At this meeting the FASB staff will announce the issuance of the following FSP and its posting to the FASB Website as final:

FSP FAS 142-2, “Application of FASB Statement No. 142, Goodwill and Other Intangible Assets, to Oil- and Gas-Producing Entities.”
At today’s meeting, the Board will discuss issues raised by respondents to the FASB Exposure Draft (ED), *Share-Based Payment*, that relate to modifications and settlements.

**ISSUE 1—TYPE III MODIFICATIONS:**

Modifications are defined in the ED as follows:

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

Paragraph C103(c) of the ED describes a Type III modification as follows:

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.

The Board will discuss the following example of a Type III modification:

On January 1, 2005, Company Z issues 1,000 at-the-money options to all employees that work in Plant J. The options cliff vest after four years. Later, Company Z decides to close Plant J and terminates the employment relationship of all employees of Plant J effective January 1, 2007. On January 1, 2007, Company Z accelerates vesting on all 1,000 options to maintain a certain level of goodwill with the employees. The estimated fair value of each option is $20 at the grant date and $10 on the date of the modification.

**Discussion Question No. 1:** Does the Board continue to support the guidance in the ED on the accounting for Type III modifications?

*View A:* Yes, retain the guidance in the ED on the accounting for Type III modifications. Paragraph 35(b) of the ED states: “Total recognized compensation cost for an award rarely will be less than the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied.” [Emphasis added.]
View B: No, change the accounting for Type III modifications to be convergent with IFRS 2, *Share-based Payment*. This view would not allow total recognized compensation cost for a Type III modification to be less than the grant date fair value.

**Staff Recommendation:** The staff recommends View B.

**ISSUE 2–EQUITY RESTRUCTURINGS:**

Paragraph 36 of the ED indicates the following with regard to equity restructurings:

> Exchanges of share options or other equity instruments or changes to their terms in conjunction with an *equity restructuring* or a business combination are modifications for purposes of this Statement. [Footnote reference omitted.]

Some questions were asked by respondents with regard to antidilution provisions that are in the original terms of an award. Respondents also asked the Board to further clarify the removal of the last sentence in paragraph 36 of Statement 123 which stated the following:

> However, a change to the terms of an award in accordance with antidilution provisions that are designed, for example, to equalize an option’s value before and after a stock split or stock dividend is not a modification of an award for purposes of this Statement.

**Staff Recommendation:** The staff recommends retaining the guidance in paragraph 36 of the ED and clarifying the basis for removing the last sentence from paragraph 26 of Statement 123.

**Discussion Question No. 2:** Does the Board agree with the staff’s recommendation on retaining the guidance on the accounting for equity restructurings?

**ISSUE 3–CALCULATION DATE FOR A MODIFICATION**

Some respondents have questioned when the calculation should be performed for a modification. The Board will discuss the following example:

Company A announces on March 1, 2005, that it will have a large, non-recurring cash dividend payable to holders of record as of November 1, 2005. Company A does not have a history of paying cash dividends. Company A’s stock option plan does not contain antidilution provisions. On June 30, 2005, Company A modifies the terms of its stock option plan by reducing the exercise price by the dividend.

**Staff Recommendation:** Paragraph 35 (a) of the ED states: “Incremental compensation shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the
original award immediately before its terms are modified.” Therefore, the modification date in this example is June 30, 2005 (that is, the date the terms of the award are changed.) The pre-and post-modification estimates of fair value would have to incorporate the expected dividend payout and compare the terms of the award pre- and post-modification.

Discussion Question No. 3: Does the Board agree with the staff’s analysis of the date that the calculation of incremental value should be performed?

ISSUE 4–LIABILITY TO EQUITY MODIFICATIONS

The ED states that based on the principle that total recognized compensation cost rarely will be less than the fair value of the award at the grant date, an entity should recognize cumulative compensation cost in the amount that would have been recognized as of the date of the modification had the liability award been accounted for as equity from the date of grant.

Discussion Question No. 4: Does the Board continue to support the guidance in the ED on the accounting for a modification from a liability award to an equity award?

View A: Yes, retain the guidance in the ED for a modification from a liability award to an equity award which states that an entity should recognize cumulative compensation cost in the amount that would have been recognized as of the date of the modification had the liability award been accounted for as equity from the date of grant, unless the modification-date fair value of the liability award exceeds the grant-date fair value of the liability had it been accounted for as equity.

