirement (which is in IFRS 2).

C57. The Board agreed that the scope of Statement 123's requirements for such transfers should be expanded to encompass transfers from any shareholder. However, the Board

saw no reason to limit the provision to transfers by shareholders. Holders of other forms of economic interests in an entity, such as holders of convertible debt or other creditors, might see the likelihood of sufficient indirect benefit to themselves to justify compensating one or more of the employees of a reporting entity by transferring to those employees shares or other equity instruments of that entity.

C58. The Board intends the provision in paragraph 15 of Statement 123 as amended by this Statement to be applied by analyzing transactions in which a related party or a holder of an economic interest in the reporting entity transfers equity instruments of the entity to an employee of the entity to determine whether the entity benefits from the transfer. If so, the transfer should be accounted for as share-based compensation to the employee and a capital contribution received from the transferring party. In broadening that requirement, the Board noted its belief that such a transfer is most likely to be made by a major shareholder or another holder of a significant economic interest in an entity, and often will be made by a party that can exercise significant influence over the reporting entity.

C59. The Board discussed whether the requirements for transfers of equity instruments by related parties and economic interest holders also should apply to other forms of compensation arrangements that do not result in transfers of equity instruments. The Board considers all forms of compensation paid to an entity's employees by holders of economic interests in that entity to result in compensation cost if the entity effectively receives employee services as a result of the transfer. The Board concluded, however, that broadening the scope of this Statement to include transfers of other than the reporting entity's equity instruments would require reconsidering FASB Statement No. 57, *Related Party Disclosures*, as well as other guidance in existing U.S. GAAP, and decided not to expand the scope of this project to include that reconsideration.

ESTIMATING THE FAIR VALUE OF SHARE OPTIONS AND OTHER EQUITY INSTRUMENTS

Fair Value Definition and General Guidance on Estimating Fair Value

C60. Many of the amendments to Statement 123's guidance on estimating the fair value of share options and other equity instruments granted to employees are clarifications or elaborations rather than substantive changes. For example, this Statement replaces the definition of *fair value* in Statement 123 with the definition in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which was issued after Statement 123. The original and amended definitions are not substantively different. This Statement also specifies that the fair value of an employee share option is to be based on an observable market price of an option with the same or similar terms and conditions if one is available. However, such market prices are not currently available in the United States, and this Statement continues to require use of a valuation technique if market prices are not available.

Estimating the Fair Value of Employee Share Options Using a Valuation Technique such as an Option-Pricing Model

C61. This Statement amends the guidance on estimating the fair value of share options to eliminate any possible inference that a specific model is required. As discussed in paragraphs C23–C25, this Statement also expands the discussion of closed-form and lattice models and explains why a lattice model will usually result in a better fair value estimate (paragraphs B9–B12).

C62. The reference to an option-pricing model in paragraph 19 of Statement 123 included the parenthetical phrase *for example, the Black-Scholes or a binomial model*. Nevertheless, the Board understands that some entities and their auditors may have interpreted Statement 123 as requiring use of the Black-Scholes-Merton formula. (That interpretation may have been based in part on the fact that the examples in Appendix B of Statement 123 used the Black-Scholes-Merton formula.) Others thought that no models other than those mentioned as examples qualified for use in applying Statement 123. The guidance in paragraph 19 of Statement 123 as amended by this Statement eliminates any reference to specific models.

C63. Statement 123 as amended by this Statement provides more guidance on how to estimate fair value than other recently issued accounting standards generally provide. For example, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which requires most derivative instruments, including options, to be measured at fair value, defines fair value but does not provide further guidance on how to apply valuation techniques if a market price is not available. The Board noted that observable market prices rarely, if ever, will be available—either when the instrument is granted or subsequently—for some instruments, such as employee share options, to which this Statement applies. In contrast, observable market prices often will be available for many of the instruments to which Statement 133 applies. In addition, Statement 133 generally is applied in a highly developed and sophisticated market environment, while this Statement will be applied broadly by entities with widely varying degrees of experience in estimating fair values. Numerous respondents to the Invitation to Comment asked the Board to revise, elaborate on, or clarify the guidance in Statement 123 on estimating the fair value of employee share options. The Board therefore concluded that providing guidance on estimating the fair value of employee share options continues to be appropriate.

C64. This Statement elaborates on or clarifies the guidance in Statement 123 for selecting assumptions used in applying an option-pricing model. The Option Valuation Group provided valuable assistance in developing the revised guidance. The more significant revisions appear in the guidance on incorporating the expected term of an option in estimating its fair value (paragraphs B20–B23).

C65. In describing the expected term of an option, Statement 123 used the phrase *expected life*, and the related guidance focused primarily on estimating a weighted average of the length of time employee options were expected to remain outstanding. This Statement refers to the *expected term* of an option, which is based on the option's

contractual term and the expected early exercise and post-vesting employment termination behaviors of employees. The valuation guidance and illustrations in Appendix B of this Statement discuss how expectations about employees' early exercise and post-vesting employment termination behavior can be related to the intrinsic value of the option—the difference between the exercise price of the option and the price of the underlying share. In using a lattice model, an option's expected term may be inferred based on the output of the model, but expected term is not a direct input to the model. Paragraph 282 of Statement 123 explained that method and indicated that entities might wish to use it. However, Statement 123 did not emphasize or illustrate that method.

What If It Is Not Possible to Reasonably Estimate Fair Value at the Grant Date?

C66. Paragraph 22 of Statement 123 provided that if it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost would be fair value estimated based on the share price and other factors at the first date at which reasonable estimation is possible. This Statement amends that provision to require that such an instrument continue to be measured at its intrinsic value at each reporting date until it is exercised or otherwise settled.

C67. In light of the variety of options and option-like instruments currently trading in external markets and the advances in methods of estimating their fair values, the Board expects that few instruments awarded to employees by public entities will fall into the category in paragraph 22 of Appendix A. For those that may, the Board is not aware of instances in which estimating fair value at a date between grant and settlement will be significantly easier than estimating fair value at the grant date. Perhaps more important, the Board is concerned that continuing to permit the final measure of compensation cost to be based on the estimated fair value at the earliest date at which an entity decides such estimation is feasible might have unintended consequences. To minimize reported compensation cost, an entity might attempt to justify measurement at a date when its share price is lower than at the grant date. Therefore, the Board decided to require remeasurement of intrinsic value at each reporting date until settlement, even if the entity decides that it would be reasonably possible to estimate fair value prior to the settlement date.¹²

Measurement Methods for Share Options of a Nonpublic Entity

C68. Statement 123 permitted a nonpublic company to omit expected volatility (or to use an expected volatility of effectively zero) in estimating the value of its share options granted to employees. The result was a measure termed *minimum value*. The Board said in Statement 123 (paragraphs 174–178) that, in concept, options granted by a nonpublic entity should be measured at fair value—the use of minimum value was only a practical response to the difficulties of estimating the expected volatility for a nonpublic entity.

C69. This Statement eliminates the minimum value method and instead requires a nonpublic entity to elect whether to measure its share options at their fair value at the

¹²Refer to footnote 6.

grant date or at intrinsic value through the date the options are exercised, lapse, or are otherwise settled. However, the Board continues to believe that, in concept, public entities and nonpublic entities should use the same measurement method, and this Statement therefore establishes the fair value method as preferable for purposes of justifying a change in accounting principle.

C70. Although the Board is reluctant to permit alternative accounting methods for the same transactions and events, it concluded that continuing to allow alternative methods is appropriate in this situation. The Board understands that relatively few small, nonpublic entities offer share options to their employees, and many of those that do are emerging entities that intend to make a future initial public offering. The Board believes that the intrinsic value alternative provided by this Statement is superior to the minimum value alternative in Statement 123. Even under Opinion 25's grant-date intrinsic value method, an entity had to determine the intrinsic value of share options granted. If the entity granted options on a regular basis, it had to measure intrinsic value at the date of each grant. In addition, the variable accounting method required by Opinion 25 for certain share options was the same as the intrinsic value method required by this Statement. Moreover, the final measurement of compensation cost under the intrinsic value method in this Statement is the same as the measure of the related income tax deduction for nonqualified options under current U.S. tax law. Thus, the intrinsic value method in this Statement generally does not impose a significant additional computation cost on a nonpublic entity.

