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Summary of
FASB Statement 123R
Share-Based Payment

Overview

Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123R) repeals the longstanding “intrinsic value” method of accounting for equity compensation prescribed by APB Opinion No. 25 (Opinion 25), and replaces original Statement 123 with a mandate that generally all equity awards granted to employees be accounted for at “fair value.” This fair value is measured at grant for stock-settled awards, and at subsequent exercise or settlement for cash-settled awards. Fair value is equal to the underlying value of the stock for “full-value” awards such as restricted stock and performance shares, and estimated using an option-pricing model with traditional inputs for “appreciation” awards such as stock options and stock appreciation rights. Compensation cost equal to these fair values is recognized net-of-tax over the vesting or performance period only for awards that vest, but there are important exceptions for awards with “stock price” or “intrinsic value” performance criteria. Subsequent modifications to outstanding awards result in incremental compensation cost if fair value is increased as a result of the modification. Thus, a value-for-value stock option repricing or exchange of awards in conjunction with an equity restructuring does not result in additional compensation cost. There are special provisions for nonpublic companies that are intended to ease compliance with the new rules.

Statement 123R is in substantial convergence with the International Accounting Standard Board’s (IASB) final standard on Share-based Payment, except for transactions with nonemployees and nonpublic companies, and minor technical differences in regard to employee stock purchase plans, modifications, liabilities, and income tax effects. Statement 123R creates a more “level playing field” for equity incentive design that is expected to result in the increased prevalence of full-value and performance-vesting awards, and a corresponding decline in plain-vanilla, tax qualified, and reload stock options, and employee stock purchase plans. The remainder of this paper summarizes the most pertinent provisions of Statement 123R and related staff guidance provided by the FASB and the Securities and Exchange Commission (SEC).

Scope

In General – Statement 123R applies to all share-based payment transactions in which a company acquires goods or services by issuing equity compensation, or by incurring liabilities that are based on the fair value of the company’s stock or are settled by issuing equity compensation.

Employees – The scope of Statement 123R focuses primarily on share-based payment transactions with employees (including certain “leased” employees) and nonemployee directors, as defined in a manner similar to the guidance provided in FASB Interpretation No. 44 (Interpretation 44). That is, employees are defined by reference to common law and federal payroll tax principles, and nonemployee directors must be elected by the company’s shareholders.

Nonemployees – Statement 123R does not affect share-based payment transactions with nonemployees, such as independent contractors, advisory board members, and other nonemployee service providers. These transactions continue to be accounted for under the vesting-date fair value provisions of original Statement 123 and EITF Issue No. 96-18. The SEC staff in Staff Accounting Bulletin (SAB) 107 instructs companies to use by analogy the guidance in Statement 123R as it applies to employees for equity compensation granted to nonemployees. The FASB intends to reconsider this issue in a later phase of its share-based payment project.

Employee Stock Ownership Plans (ESOPs) – Statement 123R does not affect share-based payment transactions with tax-qualified ESOPs, which continue to be accounted for under the provisions of AICPA Statement of Position (SOP) 93-6. The FASB also intends to reconsider this issue in a later phase of its share-based payment project.

Employee Stock Purchase Plans (ESPPs) – Statement 123R does not recognize compensation cost for ESPPs that are nondiscriminatory, incorporate no option features (such as a purchase price “look-back” provision), and provide for purchase discounts of 5 percent or less. If the above criteria are not satisfied, the ESPP is deemed compensatory and compensation cost is calculated using option valuation techniques and accrued over the purchase period. For ESPPs with a purchase price look-back provision, compensation cost is calculated under a complex methodology that assumes the award is composed of (1) a non-dividend-paying share of stock equal in value to the purchase discount, and (2) an at-the-money stock option equal in value to the discounted purchase price.

Equity versus Liability Awards

Equity Awards – A share-based payment arrangement is classified as equity if the written or substantive terms of the award call for settlement solely in company stock. Examples of equity awards are stock options, ESPPs, and stock-settled stock appreciation rights (SARs), restricted shares/share units, and performance shares/share units. Equity awards are not reclassified as liabilities merely because the company occasionally settles awards for cash, withholds shares to satisfy *minimum statutory* federal, state, and payroll tax withholding requirements applicable to supplemental income, or permits a “valid” broker-assisted cashless exercise. However, equity awards may be reclassified as liabilities if the above conditions are not met (refer to *Liability Awards* below). In addition, the stock-for-tax withholding exception referred to above applies only to equity awards granted to employees (that is, stock-for-tax withholding on nonemployee equity awards is not permissible.)