View B: No, change the guidance in the ED for a modification from a liability award to an equity award. Because the award was a liability award, the grant date fair value is irrelevant as liability awards are marked to market each reporting period. This view would compare the values pre- and post-modification. Any incremental value would be recognized as compensation cost. The fair value would then be fixed at the modification date for the equity award.

Staff Recommendation: The staff recommends View B.
At today’s meeting, the Board will discuss issues related to the modified grant-date method (MGDM) and out-of-the-money (OOTM) options.

**MGDM Applied to Deep OOTM Stock Options**

**Discussion Question No. 1:** Does the Board believe that a notion of substantive vesting based on subsequent fluctuations in the value of equity instruments is theoretically consistent with MGDM?

The proposed *Share-Based Payment* Statement states that the cost of an exchange of employee services for equity instruments shall be measured at the grant-date fair value of the employee service assets to be received or the grant-date fair value of the equity instruments issued, whichever is more reliably measurable. The grant date was chosen as the date to measure the exchange because that is the date at which (a) an employee and employer come to a mutual understanding of the key terms and conditions, (b) the employer becomes conditionally obligated to issue equity instruments, and (c) the employee’s risks and benefits vis-à-vis the amount received upon settlement begin to be affected by fluctuations in the stock price. The Board has tentatively concluded that the grant date is the best date to measure the bargained-for exchange. At this date, an explicit or implicit price is placed on the employee service assets to be received and the equity instruments to be given. Implicit within the notion of an exchange is that the value of both items is equal; that is the basis for the measurement philosophy in the proposed Statement.¹

¹ Of course, this may not hold in all cases. Please refer to FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt.*

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
The proposed Statement recognizes that the exchange of employee services for equity instruments is based on a fully executory contract. That employee service (or service condition) is at the heart of accounting for those fully executory contracts under the MGDM. If the employee satisfies the service condition of the contract, the employer shall issue equity instruments. If the employee does not satisfy the service condition, the employer is not contractually obligated to issue equity instruments. Therefore, the price—to be paid by the employee in terms of service (employee service assets paid over the requisite service period stipulated by the executory contract)—placed on the equity instruments by the employer at the grant date must be paid in full; otherwise, the equity instruments shall not be issued. The MGDM uses the notion of issuance as opposed to grant to recognize the fully executory nature of such transactions:

An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash or another financial instrument, goods, or services (or employee service assets). An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration (or employee service assets) or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration (all the employee service assets due under the contract). For that reason, Statement 123 does not use the term issued for the grant of stock options or other equity instruments subject to service or performance conditions (or both) for vesting (footnote 4 of Statement 123).

To summarize, the grant-date fair value has tentatively been chosen by the Board as the best measure of the assets to be received, and the date of issuance (which is generally the vesting date) has tentatively been chosen as the date at which all consideration necessary to transfer (or issue) the equity instruments under the executory contract has been received by the issuing enterprise. The issuance date is the final date in the accounting for an EBC equity instrument, absent a subsequent modification of its terms or conditions.
A deep OOTM stock option at the grant date is an award with a market condition. A deep OOTM stock option’s exercise price is the equivalent of a target stock price that permits an award to become rationally exercisable; that effective target stock price is a condition that affects exercisability that relates to the achievement of a specified price of the issuer’s shares. Assuming that an award can be retained only for a short amount of time subsequent to voluntary termination, an award with a market condition contains a derived service condition.

Consider an example in which stock options are granted to an employee with an exercise price of $10 and the grant-date stock price is $6 per share. Suppose further that the award is fully vested at the grant date. If the employee voluntarily terminates the employment relationship, the employee has 90 days to exercise an award. The stock options will become rationally exercisable based on the future stock price path. In measuring the grant-date fair value of the stock options, the valuation model’s output provides a distribution of future stock price paths. That distribution provides a distribution of times to exercisability (when the option becomes rationally exercisable or goes in-the-money). In this example, suppose that the mode of that distribution is 2 years, the median of the distribution is 2.5 years, and the mean of the distribution is 3 years. Therefore, the issuing enterprise would expect that the employee would likely have to work two to three years in order to realize any benefit from the stock options. That expectation is akin to establishing an explicit service condition of two to three years based on the factors establishing the option’s fair value at the grant date. Due to the stock option’s OOTM character, it contains a substantive requisite service condition; some might call that substantive service condition a substantive vesting condition.