C71. The Board noted that providing an exception from the fair-value-based method for nonpublic entities is responsive to comments from some respondents to the Invitation to Comment and others that it would not be feasible for some nonpublic entities to estimate the fair value of their share options. In light of the Board's conclusions on accounting for other instruments for which it may not be possible to reasonably estimate fair value, discussed in paragraphs C66 and C67 of this Statement, the Board concluded that continuing to permit nonpublic entities to measure their equity share options at minimum value at the grant date could not be justified. If an entity does not measure compensation cost based on the fair value of an equity share option at the date it is granted, the Board believes that an outcome-based approach is superior to either permitting another measurement method at the grant date or permitting measurement based on fair value at a date between grant and exercise or other settlement.

C72. In deciding to establish fair value as the preferable method for measuring share options of nonpublic entities, the Board acknowledged that estimating the expected volatility of a nonpublic entity's shares may be difficult, and the resulting estimated fair value may be more subjective than the estimated fair value of a public entity's options. However, the Board agrees with members of the Option Valuation Group that many nonpublic entities could consider internal and industry factors likely to affect volatility, and the average volatility of comparable entities, to develop an estimate of expected volatility. Using an expected volatility estimate determined in that manner often would result in a reasonable estimate of fair value—or at least an estimate that would be preferable to measurement at either minimum value or intrinsic value because neither of those methods incorporates expected volatility, which is a key feature that makes options

valuable. The Board also notes that subjective estimates often are necessary in other areas of accrual accounting. For many nonpublic entities, the subjectivity of estimates of volatility may be similar to, for example, the subjectivity of estimated health care cost trend rates needed in accounting for postretirement health care benefits or the subjectivity involved in determining many other financial statement items such as depreciation, impairments of long-lived tangible and intangible assets, and loan loss reserves (paragraph C22).

Difference between FASB and IASB Conclusions on Options of a Nonpublic Entity

C73. IFRS 2 applies the same measurement requirements to employee share options regardless of whether the issuer is a public or a nonpublic entity. However, IFRS 2 contains the same accounting treatment as this Statement for financial instruments granted under share-based payment arrangements if the entity concludes that fair value cannot be reasonably estimated at the grant date. The IASB noted that share options granted by a nonpublic (or newly public) entity may fall into that category.

C74. The Board considered providing the same treatment as in IFRS 2 for share options granted by a nonpublic entity, that is, to require fair value unless it is not possible to reasonably estimate the fair value of the options at the grant date. The Board concluded, however, that effectively requiring a nonpublic entity to demonstrate that it cannot reasonably estimate the fair value of its options to qualify for an exception from the fair-value-based method could raise additional implementation issues. The Board notes that the end result of this Statement's requirements for nonpublic entities and the related requirements of IFRS 2 may be the same. Nonpublic entities that are able to develop a reasonable estimate of the fair value of their share options will avoid the need to remeasure the options at their current intrinsic value through exercise or other settlement. Nonpublic entities that cannot develop a reasonable estimate of fair value will use the intrinsic value method and remeasure their share options through the date of exercise or other settlement.

EMPLOYEE SHARE PURCHASE PLANS

C75. Statement 123 permitted employee share purchase plans that satisfied certain criteria to be treated as not compensatory, with the discount from market price accounted for as a reduction of the proceeds from issuing the shares. Those criteria were designed to provide an exemption only for plans that (a) included no (or very limited) option features and (b) provided a discount that would be reasonable in an offering to shareholders or others. Statement 123 provided a "safe haven" of 5 percent for applying the second criterion.

C76. The criteria to be met for an employee share purchase plan to be considered noncompensatory in Statement 123 were more restrictive than the related criteria in Opinion 25. This Statement further restricts noncompensatory treatment of employee share ownership plans to those (a) with terms that are the same as those available to all

holders of the same class of shares and (b) in which substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis.

C77. The Board concluded that a benefit, such as the ability to purchase shares at a discount from market price, provided to employees but not to other shareholders derives from the employment relationship and is unrelated to a possible role of employees as holders of equity instruments. Transactions with employees in their roles as employees result in compensation cost, and the Board sees no reason to account for share purchase plans differently. Conversely, the Board concluded that a benefit provided to all holders of a given class of shares, such as the ability to reinvest dividends at a stated discount from the current share price, occurs in a transaction with shareholders in their roles as shareholders, and thus that benefit is not compensation to employees.

ACCOUNTING FOR AWARDS CLASSIFIED AS LIABILITIES

C78. Statement 123 required that awards of options and equivalent instruments, such as share appreciation rights that require the entity to settle in cash (cash SARs),¹³ that qualify as liabilities be measured at their intrinsic value. This Statement amends Statement 123 to require public entities to measure their liabilities under share-based payment arrangements with employees at fair value at inception, with subsequent remeasurement at each reporting date until settlement. Nonpublic entities are provided the same choice between fair value measurement and intrinsic value measurement for their share options (and equivalent instruments) that are liabilities as for similar instruments that qualify as equity, except that liabilities are required to be remeasured at each reporting date until settlement regardless of which measurement method an entity elects.

C79. Statement 123's requirement for intrinsic value measurement of cash SARs and other liabilities continued the requirements of Opinion 25 for those instruments. At that time, the Board noted that, whatever the attribute chosen for measuring those instruments initially and in subsequent periods, the final measure of compensation cost would be the amount of cash paid to settle the liability, which for a cash SAR would equal the intrinsic value of the instrument at the date it is settled. The main focus of Statement 123 was accounting for employee share options that were equity instruments—not accounting for cash-settled awards about which there had been little controversy. In addition, before Statement 123 was issued and entities began applying it (for either recognition or pro forma disclosures), many entities with share-based payment arrangements had little familiarity with option-pricing models. For those reasons, the Board decided in developing Statement 123 not to require measurement of cash SARs at fair value.

C80. The Board believes that financial instruments issued to employees under share-based compensation arrangements should, if practicable, be accounted for based on their

¹³For convenience, the appropriate measurement attribute for liabilities incurred under share-based payment arrangements with employees is discussed in terms of cash SARs, but the discussion applies equally to other such liabilities, such as put options or forward purchase contracts.

fair value regardless of whether the instruments are classified as liabilities or as equity. As discussed in paragraphs C16–C19, the Board concluded that fair value is the appropriate measurement attribute for equity instruments, such as share options or share appreciation rights that call for physical settlement by issuing shares (stock SARs). For the same reasons, fair value also is the appropriate measurement attribute for similar instruments, such as cash SARs, that are liabilities.

C81. Public entities have been using option-pricing models to estimate the fair value of their equity share options since Statement 123 was issued in 1995. In addition, Statement 133 requires derivative instruments that are similar to cash SARs and other liabilities incurred under share-based payment arrangements to be measured at fair value, which was not the case in 1995. The number and variety of both derivative instruments subject to Statement 133 and similar financial instruments granted to employees as share-based compensation have increased greatly. Finally, as indicated by the classification criteria introduced by FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the distinction between liabilities and equity continues to evolve, and the Board may make additional changes to that distinction. After taking all those considerations into account, the Board concluded that requiring public entities to account for liabilities incurred to employees under share-based payment arrangements at intrinsic value is no longer necessary or appropriate. Therefore, this Statement amends Statement 123 to require that public entities measure liabilities incurred under share-based compensation arrangements at fair value.

C82. The reasons for the measurement requirements for liabilities of nonpublic entities are the same as the reasons given in paragraphs C69–C72 for the related requirements for share options and similar equity instruments of those entities. The fair-value-based method is preferable for liabilities of nonpublic entities as it is for their share options and other equity instruments.

APPLYING SUBSTANTIVE TERMS OF AN ARRANGEMENT IN DETERMINING WHETHER A FINANCIAL INSTRUMENT QUALIFIES AS A LIABILITY OR AS EQUITY

C83. Paragraph 39 of Statement 123 noted that the substantive terms of a share-based payment arrangement might differ from its written terms and required that the substantive terms be the basis for the accounting. The example provided of substantive terms that might differ from the written terms involved a tandem award in which the choice of whether to settle in cash or equity instruments nominally is the entity's, but the entity generally settles in cash (or settles in cash whenever an employee asks for cash settlement). In that situation, Statement 123 indicated that the entity may have incurred a substantive liability.

C84. This Statement continues that requirement to consider the substantive terms of an arrangement in determining whether the arrangement gives rise to a liability or to an equity instrument. However, in certain recent projects, the Board has established criteria for liability recognition that may be more restrictive than the “substantive terms”

requirement of Statement 123. For example, FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, requires recognition of *legal obligations* associated with the retirement of a long-lived asset. Paragraph 2 of Statement 143 defines a legal obligation as one “. . . that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.” *Black’s Law Dictionary*, seventh edition, defines *promissory estoppel* as “the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment.” It is not clear whether the counterparty (an employee, in this situation) to a contract that provides for settlement in either cash or shares at the election of the other party to the contract could use the doctrine of promissory estoppel to enforce cash settlement based on an entity’s past practices.