If the employee holding that OOTM stock option completes the 2.5-year derived service period, the price of the equity instruments has been paid in the form of employee service assets, which was (or should have been) the expectation of the parties at the grant date based on then-available information. Whether the award ultimately becomes exercisable is analogous to whether an at-the-money option ultimately becomes exercisable; in both instances, the ultimate outcome does not impact the deemed exchange of employee services for equity instruments under the MGDM. That exchange under the MGDM
occurs independently from subsequent fluctuations in the value of the equity instruments to be issued upon the completion of the requisite service condition. The same would be true for OOTM nontransferable, detachable warrants issued with a debt instrument. The likelihood of those warrants ever being exercised during their contractual life may be trivial; however, the imputed interest on the debt instrument recognized under APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, would not be eliminated.

The substantive service condition described above also is the basis on which the staff argues that a modification to accelerate vesting of deep OOTM stock options is a nonsubstantive modification. That is, the employer has replaced one explicit service condition with another implied service condition; hence, an employee must continue to pay the grant-date price of the equity instruments with employee service assets. In other words, the modification has not changed the underlying executory contract that continues to be only partially executed.

It is true that sufficient out-of-the-moneyness is the equivalent of a service condition; nevertheless, substantive service conditions established at the grant date are not trued up in terms of their grant-date fair value under the MGDM. The MGDM does not allow expected term to be trued up for actual outcomes. The Exposure Draft of FASB Statement No. 123, Accounting for Stock-Based Compensation, requires that expected term be trued up to the actual term. The Board decided to eliminate that treatment for two reasons: (1) the treatment led to the counterintuitive result of OOTM options having the highest cost (based on the grant-date stock price and other relevant assumptions and because the actual term would be 10 years) to the issuing enterprise and (2) the treatment would have resulted in the remeasurement of an equity interest. Such treatment also implies that the service condition of the partially executory contract is renegotiated each time there is a subsequent fluctuation in the value of equity instruments. That is an argument for a form of service expiration date measurement that the Board rejected in favor of grant-date measurement. The MGDM is based on the premise that all key terms are established at the grant date and that one of those terms is the service condition. It is
inconsistent with that model to argue that the employer and employee would view the service condition as the subject of continuous renegotiation subsequent to the grant date.

Staff Recommendation: The staff does not believe that the notion of substantive vesting based on subsequent fluctuations in the value of equity instruments is theoretically consistent with the MGDM.
At today’s meeting, the Board will discuss the existing authoritative literature and will address how to account for a spinoff under the guidance in the proposed Statement.

ISSUE 1–MODIFICATION GUIDANCE EXCEPTION FOR SPINOFFS

Paragraph 36 of the Share-Based Payment ED states: “Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this Statement.” The glossary of the ED defines an equity restructuring as follows:

A nonreciprocal transaction between an entity and its shareholders, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend that causes the per-share fair value of the shares underlying an option or similar award to change.

Several respondents to the ED had questions about the accounting for spin-off transactions. Examples would include the spin-off of a more volatile unit from a less volatile parent, or the acquisition of a less volatile unit by a more volatile parent

Discussion Question No. 1a: Does the Board want to use a fair value or intrinsic value approach for comparing the values pre- and post-modification for modifications of awards as a result of a spinoff?

View A: Use a fair value approach for comparing the values pre- and post-modification. This view would not change the modification guidance in paragraph 36 of the ED pertaining to equity restructurings.

View B: Use an intrinsic value approach for comparing the values pre- and post-modification. This view would make an exception for spinoff transactions and allow companies with spinoffs to follow the current guidance under Opinion 25 and its related interpretations for measuring the values pre- and post-modification.

Staff Recommendation: The staff recommends View A.

Discussion Question 1(b): If the Board decides that companies should use a fair value approach for comparing the values pre- and post-modification, does the Board want to provide any additional guidance on calculating fair value pre- and post-modification?
View A: Include guidance stating that insignificant differences between the pre-and post-modification fair value of awards would not give rise to additional compensation cost.

View B: Modify the guidance in the ED to include a presumptive approach. That is, if the intent of management is to equate the fair value of the award pre- and post-modification, then unless it is readily apparent that additional value is being transferred, there would be no accounting consequence. This view would include a definition of antidilution provisions that would state something to the effect of “a change to the terms of an award that are designed to equalize an option’s value before and after an equity restructuring.”

View C: Do not provide any additional guidance on calculating fair value pre- and post-modification.

Staff Recommendation: The staff recommends View C.

ISSUE 2–CHANGE IN STATUS EXCEPTION FOR SPINOFFS

The next issue that arises for spinoff transactions relates to changes in status from employee to nonemployee as a result of a spinoff transaction. After a spinoff occurs, employees of the spinoff entity typically are no longer employees within the spinnor’s consolidated group. Assume the spinnor either distributes all of its shares in the subsidiary to the spinnor’s shareholders, or a sufficient portion of those shares to lose control of the subsidiary and cease consolidation. The issue that arises is how awards in the spinnor’s stock retained or received by spinee employees should be accounted for by the spinnor. This issue also covers the accounting by the spinee for awards in spinee stock retained or received as part of the equity restructuring by employees of the spinnor. In both cases, the spinoff transaction causes the spinnor to lose control of the spinee and, as a result, causes employees of the separate entities after the spinoff to become nonemployees with regard to the other entity and its SBP awards.

Discussion Question No. 2: Do Board Members want to retain the exception guidance similar to that in FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, with regard to changes in status as a result of a spinoff?

View A: Retain an exception to changes in status as a result of a spinoff.

View B: Do not carry forward an exception for changes in status as a result of spinoff.

Staff Recommendation: The staff recommends View A.
ISSUE 3–TRANSITION ISSUES FOR SPINOFFS

Forfeitures
The staff recommends providing guidance in the proposed Statement that states that in the event of forfeiture, compensation cost can only be reversed to the extent that the employer company recognized compensation expense for that employee. For example, the compensation cost recognized by the spinnor prior to the spinoff cannot be reversed once the option holder forfeits their award as an employee of the spinnee.

Deferred Taxes
The staff recommends that deferred tax assets in a spinoff must follow the terms of the specific agreement and that no specific guidance should be given in these instances.

Discussion Question No. 3: Does the Board agree with the staff’s analysis with regard to transition in a spinoff transaction and the accounting for forfeitures and deferred taxes?
At today’s meeting, the Board will discuss issues raised by respondents to the FASB Exposure Draft (ED), *Share-Based Payment*, that relate to fair value measurement.

**ISSUE 1: RELIABLE FAIR VALUE MEASUREMENT AT THE GRANT DATE**

Some comment letter respondents did not agree that the fair value of employee stock options could be measured reliably at the grant date. Generally, those who did not agree that granting employee stock options is an exchange that gives rise to compensation cost did not believe that the fair value of employee stock options could be estimated reliably by an existing option-pricing model. Generally, accounting firms and other valuation experts support the notion that the fair value of employee stock options can be reliably measured by existing option-pricing models. That conclusion is consistent with results of our work with the Option Valuation Group (OVG) and academics who specialize in the valuation of derivative instruments that the FASB has worked extensively with on this issue. That conclusion also is consistent with the extensive research that the FASB has performed with respect to this issue. Further, that conclusion is consistent with the FASB position related to derivatives in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Additionally, approximately 800 public companies are already estimating fair value and all Canadian public companies are estimating fair value. The staff does not agree with arguments presented in comment letters with respect to this issue; therefore, the staff recommends that the Board reaffirm its tentative conclusion in the proposed Statement that the grant-date fair value of EBC instruments issued by public companies is measurable and estimable with sufficient reliability for purposes of financial statement recognition.
Discussion Question No. 1: Does the Board reaffirm its conclusion that the fair value of EBC instruments issued by public companies is measurable and estimable with sufficient reliability for purposes of financial statement recognition?

ISSUE 2: MODEL SELECTION AND PREFERENCE

The proposed Statement explicitly states that a lattice model is preferable because that model is more fully able to capture and better reflects the characteristics of a particular employee share option or similar instrument in the estimate of fair value. Some respondents have stated that the Board should pick one valuation model because that would put all companies on an equal footing; however, valuation experts have counseled the Board that there is no one-size-fits-all model. Other respondents argued that the Board should eliminate the explicit preference for the lattice model. Certain valuation experts have noted that Monte Carlo simulation techniques and other valuation techniques may be just as preferable as a lattice model over a closed-form model.

The staff has been made aware that some accounting firms have told their clients that the explicit preference for a lattice is effectively a requirement. The staff does not believe that the Board should stipulate the use of one model. The staff believes that the grant date fair value should be estimated by using a valuation technique that reflects any and all substantive characteristics of the instrument (except those characteristics explicitly excluded).