C85. The Board has encountered similar issues of whether a liability exists in other projects; some of those issues involve the current model for accounting for employee services, while others do not. The Board has on its agenda a project on distinguishing between liabilities and equity and accounting for instruments with aspects of both liabilities and equity. In the course of that project, the Board expects to consider both the conceptual distinction between liabilities and equity and the appropriate criteria for liability recognition. The Board therefore decided not to consider changes to Statement 123’s requirements for recognition of a substantive liability at this time. If progress on the Board’s project on liabilities and equity suggests that Statement 123’s provision may be inappropriate, the Board will reconsider it at that time.

RECOGNITION OF COMPENSATION COST

Accounting during the Requisite Service Period for Awards Not Expected to Vest

C86. This Statement requires entities to base accruals of compensation cost during the requisite service period on the estimated number of instruments for which the requisite service is expected to be rendered and to subsequently revise that estimate if 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. Statement 123 permitted entities either to use that method or to begin accruing compensation cost as if all instruments subject only to a service requirement were expected to vest and to recognize actual forfeitures as they occur.

C87. In deciding to eliminate the alternative that permitted recognition of the effects of forfeitures as they occur, the Board considered other areas of accounting in which similar estimates are made at initial recognition and subsequently adjusted if necessary, for example, recognition of coupon redemptions and promotional allowances in the retail industry. The Board sees no reason why estimating the number of instruments for which the requisite service is expected to be rendered will be more difficult than making similar estimates in those situations. Entities having share-based payment arrangements with employees have had to keep track of the number of instruments granted and subsequently

forfeited for purposes of either the recognition or the pro forma disclosure requirements of Statement 123. Until sufficient entity-specific information is available, start-up entities may base forfeiture estimates on the experience of other entities in the same industry.

C88. The Board also notes that requiring a single method of recognizing the effects of forfeited instruments will improve comparability. In addition, eliminating alternatives wherever practicable is consistent with the Board's initiative to simplify accounting standards.

Awards with Graded Vesting

C89. Statement 123 also provided for two methods of accruing the compensation cost related to awards with graded vesting provisions, although the methods were not described as alternatives for the same set of facts and circumstances. If the fair value of an award was determined based on different expected lives for the options that vest each year, compensation cost was required to be recognized separately over the life of each separately vesting portion. That was the method required for accounting under Opinion 25 by FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. That method considers an award with a graded vesting schedule to be in substance separate awards, each with a different vesting date. If the expected life of an award was determined in another manner, Statement 123 permitted the related compensation cost to be recognized on a straight-line basis, provided that the amount of compensation cost recognized at any date at least equaled the fair value of the vested portion of the award at that date.

C90. This Statement requires entities to use the first method described in paragraph C89. In deciding to require that method, the Board noted that the length of the vesting period of an award is one important factor that influences the expected term of an option. For example, if the expected term is inferred based on the results of applying a lattice model, the effects of early exercise on any share-price paths on which vesting has not yet occurred or the option is not yet exercisable are excluded. In addition, as discussed in paragraph B23, estimates of employees' early exercise and post-vesting employment termination behavior, and thus the related estimates of fair value, are improved if employees are aggregated into groups with relatively homogenous behavior. The length of the vesting period is a significant determinant of that behavior.

C91. Because of the interaction between the vesting period and the expected term, and because the latter affects the estimated fair value of an option, the Board concluded that an award with graded vesting should be accounted for as separate awards with different vesting periods. Moreover, the Board believes that accounting for an award with graded vesting as separate awards better reflects the exchange of employee services for the equity instruments. The Board notes that Statement 123 permitted the straight-line method in part because it is simpler than the method required by this Statement. But that attempt at simplification resulted in alternative attribution methods for what arguably is the same set of facts and circumstances. The Board wishes to eliminate alternatives wherever possible and appropriate because doing so simplifies accounting standards. In

addition, eliminating the straight-line alternative results in convergence of this Statement's and IFRS 2's requirements on this issue.

Market Conditions, Performance Conditions, and Service Conditions

C92. In discussing the treatment of various conditions that can affect the vesting, exercisability, or exercise price of an award, paragraph 26 of Statement 123 provided that:

No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award**, or because the entity does not achieve a **performance condition**, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. [Footnote reference omitted.]

A fixed award was defined as one for which vesting is based solely on an employee's continuing to render service to the employer for a specified period of time. A performance award was defined as one for which vesting depends on both (a) an employee's rendering service for a specified period of time and (b) the entity's achievement of a specified performance target, such as attaining a specified growth rate in return on assets or a specified increase in market share for a specified product.

C93. The Board concluded that Statement 123's definitions may not clearly classify some conditions for vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award included in instruments awarded under share-based payment arrangements. Thus, this Statement revises the definitions of those conditions to more clearly distinguish among them, although the accounting effects of the revised conditions are not significantly different from the effects of those conditions in Statement 123. The most significant clarification is to separately define *market condition*, which Statement 123 included as one type of performance condition. This Statement defines market condition as a condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award 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 similar¹⁴ (or index of similar) equity security (securities).

¹⁴The 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.

C94. This Statement continues Statement 123's different accounting for market conditions and performance conditions.¹⁵ That is, no compensation cost is recognized for awards that do not vest because a performance condition is not achieved, even though employees remain in service for the requisite service period. However, compensation cost is recognized for awards to employees who remain in service for the requisite service period regardless of whether (and when) a market condition is satisfied. The Board considered eliminating that distinction but decided to maintain it due to concerns about the measurability at the grant date of the expected outcomes associated with performance conditions. Some Board members also were concerned about the potential inconsistency if the effects of performance conditions were taken into account in measuring fair value at the grant date if the effects of service conditions were not treated similarly.

C95. The fair value of a share option with a market condition can be estimated at the grant date using a lattice model or another valuation technique developed for similar options that trade in external markets. The Board concluded that it would be inappropriate and illogical not to take advantage of relatively well-developed valuation techniques for those traded options in accounting for awards with market conditions. Performance conditions, on the other hand, involve the performance of the entity itself rather than the path of its stock price. Although it would be possible, in theory, to estimate the grant-date fair value of an award with a performance condition, to do so would involve developing a probability distribution reflecting the likelihood that the entity will, for example, achieve a specified percentage increase in return on assets in a specified period of time. An entity might have little, if any, data on which to base such a probability distribution, and it would be unlikely to be able to obtain adequate pertinent information about similar awards made by similar entities. Also, the IASB proposed in ED2 a requirement to take into account the effects of performance in estimating an award's fair value at the grant date. Respondents to both ED2 and the Invitation to Comment generally objected to that proposal on the grounds that it would not be feasible to develop sufficiently reliable estimates of the probability of achieving performance conditions. The Board agreed and concluded that the difference in recognition of compensation cost if a market condition is not achieved versus if a performance condition is not achieved should be maintained.

MODIFICATIONS OF THE TERMS OR CONDITIONS OF AWARDS

The Nature of a Modification of Terms

C96. Statement 123 required that an entity recognize additional compensation cost if it modified the terms of an award to increase the award's value. Statement 123's basis for conclusions (paragraph 187) explained that a modification of terms is indistinguishable

¹⁵References throughout the remainder of this appendix to conditions affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award use the terminology and related definitions as they appear in this Statement rather than as they appeared in Statement 123 as originally issued.

from an exchange of the existing equity instrument for a new instrument. That discussion continues in paragraph 188:

The repurchase of an equity instrument generally is accounted for based on the fair values of the instrument repurchased and the consideration paid for it. For example, if an entity repurchases shares of common stock at an amount significantly in excess of the current market price of the shares, the excess is presumed to be attributable to stated or unstated rights the issuer receives in addition to the shares surrendered, such as an agreement that the stockholder will not purchase additional shares.

C97. In reconsidering the accounting for a modification of the terms of an award of employee share-based compensation, the Board reaffirmed the conclusion that such transactions generally are transfers of value from the entity to its employees that give rise to additional compensation cost. A modification of the terms of an equity instrument granted to employees as compensation is inherently a transaction between the entity and its employees in their role as employees—not in their role as holders of equity instruments. For instance, a common type of modification is the lowering of the exercise price of an option—a repricing—after a significant decrease in the price of the underlying share. Entities sometimes explain repricings as necessary to restore the incentive value of the options following a share price decrease. Entities provide that benefit only to employees (and perhaps other suppliers) if the original terms of an option are no longer deemed to provide adequate compensation.