Discussion Question 2(a): Does the Board desire to stipulate the use of one valuation model?

Discussion Question 2(b): Does the Board believe that the principles in paragraph B5 are sufficient guidance for the selection of an appropriate valuation technique? If so, does the Board desire to retain the explicit preference for the lattice model?

ISSUE 3: VOLATILITY

The majority of respondents agreed with the Board’s position on volatility because it is consistent with principles-based accounting and it provides companies the ability to appropriately consider their own facts and circumstances. However, other respondents
requested that the Board consider other alternatives. Some respondents requested that the Board stipulate one method of estimating volatility and specify in minute detail how it should be calculated. Such respondents generally asked that all estimates begin with historical volatility and adjust that volatility only if there is objective evidence to do so. Some respondents requested that the Board specify historical volatility as a safe harbor, and other respondents requested that the Board specify that volatility be based on an index (such as the S&P 500). Those alternatives generally were requested to simplify the estimation process and improve comparability across companies.

The Board considered those alternatives in its work with OVG members. OVG members do not believe there is one way to estimate expected volatility; however, OVG members generally agreed that the use of historical volatility, without considering how that volatility may change in the future, is not an appropriate surrogate for expected volatility. Just as the staff believes the Board should not stipulate one model, the staff also believes the Board should not stipulate one method of estimating volatility. Other valuation experts agree that there is no one right way to estimate expected volatility. Indexed volatility would never be used by marketplace participants to value a stock option unless that option was on the specified index. Historical volatility may or may not be representative of expected volatility as noted above. The staff recommends that the Board retain the proposed Statement’s guidance on estimating expected volatility and not specify a single method of estimating volatility.

Discussion Question 3(a): Does the Board reaffirm the proposed Statement’s guidance on estimating expected volatility (and thereby not specify a single method of estimating volatility)?

Several comment letter respondents made a number of suggestions such as establishing a volatility hierarchy, providing examples of estimating volatility, providing additional guidance on the process a company might follow in estimating volatility, and adding guidance that states that a company may consider the implied volatility of its convertible debt instruments. The staff believes that a volatility hierarchy would be interpreted as establishing a de facto requirement for the top level. While the staff acknowledges that many experts believe that implied volatilities provide better information for estimating
expected volatility, as noted previously most experts do not believe there is one right way to estimate expected volatility. The staff does not believe it should provide examples of estimating volatility. Those examples would be used as de facto standards, the deviation from which would require justification to auditors and, perhaps, the SEC.

With respect to the final two suggestions, the staff believes that some additional guidance on the process a company might follow in estimating volatility could be added as well as noting that a company may consider the implied volatility of its convertible debt instruments. That guidance would simply expand on the considerations a company might make in selecting a volatility assumption. The staff recommends that such additional guidance be added in Appendix B of the proposed Statement.

Discussion Question 3(b): Does the Board agree with the staff recommendations regarding additional volatility guidance?

ISSUE 4: EXPECTED TERM

Some commentators expressed concern about a company’s ability to estimate early exercise patterns; those commentators generally did not support recognizing compensation cost for an exchange of employee services for EBC equity instruments. Other commentators made a number of other suggestions. Some commentators asked that the guidance in Appendix B be expanded to include other factors that may affect an employee’s early exercise decision: those factors included an employee’s age, an employee’s length of service at the enterprise, the evolution of the stock price during the option term, and an employee’s home jurisdiction (i.e., domestic or foreign). Based on discussions with various valuation experts, the staff believes that all of those factors could be considered by an enterprise in estimating early exercise algorithms; therefore, the staff recommends that the guidance in Appendix B be expanded to note them. Additionally, one respondent suggested that the guidance ought to state that companies should calibrate early exercise algorithms for actual experience. The staff believes that such a statement is practical and should be added to the guidance in Appendix B.

Discussion Question No. 4: Does the Board agree with the staff recommendations above with respect to the guidance on and method of estimating an option’s expected term?
ISSUE 5: NONTRANSFERABILITY

Some comment letter respondents advocated that arbitrary discounts be taken from fair value estimates produced by an option-pricing model (e.g., a 50 percent discount). The staff does not support the use of arbitrary discounts. Other respondents suggested that the FASB should not stipulate a single method for estimating nontransferability, but should allow enterprises to choose any reasonable method. Many valuation experts, including those in the OVG, believe that the most objective method of taking nontransferability into account is by using the option’s expected term rather than its contractual term.

Other respondents believe that nontransferability should be taken into account by reducing the value of the call option by the value of a put option containing the same terms as the call option because the option holder gives up the right to sell the option. The staff believes that this method does not faithfully represent the economic exchange because a call option holder has no payoff if the option expires out-of-the-money, whereas the holder of a put would have a payoff because that option would be in-the-money. The staff and valuation experts of the OVG do not support this method. Additionally, the staff believes that this method is designed to estimate the value of an award to the employee.

The staff believes that the proposed Statement’s method of accounting for the effects of nontransferability by using the expected term is robust, operational, grounded in financial economic theory, and supported by well-respected valuation experts. Therefore, the staff recommends that the Board reaffirm its support for the proposed Statement on this matter.

Discussion Question No. 5: Does the Board wish to retain the proposed Statement’s method of accounting for the effects of nontransferability?

ISSUE 6: RELOAD OPTIONS

Various respondents requested that the Board reconsider the proposed Statement’s position that requires that reload features be excluded from the grant-date fair value estimate and that reload grants be accounted for as new grants. Several respondents
believe that the reload feature should be included in the grant-date fair value estimate and that reload grants should not be accounted for as new grants. OVG members believe that current option-pricing models can estimate the value of awards with such features. The staff did not find arguments presented on this topic persuasive enough for it to recommend that the Board change the ED’s position on this matter.

Discussion Question No. 6: Does the Board wish to retain its tentative conclusion on awards with reload features as described in the proposed Statement?

ISSUE 7: OTHER ISSUES

Issue 7(a): Certain Events Affecting Expected Term

Valuation experts have pointed out that many options have accelerated vesting clauses for death and disability, which generally truncate the life of the then-vested option. Such experts believe that, by using actuarial tables for the general population, a probability of death and disability (based on the employee’s age) can be factored into a lattice model. This issue was not specifically addressed in the Board’s original deliberations.

Discussion Question 7(a): Does the Board wish to specifically preclude enterprises from taking those factors into account in the pre-vesting period, the post-vesting period, or both?

Issue 7(b): Clawback Provisions

Some respondents argued that clawback provisions related to noncompete, nonsolicitation, or fraudulent behavior conditions should be included in the grant-date fair value estimate. Those respondents generally argued that such provisions affect the fair value of EBC awards. The staff believes that the Board should retain the current guidance in the ED.

Discussion Question No. 7(b): Does the Board wish to retain the guidance in the ED related to clawback provisions?

Issue 7(c): Statistical Significance
Several comment letter respondents requested that the Board consider a discussion of statistical significance, specifically related to the determination of whether information is sufficient to support conclusions underlying the valuation process. The staff does not believe the Board should provide elementary statistics guidance and recommends that no such guidance be added to the proposed Statement.

**Discussion Question No. 7(c):** Does the Board prefer not to include a discussion of statistical significance in Appendix B?

**Issue 7(d): Lack of Historical Information**

Some respondents requested that the Board provide additional information on procedures to follow if sufficient historical information is not available. Paragraph B16 of Appendix B provides guidance about historical information. The staff does not recommend providing more guidance on this topic.

**Discussion Question 7(d):** Does the Board wish to provide additional guidance on this topic?

**Issue 7(e): Number of Steps in a Lattice Model**

Several respondents suggested that the Board provide guidance on selecting the number of steps needed to construct a binomial lattice. Lattice models can be constructed with more or less steps depending upon their design; the staff understands that mathematical functions can be used to reduce the number of steps and still achieve the same output. The staff believes that this type of guidance goes well beyond what the FASB should provide and therefore, recommends that no additional guidance be included in Appendix B. Further, the staff believes that the principles in paragraph B5 give implicit guidance on that question.

**Discussion Question 7(e):** Does the Board wish to provide additional guidance on the number of steps a lattice model should contain?

**Issue 7(f): Supporting Evidence**
One respondent suggested that the guidance in Appendix B should explicitly state that a company must have supporting evidence to justify its position. The staff believes that notion is implicit in many places in Appendix B. The document assumes that an enterprise will exercise a certain amount of due diligence in selecting a valuation model and assumptions to use in that model, including the rationale and evidence justifying its decisions. At this point, the staff does not believe such a statement is needed because it is implicit in this guidance and many other areas of U.S. GAAP.

Discussion Question 7(g): What does the Board prefer to do with respect to this topic?