Measuring the Effects of a Modification

C98. Statement 123 required that the effects of a modification be measured as the difference between the fair value of the modified award at the date it is granted and the award's value immediately before the modification determined based on the shorter of (a) its remaining initially estimated expected life or (b) the expected life of the modified award. That method precluded the counterintuitive result that certain modifications favorable to employees could result in a credit to compensation cost. However, that advantage was gained by requiring a difficult-to-explain measurement procedure for the original award—a procedure whose result could not be described as fair value.

C99. This Statement amends Statement 123 to require that the effects of a modification be measured by comparing the fair values of the modified and original awards at the date of the modification. The Board concluded that the method required by this Statement is more consistent with the fair-value-based method of accounting for share-based payment arrangements. However, the Board believes it would be rare for employees to accept a modification that decreases the value of their awards without receiving anything of value in return. Therefore, this Statement indicates that total recognized compensation cost for an equity award rarely will be less than the fair value of the award at the grant date.

Additional Guidance on Accounting for a Modification

C100. This Statement amends Statement 123 to provide additional guidance on accounting for a modification of the terms or conditions of an award. Appendix B explains and illustrates that guidance. The implementation questions on which guidance is provided are taken from Interpretation 44 or Issue 00-23, both of which addressed accounting under Opinion 25. However, the Board expects that similar questions will arise in accounting under Statement 123 as amended by this Statement. The reasons for the Board's conclusions on the more significant aspects of the additional guidance, including areas in which the FASB and the IASB reached different conclusions, are discussed in the following paragraphs.

Modifications of Service and Performance Vesting Conditions

C101. This Statement amends paragraph 35 of Statement 123 to provide guidance on accounting for a modification of the vesting conditions of an award. The effect of a change in vesting conditions is measured in the same way as other modifications—by comparing the fair values of the award immediately before and after the modification. However, the amount of compensation cost recognized must at least equal the fair value of the original award at the grant date unless at the date of the modification it is not probable that the original vesting conditions will be satisfied. The combination of that requirement with the application of the modified grant-date method to performance conditions calls for additional discussion.

C102. Under the modified grant-date method, the effects of service and performance conditions are not reflected in the estimated fair value of the award at the grant date. Rather, the grant-date fair value is estimated as if those conditions did not exist, and their effect is reflected by recognizing compensation cost only for the number of awards that actually vest (that is, the number of instruments for which the requisite service is rendered). Accrual of compensation cost during the vesting period is based on the entity's expectation of the number of awards that will vest. Although the probability that a performance condition will be achieved can vary between zero and one, ultimately a performance condition either is or is not achieved, which means that compensation cost for an award with a performance condition is or is not accrued.¹⁶ If an award has more than one possible outcome, that approach is applied to each condition and the related compensation cost.

C103. In reconsidering the provisions of Statement 123, the Board divided modifications of performance- and service-vesting conditions into four categories:

- a. **Type I: Probable-to-Probable.** A service or performance condition is changed in a way that does not affect the estimate of whether the award will vest. An example is a change from an original performance condition, which required a 20 percent

¹⁶For simplicity, expected employee terminations before a performance condition is achieved are disregarded in the discussion. That is, even if a performance condition is achieved, some employees likely will have terminated service before the end of the requisite service period.

increase in market share of Product A, to a modified requirement for a 22 percent increase in market share, when both conditions are expected to be satisfied.

- b. **Type II: Probable-to-Improbable.** A service or performance condition is changed in a way that affects the estimate of whether the award will vest by substituting a condition that is not expected to be satisfied for one that was expected to be satisfied. An example is a change from an original performance condition that required a 20 percent increase in market share of Product A and was expected to be achieved to a requirement for a 25 percent increase in market share that is not expected to be achieved.
- c. **Type III: Improbable-to-Probable.** A service or performance condition is changed in a way that affects the estimate of whether the award will vest by substituting a condition that is expected to be achieved for one that was not expected to be achieved. An example is a change from a performance condition that required a 20 percent increase in market share of Product A and was not expected to be achieved to a requirement for a 15 percent increase in market share that is expected to be achieved.
- d. **Type IV: Improbable-to-Improbable.** A service or performance condition is changed in a way that does not affect the estimate of whether the award will vest by substituting one condition that is not expected to be achieved for another that also was not expected to be achieved. An example is a change from a performance condition that required a 25 percent increase in market share of Product A and was not expected to be achieved to a requirement for a 20 percent increase in market share that also is not expected to be achieved.

C104. Application of the required modification accounting to Types I and IV is relatively straightforward. No additional compensation cost would be recognized at the date of either a Type I or a Type IV modification because the modification changes neither the expectation of whether the vesting condition will be satisfied nor the fair value of the award (unless other terms also are changed). Employees are unlikely to accept Type II modifications (unless perhaps accompanied by changes in other terms), and the following discussion does not deal with them.¹⁷

C105. A Type III modification of a service or performance condition can result in recognition of compensation cost that is less than the estimated fair value of the award at the grant date if expectations about the probability of vesting are accurate. The following example illustrates that situation:

On February 1, 20X5, an entity grants its vice president for marketing 5,000 at-the-money options with a provision that the awards will vest only if the market share of Product A increases 20 percent by January 31, 20X6. On September 1, 20X5, market share has increased only 12 percent, and the 20 percent goal is not expected to be achieved. On that date, the entity modifies the performance condition to require only a 15 percent increase in market share, which is expected to be achieved. The

¹⁷Illustration 13 of Appendix B provides examples of Type I, II, III, and IV modifications and describes how the accounting for those modifications is consistent with the principles established in paragraph 35 of Statement 123 as amended by this Statement.

estimated fair value of each option is \$50 at the grant date and \$30 on the date of the modification.

FASB and IASB Conclusions on Type III Modifications

C106. The FASB concluded that a Type III modification should be accounted for in the same way as other modifications. Thus, on the date of the modification, the fair value of the original award, which is \$0 ($\$30 \times$ zero options expected to vest under the original target) in the example, is subtracted from the fair value of the modified award, or \$150,000 ($\$30 \times$ 5,000 options expected to vest under the modified target). If the modified target in the example is ultimately satisfied, the total recognized amount of compensation cost (\$150,000) will be less than the fair value of the award at the grant date (\$250,000) because at the date of the modification, the original vesting conditions were not expected to be satisfied. The Board considers that accounting for a Type III modification to be consistent with both the modified grant-date method and the requirements for accounting for a modification of the terms or conditions of an award. The Board also notes that its conclusions on Type III modifications would result in recognizing compensation cost that exceeds the fair value of the award at the grant date if the fair value of the award at the modification exceeds that amount. However, that situation may be less common than the one illustrated because failure to satisfy an original performance condition may be correlated with decreases in the price of the underlying share.

C107. The IASB reached different conclusions on Type III modifications of performance vesting conditions. Under IFRS 2, the modification in the example in paragraph C105 of this Statement would be accounted for as a change only in the number of options expected to vest (from zero to 5,000), and the full grant-date fair value of the award (\$250,000) would be recognized over the remainder of the service period. That result is the same as if the modified performance vesting condition had been in effect at the grant date. If the fair value of the award at the modification date exceeds its fair value at the grant date, however, IFRS 2 would require recognition of the higher amount as compensation cost.

C108. The Board reconsidered its conclusions on Type III modifications in light of the IASB's conclusions on that issue; that reconsideration resulted in reaffirming the FASB's conclusions. The principles established in paragraph 35 of Statement 123 as amended by this Statement require that the amount of compensation cost recognized after a modification of the terms and conditions of an award 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*. The emphasized phrase is significant for Type III modifications. In a modification that makes it probable that a vesting condition will be achieved, the original vesting conditions ordinarily will not be expected to be achieved, and the grant-date fair value of the award thus is not a floor on the amount of compensation cost recognized.

FASB and IASB Conclusions on Modifications That Change the Classification of an Award from Equity to Liability

C109. The Board's conclusions on a modification of the terms of an award that changes its classification from an equity instrument to a liability are consistent with its conclusions on accounting for other modifications of awards of equity instruments. In particular, the minimum amount of compensation cost to be recognized is the fair value of the instrument at the date it was granted, unless at the modification date the original vesting conditions are not expected to be satisfied. To illustrate, if an entity modifies a vested award of share options to add a feature under which the employee may elect cash settlement of the intrinsic value of the options at the exercise date, a financial instrument that formerly was classified as equity instead will be classified as a liability because the entity is obligated to pay cash if the employee elects cash settlement. If the fair value of the award is \$500,000 at the grant date and \$400,000 at the modification date, no decrement to compensation cost is recognized at the modification date because the previously recognized grant-date fair value of the award is the minimum compensation cost. Rather, the fair value of the liability at the modification date is reclassified from paid-in capital to the liability resulting from the modification. If the liability subsequently is settled for \$400,000 (or any amount less than \$500,000), no credit to the income statement is recognized because compensation cost must at least equal the grant-date fair value of the original equity award.

C110. The IASB concluded that the modification described in paragraph C109 should be viewed as the substantive repurchase of an equity instrument by incurring a liability. Under IFRS 2, changes in the fair value of the liability subsequent to the modification date are recognized in the income statement. The requirements of IFRS 2 treat the liability as a separate award.

C111. The FASB considers its conclusions on a modification that changes the classification of an award from equity to a liability to be internally consistent with other aspects of accounting for modifications, especially the principle that compensation cost for an equity award rarely will be less than the fair value of the award at the grant date. The Board believes that principle creates a floor for compensation cost. Recognizing decreases in the fair value of the liability subsequent to the modification date in the income statement results in cumulative compensation cost being less than the grant-date fair value of the original equity award.

Cancellations and Replacements

C112. The Board concluded that certain cancellations of awards accompanied by the grant of a replacement award are indistinguishable from modifications of the terms or conditions of the original award. For example, an entity might effectively reprice an award of share options with an exercise price of \$50 by taking either of the following actions:

- a. Modifying the terms of the award to lower the exercise price to \$40

- b. Cancelling the original award and concurrently granting a new award of share options with an exercise price of \$40.

In either case, the effect is the same—employees who previously had share options with an exercise price of \$50 now have share options with an exercise price of \$40.

C113. The Board considered what guidance to provide on distinguishing between a cancellation and grant of a replacement award that is substantively a modification, and a cancellation of an award that should be accounted for as a settlement, with any replacement award accounted for separately. The Board concluded that a modification of an award, regardless of whether that modification is in the form of a cancellation of an existing award and grant of a replacement award, would be explained as such to the employees affected by the transaction. Thus, a cancellation and grant of a replacement award must occur concurrently if the transaction is to be accounted for as a modification. Otherwise, cancellation of an award is accounted for as a settlement.

Effect of Modifications on Determining Whether a Grant Date Has Occurred

C114. This Statement defines *grant date* as the date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment arrangement. The effect of a modification is to change one or more of those terms or conditions, such as the exercise price of a share option.

C115. The Board considered whether multiple modifications of the same award might in some circumstances indicate that an employer and employees who benefit from the change(s) to their awards no longer have a mutual understanding of the award's key terms and conditions. The accounting result of a determination that such a mutual understanding does not exist would be to account for that award, and possibly similar awards, based on their estimated fair value at each reporting date until settlement. The Board considered several possible means of identifying awards to be accounted for as if a grant date has not yet occurred and concluded that each possible method could result in significant implementation problems. The Board also noted that most modifications of awards will result in recognition of incremental compensation cost. Accordingly, the Board decided not to establish special accounting requirements for multiple modifications of the same award.

INTERACTION OF THIS STATEMENT WITH STATEMENT 150

C116. When Statement 123 was issued in 1995, financial instruments were classified as liabilities or equity depending on whether the obligations embodied in them called for settlement by transferring cash or other assets (liabilities) or by issuing equity instruments

(equity).¹⁸ In 2003, the Board issued Statement 150, which establishes classification criteria for freestanding financial instruments under which some instruments that do not require the issuer to transfer its cash or other assets (either unconditionally or at the election of the holder) are classified as liabilities rather than as equity. Statement 150 also requires all freestanding instruments that call for settlement by transferring assets, including those issued in the form of mandatorily redeemable shares, to be classified as liabilities. Obligations under share-based payment arrangements accounted for under Statement 123 are excluded from the scope of Statement 150 until they are no longer subject to Statement 123. For example, mandatorily redeemable shares issued upon exercise of an employee share option are subject to Statement 150. Because of the potential overlap of Statement 123 and Statement 150, the Board considered how best to provide for the interaction between them.

C117. The Board considered amending Statement 150 to eliminate its scope exception for financial instruments accounted for under Statement 123 or related guidance and concluded that that amendment would not be appropriate because some of the recognition and measurement requirements of Statement 150 differ from those in this Statement. Nevertheless, the Board believes that the classification of a freestanding financial instrument issued in a share-based payment transaction should be the same as if the instrument were issued in a financing transaction. Therefore, the Board concluded that this Statement should require that an entity apply the criteria in paragraphs 8–14 of Statement 150 as they are effective at the reporting date in classifying freestanding financial instruments granted to employees under share-based payment arrangements.

Classification of Certain Instruments Issued by Nonpublic Entities

C118. In November 2003, the Board indefinitely deferred (through 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*”) the effective date of the provisions of Statement 150 pertaining to the classification, measurement, and disclosure provisions for certain mandatorily redeemable financial instruments issued by entities that are not SEC registrants. The indefinite deferral applies to all mandatorily redeemable instruments that are not mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate, currency, or other external index. Accordingly, an instrument granted to an employee by an entity that is not an SEC registrant that is redeemable upon the employee’s retirement or death at the fair value of the instrument at the date of redemption is not subject to Statement 150 unless and until the Board rescinds that indefinite deferral. Classification of certain such instruments was dealt with in

¹⁸Accounting for mandatorily redeemable shares varied before issuance of Statement 150, but those financial instruments usually were not treated as liabilities for accounting purposes. SEC regulations required public entities to display mandatorily redeemable instruments between total liabilities and equity on the balance sheet, but “dividends” on those instruments were not included with interest expense in determining net income.

paragraph 40 of Statement 123. Such instruments would continue to be classified as equity as long as the indefinite deferral remains in effect in accordance with FSP FAS 150-3. In addition, for internal consistency, the Board concluded that call options written on instruments that continue to be classified as equity due to that indefinite deferral also should be classified as equity while the deferral is in effect.

Certain Fair Value Repurchase Features

C119. Because Statement 150 applies only to freestanding financial instruments, it does not apply to a puttable share, which is a share that conveys to the holder the right, but not the obligation, to require the issuer to repurchase the share at a fixed or determinable price for a specified period of time or upon the occurrence of a specified event. Such a share is a compound rather than a freestanding financial instrument because the put is embedded within the share. The Board is considering the accounting for such shares in the second phase of its project on liabilities and equity.

C120. The Board considered whether to provide guidance in this Statement on the classification of shares that are puttable at fair value and are issued to employees under share-based payment arrangements. The Board concluded that it would be inappropriate to provide such guidance. It is more efficient to consider all issues involving the distinction between liabilities and equity in the project on liabilities and equity. In addition, including that issue in this Statement could have significantly delayed its issuance. The Board considered it more important to complete this Statement expeditiously, thereby requiring entities to recognize at fair value compensation cost from share-based payment arrangements with employees, than to attempt to include in it temporary resolutions of issues being actively considered in other projects.

Subsequent Accounting for Certain Freestanding Financial Instruments

C121. The Board considered when a financial instrument granted to employees in a share-based payment transaction should become subject to the requirements of Statement 150. Statement 123 as amended by this Statement deals with all aspects of measuring and recognizing financial instruments issued in exchange for employee services and the related compensation cost. In contrast, the financial instruments dealt with by Statement 150 generally are issued in exchange for cash or other financial instruments, that is, in financing transactions. Therefore, those instruments generally give rise to interest rather than compensation cost or other cost of goods or services received. Accordingly, the Board concluded that this Statement should govern the accounting for a freestanding financial instrument granted to employees until an employee could terminate service and receive or retain the fair value of the instrument. In other words, such instruments are subject to Statement 150 rather than Statement 123 when the employee's right to benefit from them is not contingent on continued employee service.

C122. An employee ordinarily is able to terminate service with vested shares (as opposed to options or option-like instruments) and still retain all rights inherent in the

shares. Therefore, instruments such as mandatorily redeemable shares or other nonvested shares generally will become subject to Statement 150 upon vesting.

C123. The Board understands that the terms of most employee share options provide an employee who terminates service with vested options only a limited time, often 90 days, in which to exercise them. In effect, the contractual term of vested options held upon termination of service is truncated. In that situation, continued employee service is necessary to maintain the exercisability of the options, and the instruments thus continue to be subject to the requirements of Statement 123 as amended by this Statement. However, some vested employee share options either may be freely transferable or may permit employees who terminate service to retain the right to exercise the options until the end of their original contractual term. In those situations, continued employee service is not necessary to maintain the exercisability of the instruments, and the instruments thus become subject to Statement 150 upon vesting.