**Issue 7(h): Change in Valuation Model**

Some respondents commented on the contents of paragraph B18, which specifies that a lattice model is preferable for justifying a change in accounting principle. One respondent noted that such a statement seems at odds with the *Fair Value Measurements* ED, which does not specify that any valuation technique is preferable. The staff would point out that the *Fair Value Measurements* ED states in many places that some valuation techniques may not provide significant additional information. The staff does not believe that this argument is sufficient enough to change the Board’s position.

Another respondent notes that paragraph B18 appears inconsistent with paragraph 8 of the *Fair Value Measurements* ED. The staff recommends that the language in paragraph B17 conform to the first and second sentence of paragraph 8 of the *Fair Value Measurements* ED.

Discussion Question 7(h)(1): Does the Board prefer to conform the language in paragraph B17 as recommended?

Paragraph 8 of the *Fair Value Measurements* ED also states that a change in valuation technique is a change in estimate. The staff observes that comment letter respondents did not provide new insights into this issue; therefore, the staff recommends that the language in B18 on this matter remain unchanged (at least until the *Fair Value Measurements* ED is finalized).
Discussion Question 7(h)(2): Does the Board wish to retain its tentative conclusion on this matter as articulated in paragraph B18?

ISSUE 8: ALTERNATIVE MEASUREMENT METHOD

This issue is being addressed in the context of public companies only. Respondents made a number of comments about the alternative measurement method. Some commentators noted that circumstances in which fair value could not be estimated would be rare and that the proposed Statement should contain a strong presumption that fair value can be estimated, unless there is substantial evidence to the contrary. The staff agrees with those commentators. One respondent was concerned that the alternative measurement method would incorporate an unintended level of flexibility and asked that the Board provide guidance on the types of instruments that would qualify for such treatment. Other commentators noted that intrinsic value is inconsistent with the principles in the proposed Statement and should not be used as a measurement attribute.

The staff believes that an alternative measurement method is important to retain because it provides a mechanism to deal with a small class of instruments. In addition, the staff believes that it is generally the time value portion of an instrument that would not be estimable for that small class of instruments; therefore, the staff believes that intrinsic value is the most appropriate measurement attribute to use. The staff is sympathetic with those respondents that suggested that it would be rare when fair value could not be estimated. Therefore, the staff recommends that the Board add that type of language to the proposed Statement. Given that this exception would cover a small class of instruments and the weight the staff assigns to convergence, the staff recommends no further change to the alternative measurement method.

Discussion Question No. 8(a): Does the Board wish to retain the proposed Statement’s alternative measurement method?

Discussion Question No. 8(b): Does the Board prefer to add a statement in the proposed Statement that suggest that the alternative measurement method would be rarely used because it would be unusual when a fair value could not be estimated (the staff requests some liberty in crafting the best wording to convey that message)?
At today’s meeting, the Board will discuss transition alternatives for public entities. Additional transition issues as well as transition alternatives for nonpublic entities will be discussed at a future meeting.

**TRANSITION ALTERNATIVES FOR PUBLIC COMPANIES**

**Retrospective Method**

The Exposure Draft (ED) states that the proposed Statement shall be effective for awards that are granted, modified, or settled in fiscal years beginning after December 15, 2004, for public entities (the effective date will be discussed at a future meeting.) Earlier application is encouraged provided that financial statements for those earlier years have not yet been issued. The ED states that retrospective application of the proposed Statement is not permitted.

**Discussion Question No. 1a:** Does the Board want to allow retrospective application, or modified retrospective application?

*View A:* Yes, allow (question 2b will ask Board members if they wish to require, encourage, or permit) retrospective application.

*View B:* Yes, allow (question 2b will ask Board members if they wish to require, encourage, or permit) modified retrospective application.

*View C:* No, do not permit retrospective application or modified retrospective application.

*Staff Recommendation:* The staff recommends View B.

**Discussion Question No. 1b:** If the Board chooses View A or B in Question 1a, does the Board want to require, encourage, or permit retrospective or modified retrospective application?
Early Adopters of Statement 123

The Board has been asked by respondents to consider those companies that adopted Statement 123 under Statement 148 and whether the transition in the proposed Statement would have any impact on those companies. The majority of the companies that have voluntarily adopted Statement 123 have done so under the prospective method.

Discussion Question No. 2: Does the Board want to provide an alternative transition method for those entities that adopted Statement 123 early under the prospective transition method under Statement 148?