C124. An entity may modify the terms of a fully vested, freestanding financial instrument after it becomes subject to Statement 150. The Board considers a modification of the terms of a financial instrument, such as a repricing of a share option, held by a current or former employee to be a transaction between the entity and those parties in their roles as employees rather than in their roles as holders of equity instruments. Any incremental value provided by the modification thus is additional compensation. (Refer to paragraphs C96 and C97 for discussion of the Board's conclusions on the nature of a modification of the terms of an award of share-based compensation.) Therefore, under this Statement, a modification that does not apply equally to all financial instruments of the same class regardless of whether the holder is or was an employee (or an employee's beneficiary) is a share-based payment transaction to be accounted for under the requirements of this Statement. Subsequently, the modified instrument will continue to be accounted for under Statement 150.

C125. Some classes of financial instruments are held only by current (or perhaps former) employees or their beneficiaries. Employee share options are one obvious example, but other instruments, such as the common shares of an entity that is wholly owned by its employees, fall into that category as well. The Board concluded that all modifications or settlements of such financial instruments may inherently stem from the employment relationship depending upon the terms of the transactions and thus may need to be accounted for under the requirements of this Statement.

Differences between This Statement and IFRS 2 on Distinguishing between Liabilities and Equity

C126. Currently, U.S. and international accounting guidance differ on various aspects of distinguishing between liabilities and equity and accounting for financial instruments with characteristics of both, and the FASB has an active project to reconsider portions of that guidance. In the meantime, related aspects of accounting for certain financial instruments issued to employees as compensation may differ under this Statement and under IFRS 2. For example, IFRS 2 does not distinguish between liabilities and equity using all the criteria established in Statement 150.

C127. This Statement does not attempt to analyze all potential differences between this Statement and IFRS 2 that stem from different U.S. and international accounting standards on liabilities and equity because at least some of those differences may be resolved when the FASB completes its project on that topic. As noted in paragraph C48, the FASB and the IASB will consider undertaking a joint project at that time to resolve any remaining differences between their standards on share-based payment.

ACCOUNTING FOR INCOME TAX EFFECTS OF INSTRUMENTS AWARDED TO EMPLOYEES

Awards of Equity Instruments

C128. Consistent with the original provisions of Statement 123, the Board concluded that compensation cost recognized in the financial statements gives rise to a temporary difference to be accounted for under FASB Statement No. 109, *Accounting for Income Taxes*. However, any deferred tax asset that is recognized for that temporary difference is not remeasured for changes in the amount that would be deductible for tax purposes at subsequent balance sheet dates.

C129. Under existing U.S. tax law, the tax deduction for an award of share-based employee compensation is based on the intrinsic value of the related instruments determined at a date after the grant date—generally the exercise date for share options (or equivalent instruments) and the vesting date for shares. The ultimate tax benefit thus may be higher or lower than the temporary difference recognized for accounting purposes. The Board concluded that tax deductions in excess of recognized compensation costs that result from increases in intrinsic value after the grant date (that is, excess tax deductions) are due to an equity transaction. Therefore, the related tax effect (or excess tax benefit) should be an adjustment of paid-in capital. The result of that accounting is that the tax effects of an award of share-based employee compensation affect both the income statement and paid-in capital because the total tax deduction pertains to two separate transactions or events:

- a. A transaction in which employees render services as consideration for an award of shares, share options, or other forms of share-based payment. Use of those services in the entity's operations results in compensation cost, which is an income statement item.
- b. An equity transaction, such as the exercise of share options. That equity transaction will be affected by share price changes between the date an award of options is granted and the date the award is exercised or otherwise settled.

C130. If the tax benefit for an instrument is less than the amount of the related deferred tax asset, referred to as a *tax deficiency* in this discussion, Statement 123 required that the write-off of the deferred tax asset be recognized in the income statement except to the extent of any remaining paid-in capital arising from excess tax benefits from previous awards accounted for using the fair-value-based method. This Statement requires that the full amount of a tax deficiency be recognized in the income statement.

C131. Statement 123's requirement to first allocate any effects of an income tax deficiency to paid-in capital to the extent of remaining tax effects of previous awards was based on a portfolio view of income tax effects of awards of share-based employee compensation. The result was to reduce the volatility of reported net income because some of the effects of a tax deficiency were absorbed by paid-in capital. In reconsidering that requirement, the Board noted that the potential effect of the portfolio approach was to recognize in income a tax benefit on an individual employee's instruments greater than the benefit actually received for those instruments. The Board concluded that the portfolio approach of netting of tax deficiencies on some instruments against excess tax benefits on other instruments is not appropriate. The Board also believes that recognizing income tax deficiencies for an individual employee's instruments is more consistent with the required recognition of compensation cost stemming from employee share-based compensation arrangements, which is recognized based on instruments issued to an individual employee.

Awards of Liability Instruments

C132. This Statement amends Statement 123 to provide guidance on accounting for the income tax effects of awards of liability instruments to employees in share-based payment transactions. Statement 123 did not address that issue because its required measurement date (settlement date) and measurement basis (intrinsic value) for those liabilities were the same as the measurement date and basis for tax purposes. However, this Statement amends Statement 123 to require that awards of liability instruments given by public entities be measured at fair value rather than intrinsic value. That requirement results in a temporary difference under Statement 109. That temporary difference is measured based on the fair value of the award because fair value is the measurement basis for accounting purposes.

FASB and IASB Conclusions on Other Aspects of Accounting for the Income Tax Effects of Equity Instruments Awarded to Employees

C133. The FASB's conclusion that the total tax deduction for an award of equity instruments arises from two transactions (paragraph C129) and its conclusion on the accounting for excess tax benefits and tax deficiencies are consistent with the requirements of IFRS 2. However, the FASB and the IASB reached different conclusions on certain aspects of accounting for the income tax effects of equity instruments awarded to employees.

Book and Tax Measurement Basis for Share Options

C134. In tax jurisdictions such as the United States, where the time value of share options generally is not deductible for tax purposes, IFRS 2 requires that no deferred tax asset be recognized for the compensation cost related to the time value component of the fair value of an award. A deferred tax asset is recognized only if and when the share options have intrinsic value that could be deductible for tax purposes. Therefore, an entity that grants an at-the-money share option to an employee in exchange for services would not recognize tax effects until that award was in-the-money. The IASB concluded

that to recognize a deferred tax asset based on the fair value of share options, including time value, would overstate the income tax effects of the award if time value is not deductible for tax purposes. The IASB's conclusion is consistent with viewing the total difference between book and tax accounting for an award of share options as resulting from both a difference in measurement date (grant date and exercise date, respectively) and a difference in measurement basis (fair value and intrinsic value, respectively).

C135. The FASB concluded that the deferred tax benefit recognized at the time compensation cost attributable to an award of share options is being recognized should be measured based on the fair value of the options, including time value, because that method is consistent with the measurement of the related compensation cost. The Board does not consider a portion of the total difference between book and tax accounting for an award of share options to result from a difference in measurement basis (fair value and intrinsic value, respectively). At the date share options are exercised (or lapse unexercised at the end of their contractual term) and the actual tax deduction (if any) is determined, fair value and intrinsic value are the same. At that date, either the employee has sacrificed the remaining time value upon early exercise or the time value has expired because the option has reached the end of its contractual term. Accordingly, the Board concluded that the difference between book and tax accounting under existing U.S. tax law results solely from different measurement dates and not from different measurement bases.

C136. The Board acknowledges that the IASB's conclusion is more consistent with the general approach to accounting for deferred taxes under both Statement 109 and IAS 12, *Income Taxes*. However, the Board decided to retain the existing departure from that basic tax-accounting model for the reasons noted above.

Accounting for the Deferred Tax Asset between Grant Date and Exercise Date

C137. Once a deferred tax asset pertaining to an award of share-based employee compensation is established as the related compensation cost is recognized, Statement 123 required that the effect of subsequent changes in the share price not be reflected in accounting for the deferred tax asset before that compensation is recognized for tax purposes. Rather, the deferred tax asset would be subsequently reduced by a valuation allowance only if, based on the weight of the available evidence, it is more likely than not that future taxable income will be insufficient to recover the deferred tax asset in the periods the tax deduction for the award will be recognized (or in a carry-back or carry-forward period).

C138. IFRS 2 requires that the deferred tax asset be remeasured based on the share price at each reporting date before the tax benefit is realized (or not realized). The IASB concluded that reflecting changes in the share price before realization of the tax benefit would be more consistent with other aspects of accounting for income taxes under its applicable accounting standard. As noted in paragraph C136, the FASB believes that treatment also could be viewed as conceptually consistent with Statement 109, but it decided for practical reasons to retain Statement 123's requirements.

AMENDMENTS TO STATEMENT 95

C139. FASB Statement No. 95, *Statement of Cash Flows*, requires an entity to provide a statement of cash flows that reports cash receipts and payments during the reporting period, classified according to whether they result from operating, investing, or financing activities. As originally issued, Statement 95 required all income tax payments (or receipts) to be classified as operating cash flows. In paragraph 92 of Statement 95, the Board explains that “. . . allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved.” The Board continues to consider that conclusion generally accurate. However, it decided for the reasons discussed in paragraphs C140–C143 to make an exception for the effects of excess tax benefits. Those excess tax benefits reduce the taxes otherwise payable, because increases in the intrinsic value of equity instruments issued to employees are deductible for tax purposes (but not recognizable for accounting purposes).

C140. As discussed in paragraphs C128 and C129, this Statement considers the tax effects of equity instruments awarded to employees to result from two transactions. Under that view, tax deductions that result from increases in intrinsic value after the grant date in excess of the grant-date fair value of the instruments awarded are considered to be due to an equity transaction and thus are recognized as an adjustment of paid-in capital. Thus, the tax effects of an award of share-based employee compensation affect both an income statement item and an equity item because the total tax deduction pertains to two separate transactions.

C141. For some entities, the tax benefits received upon employees’ exercise of share options have significantly reduced the amount of income taxes otherwise payable. As a result, questions arose concerning the reporting of the net amount of taxes paid as an operating cash flow, especially since for income statement purposes the reduction in taxes otherwise payable is effectively accounted for as a part of the equity transaction when employees exercise their options (or shares vest). Some accountants said that the amount of the tax reduction should be classified in the statement of cash flows as resulting from a financing activity. In July 2000, the EITF considered that question¹⁹ and concluded that entities should classify the amount of taxes paid as an operating cash payment because that is what Statement 95 required. At that time, however, the Board agreed to reconsider the issue if it subsequently undertook a project on accounting for share-based payment.

C142. Advocates of retaining the original provisions of Statement 95 on classification of taxes paid note that the primary object of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period (Statement 95, paragraph 4). They point out that a reduction in taxes otherwise payable is not a cash receipt, nor is the related amount of taxes that would have been payable in the absence of a particular tax deduction a cash payment. Proponents of reporting the

¹⁹Refer to EITF Issue No. 00-15, “Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option.”

excess tax benefit with cash flows from financing activities note that net operating cash flows often is used as an indicator of the liquidity or “nearness to cash” of net income. For that reason, they advocate restricting operating cash flows, to the extent feasible, to the cash flow effects of transactions and events that enter into the determination of net income. The tax benefit in question, they point out, while not itself a cash receipt, is a “cash flow effect” of a financing activity that does not enter into the determination of net income.

C143. The Board acknowledges that both views on this issue have merit, but on balance, it concluded that Statement 95 should be amended to report the tax reduction from excess tax benefits in the financing section of the statement of cash flows. The Board believes that this item differs from other components of taxes paid that might be allocated among categories in the statement of cash flows because this item involves both compensation cost included in the income statement and an adjustment of paid-in capital as a result of an issuance of shares—a financing transaction. The Board does not think that allocating to the financing section of the statement of cash flows the tax benefit of the excess tax deduction will be complex or arbitrary because that amount is accounted for as resulting from an equity transaction. The Board also decided that the amendment of Statement 95 should apply to share-based payment transactions with nonemployees so that similar economic transactions are accounted for similarly. The Board also notes that the amendment to Statement 95’s treatment of taxes paid removes a potential point of nonconvergence with IFRS 2.

DISCLOSURES

Objectives-Based Approach

C144. Statement 123’s disclosure requirements were developed in the context of recognition provisions that would not necessarily result in financial statements that adequately account for the economic effects of share-based payment arrangements with employees. Because entities could continue to use Opinion 25’s requirements if they chose, many valuable equity instruments granted to employees resulted in no compensation cost being recognized in the financial statements. Thus, one purpose of Statement 123’s disclosure requirements was to mitigate the inadequate accounting for share-based employee compensation arrangements. The pro forma disclosures were the most obvious example of disclosures intended for that purpose, and this Statement eliminates those disclosures prospectively. The Board reevaluated Statement 123’s other disclosure requirements in light of this Statement’s requirement to recognize the compensation cost from share-based payment arrangements in accordance with the fair-value-based method.

C145. The Board believes that the purpose of disclosures is to explain and elaborate on information recognized in the financial statements. The Board also notes that IFRS 2 establishes specific disclosure objectives for share-based payment arrangements and indicates minimum disclosures that would be needed to achieve each objective. Some respondents to the Invitation to Comment commented favorably on that approach, and the

Board agrees that an objectives-based approach to disclosure requirements has merits. This Statement thus establishes four specific disclosure objectives. Paragraph B191 indicates the minimum disclosures needed to achieve each objective, and paragraph B192 illustrates how the minimum requirements might be satisfied.

Information about the Nature and Terms of Share-Based Payment Arrangements

C146. The Board concluded that an important disclosure objective is to provide information that enables users of financial statements to understand the nature and terms of share-based payment arrangements with employees that existed during the reporting period and the potential effects of those arrangements on shareholders. Information needed to understand the potential effects of share-based payment arrangements on shareholders includes, but is not necessarily limited to, information about the potential transfer of value from preexisting shareholders to option holders upon exercise of in-the-money options. That objective was implicit in many of the disclosure requirements of Statement 123.

C147. The minimum disclosures this Statement specifies as necessary to achieve the objective discussed in paragraph C146 also were required by Statement 123, and many of them also were required by Opinion 25. Thus, entities have for many years been disclosing items such as the nature and terms of share-based payment arrangements and a reconciliation of instruments outstanding at the beginning and end of the year. Those disclosures generally have been considered useful and have not been controversial. (Refer to paragraphs 243–261 of Statement 123 for a discussion of the basis for the Board’s conclusions on the disclosures required by Statement 123.)

C148. Statement 123 required entities to disclose the items specified in paragraph B191(b) of this Statement for each year for which an income statement was provided. Thus, an entity that presented comparative financial statements had to disclose, for example, the number and weighted-average exercise price of options granted, exercised, forfeited, or expired during a given year not only in the notes to that year’s financial statements but also in the notes for succeeding years in which that year’s financial statements are presented for comparative purposes. Although the Board continues to consider those disclosures important, it concluded that they are necessary only for the current year. The Board is not aware of a significant use or need for comparative disclosures of, for example, a reconciliation of the number of share options outstanding at the beginning of the year with those outstanding at the end of the year. Moreover, users who wish to see reconciliations for earlier years can consult the notes to the financial statements for those years. However, the Board concluded that the items specified in paragraph B191(c) of this Statement should be required for all periods presented to facilitate an understanding of trends.

C149. Statement 123 required disclosure of both (a) the weighted-average exercise price of options outstanding at the beginning of the year, those outstanding at the end of the year, and those granted, exercised, forfeited, or expired during the year and (b) the range of exercise prices of options outstanding at the date of the latest statement of financial position presented. The Board concluded that both weighted-average and ranges of

exercise prices are not essential minimum disclosures. The Board understands that ranges of exercise prices, by themselves, are not adequate to enable users to understand the potential increase in outstanding shares as a result of option exercises. Accordingly, the Board decided to retain only the required disclosure of weighted-average exercise prices. However, the Board emphasizes that paragraph B191 specifies only minimum disclosures needed to achieve the objective of enabling users to understand the nature and general terms of share-based payment arrangements with employees that existed during the reporting period and the potential effects of those arrangements on shareholders. An entity that considers ranges of exercise prices also to be important in achieving that objective may voluntarily provide that disclosure.

Information about the Effect of Compensation Cost on the Income Statement

C150. The Board concluded that information should be provided to enable users of the financial statements to understand the income statement effect of compensation cost arising from share-based payment arrangements with employees. Paragraphs B191(g) and B191(h) of this Statement specify minimum disclosures needed to achieve that objective. Many of those minimum disclosures, such as the total compensation cost recognized in income, also were required by Statement 123. However, the Board decided that certain other disclosures not specified by Statement 123 also are important in achieving the objective of enabling users to understand the income statement effects of compensation cost.

C151. To understand the effects of share-based payment arrangements on the income statement, users need to know not only the compensation cost recognized in income but also the related tax effects recognized in income. Users of financial statements, including many of those who responded to the Invitation to Comment, also asked for information to help understand the potential effects of compensation cost resulting from outstanding awards on future income statements. The Board considered that request to be both reasonable and consistent with the disclosure objectives. Accordingly, this Statement requires disclosure of total compensation cost related to nonvested awards that has not yet been recognized and the period over which it is expected to be recognized, as well as the total compensation cost capitalized as part of the cost of an asset (and thus recognizable in future years' income statements). Because that information should be readily available, the Board believes that the cost of disclosing it is not likely to exceed the related benefits.

How the Fair Value of Goods or Services, Including Employee Services, Received as Consideration for Equity Instruments Issued Was Determined

C152. Another important objective of disclosures about share-based payment arrangements is to enable users of financial statements to understand how the fair value of the goods or services received, or the equity instruments issued, during the period was determined. Paragraph 16 of Statement 123 as amended by this Statement requires that employee services received as consideration for equity instruments issued and liabilities incurred in share-based payment transactions with employees be measured based on the fair value of the instruments issued. However, the fair value of goods or services

received in exchange for financial instruments issued to nonemployees in share-based payment transactions may be directly measurable, and, if so, that amount is to be the basis for measuring the effects of the transaction. To understand the effects of share-based payment arrangements on the financial statements, users need to understand how the related fair value amounts were determined.

C153. The minimum disclosures specified in paragraph B191(f) of this Statement as necessary to enable users to understand how fair values were determined also were required by Statement 123. However, because this Statement gives greater emphasis to lattice models than Statement 123 did, the required disclosures of the significant assumptions used to estimate the fair value of share-based compensation awards are revised to specifically encompass assumptions used in lattice models that employ a range of assumptions. For example, an entity that uses a valuation method in which different expected volatilities are used during the contractual term of an option is required to disclose the range of volatilities used.

Information about Cash Flow Effects of Share-Based Payment Arrangements

C154. The Board concluded that an objective of the disclosures required by this Statement should be to provide information that enables users to understand the cash flow effects of share-based payment arrangements. The Board considers that objective to be consistent with the focus of users of financial statements on cash flows and with the overall financial reporting objective of providing information useful in assessing future cash flows.

C155. Statement 123 did not require the disclosures specified in paragraphs B191(i)–B191(k) of this Statement as necessary to achieve this objective, but some of them may have been provided in the statement of cash flows for periods in which they were significant. Separate disclosure in the statement of cash flows of (a) the amount of cash received from exercise of share options and similar instruments and the related income tax benefits that were recognized in equity and (b) the amount of cash used to settle equity instruments granted under share-based payment arrangements will satisfy the related disclosure requirements of this Statement.

C156. The Board considered also requiring disclosure of the cash used to repurchase shares in conjunction with share-based payment arrangements. However, an entity may repurchase its shares for various reasons, and the Board concluded that distinguishing between shares repurchased for share-based payment arrangements and shares repurchased for other reasons would not be feasible. Accordingly, it decided instead to require a description of the entity's policy for repurchasing shares in conjunction with share-based payment arrangements if such a policy exists, and the number of shares, if any, expected to be repurchased for that purpose in the following annual reporting period.

EFFECTIVE DATE AND TRANSITION

C157. For public entities and nonpublic entities that use the fair-value-based method for recognition or pro forma disclosures, the Board decided that this Statement should be

effective for awards that are granted, modified, or settled in fiscal years beginning after December 15, 2004. The Board concluded that a relatively early effective date would be feasible for public entities because those entities already have been either recognizing, or disclosing the pro forma effects of recognizing, compensation cost based on the fair value of awards to employees. Even though the fair-value-based method in this Statement differs in various respects from the one in Statement 123, those differences are not sufficient to warrant an extended transition period.

C158. The Board considered several alternatives for how public entities should accomplish the transition to this Statement, including both full retrospective application with restatement of prior periods, prospective application, and variations of each. The Board evaluated those alternatives in the context of the proposed requirements in its Exposure Draft of a proposed Statement, *Accounting Changes and Error Corrections*, which would replace Opinion 20 and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. That Exposure Draft was issued for comment on December 15, 2003, as part of the Board's international convergence project. Under the provisions of that proposed Statement, a change in accounting principle would be applied retrospectively unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. Retrospective application would be deemed impracticable if it would require significant estimates as of a prior period, and it would not be possible to objectively determine whether information used to develop those estimates would have been available at the time the affected transactions or events would have been recognized in the financial statements, or whether that information arose subsequently. Paragraph A12 of the Exposure Draft explains that proposal:

. . . the objective of estimates related to prior periods is the same as the objective of estimates related to current periods. That objective is to make an estimate that reflects the conditions that existed at the date the transaction would have been recognized in the financial statements had the newly adopted accounting principle been applied as of that earlier date. Achieving this objective requires differentiating between information that provides additional evidence about conditions that existed at the transaction date and information about conditions that arose subsequently. For some types of estimates (for example, an estimate of fair value not based on an objectively observable price or objectively observable inputs), it is not practicable to distinguish the information that would have been available about conditions that existed at the transaction date from all other types of information.

C159. If retrospective application with restatement was practicable, the Board believes it would be the best transition method for this Statement because retrospective application would provide the maximum amount of comparability between periods and thus enhance the usefulness of comparative financial statements. However, the Board concluded that retrospective application of the change in accounting principle to adopt this Statement would be impracticable because it could require an entity to make estimates as of a prior period. Although the guidance in this Statement on estimating the fair value of an award at the grant date is similar to the guidance in Statement 123 that public entities have been

following for either recognition or pro forma disclosure purposes, this Statement clarifies and elaborates on Statement 123's guidance. As a result, an entity might conclude that some aspects of its estimation method used in prior years should be changed, which could call for estimates of, for example, employees' expected early exercise and post-vesting employment termination behavior as of earlier periods. Other requirements of this Statement, for example, the method of measuring the effects of a modification of an award, also differ from the related requirements of Statement 123 and could require estimates as of an earlier period. The Board thus rejected retrospective application.

C160. For public entities and nonpublic entities that use the fair-value-based method for recognition or pro forma disclosures, the Board also rejected full prospective application, that is, application only to awards granted, modified, or settled in fiscal years beginning after December 15, 2004. Public entities have for many years been either recognizing, or disclosing the pro forma effects of recognizing, compensation cost from share-based payment arrangements with employees using a fair-value-based method that is similar to the method in this Statement. Accordingly, the Board concluded that public entities and nonpublic entities that use the fair-value-based method for recognition or pro forma disclosures also should be required to apply this Statement to the nonvested portion of awards outstanding at the date of adoption granted in fiscal years beginning after December 15, 1994, using the previously estimated grant-date fair value used for recognition or pro forma disclosures. Because measurement and attribution of those awards are to be based on the estimate of their grant-date fair value used to apply the original recognition or pro forma disclosure requirements of Statement 123, current estimates as of prior periods will not be necessary. The Board also notes that the modified prospective transition method required by this Statement does not require public entities that adopted Statement 123's fair-value-based accounting method to restate prior years' financial statements.

C161. The Board decided that nonpublic entities (excluding nonpublic entities that use the fair-value-based method for recognition or pro forma disclosures) should be permitted an additional year, until fiscal years beginning after December 15, 2005, to adopt this Statement even though those entities are permitted to use either the fair-value-based or the intrinsic value method. The Board recognizes that nonpublic entities generally have fewer resources than public entities to devote to adopting new accounting requirements. More important, nonpublic entities may not previously have been using either a fair-value-based method or the intrinsic value method prescribed by this Statement for recognition or pro forma disclosure purposes. Statement 123 permitted nonpublic entities to use the minimum value method to estimate the value of their employee share options and similar instruments. Because it omits expected volatility, an estimate based on minimum value is not comparable to one based on fair value. In addition, the intrinsic value method that this Statement permits nonpublic entities to use requires remeasurement of intrinsic value at each reporting period until an award of share options is forfeited, exercised, or otherwise settled. It thus differs from the grant-date intrinsic value method in Opinion 25. Accordingly, the Board concluded that nonpublic entities should apply this Statement prospectively to awards granted, modified, or settled in fiscal years beginning after December 15, 2005.

C162. Application of this Statement, combined with application of the classification provisions of Statement 150, may change the classification of freestanding financial instruments granted to employees from equity to liabilities. The Board concluded that such changes in classification should be made by means of a cumulative catch-up adjustment in the period of adoption. The Board does not consider continuing to classify as equity an instrument that qualifies as a liability under this Statement to be acceptable. However, the Board also does not consider retrospective application of changes in classification to be practicable because that transition method could require estimates of the fair value of the reclassified instruments for earlier periods. The Board thus concluded that reclassification of such instruments at the date this Statement is adopted, with the cumulative effect of the change reported in that period, is the best available alternative. It also is consistent with the Board's conclusions on the transition method for a change in accounting principle if retrospective application is impracticable, as reflected in the Exposure Draft on accounting changes and error corrections.