Liability Awards – A share-based payment arrangement is classified as a liability if (1) the written or substantive terms of the award call for settlement in cash or other assets, (2) the award provides for a puttable or callable repurchase provision that is based on other than fair value or can occur less than 6 months after option exercise or share vesting, or (3) the award is indexed to a factor other than a service, performance, or market condition (refer to *Vesting Conditions* below). Examples of liability awards are cash-settled SARs and restricted/performance share units. Cash-denominated awards such as performance units are not accounted for as share-based payments, unless the awards are in some way based on or settled in the company’s stock. As noted above, equity awards may be reclassified as liability awards if the company exhibits a pattern of cash settlement, withholds shares for taxes in excess of minimum statutory rates, or permits an “invalid” broker-assisted cashless exercise.

The FASB staff in FASB Staff Position (FSP) FAS 123(R)-1 “indefinitely defers” a complex requirement under Statement 123R that would potentially reclassify equity awards as liability awards (or vice versa) under other applicable generally accepted accounting principles (GAAP) when the right to receive the award is no longer dependent on the holder being an employee of the company (examples of other applicable GAAP are FASB Statements No. 133 and 150, and EITF Issue No. 00-

19). That is, an award granted for past or future employee services remains subject to the measurement and recognition provisions of Statement 123R for the entire existence of the award, unless the award is subsequently modified when the holder is no longer an employee.

The FASB staff in FSP FAS 123(R)-5 amends FSP FAS 123(R)-1 to provide that, solely for purposes of that FSP, a modification does not include changes to former employees' outstanding award terms in connection with an equity restructuring provided (1) there is no increase to the awards' fair value, *or* the ratio of intrinsic value to exercise price is preserved (that is, the equity holder is "made whole"), *or* the modification is not done in contemplation of the restructuring, *and* (2) all equity holders are treated similarly.

The FASB staff in FSP FAS 123(R)-4 provides that a cash settlement feature of a stock option or SAR that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as a change-in-control or initial public offering) does not result in liability classification until it becomes probable the event will occur. If and when a contingent event becomes probable of occurrence, the reclassification is accounted for as a modification from an equity to liability award. This guidance is consistent with required treatment for other equity awards, such as restricted stock and performance shares (or stock-settled share units).

Compensation Cost for Equity Awards

In General – Compensation cost is based on the award's fair value at grant, less the amount (if any) paid by the award recipient, with a corresponding credit to equity (generally, paid-in capital). The date of grant occurs when there is a mutual understanding of the award's key terms and conditions, the company becomes contingently obligated to issue equity or transfer assets, and all necessary approvals are obtained. That is, the employee begins to benefit from, or be adversely affected by, subsequent changes in stock price. The FASB staff in FSP FAS 123(R)-2 provides that a mutual understanding of the award's key terms and conditions is presumed to exist on the relevant approval date, provided those key terms and conditions are not negotiable by the employee and are communicated to recipients within a "relatively short time period."

Full-Value Awards – Compensation cost for full-value awards such as restricted stock and performance shares (or share units payable solely in stock) is based on the market value of the underlying stock at the date of grant. Dividends or dividend equivalents (if any) paid during the vesting or performance period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited and the dividends are not repaid. Compensation cost for a dividend-paying company that grants non-dividend-paying awards is reduced by the present value of estimated forgone dividends over the vesting period.

Appreciation Awards – Compensation cost for appreciation awards such as stock options or stock-settled SARs is estimated at grant date using an option-pricing model taking into account at a minimum the six traditional inputs identified below, assuming observable market prices are not available (refer to *Option-Pricing Model Inputs* below). Permissible option-pricing techniques include a "lattice" model such as a binomial model, a "closed form" model such as the Black-Scholes-Merton formula, and a "Monte Carlo" simulation technique. Statement 123R does not explicitly mandate a specific option-pricing model, but states that a lattice model "more fully reflects the substantive characteristics" of employee stock options and should be used if it produces a better estimate of fair value.

The SEC staff in SAB 107 acknowledges that fair value estimates cannot predict actual future events and provides comfort to companies that, so long as the estimates are made in good faith, they will not be subsequently questioned no matter what the actual outcome. The SEC staff will not object to a company's choice of option-pricing model provided it meets Statement 123R's three-pronged

requirements that the valuation technique (1) is consistent with the fair value measurement objective, (2) is based on established principles of financial economic theory, and (3) reflects all substantive characteristics of the award. So long as fair value estimates are prepared by a person with “requisite expertise,” it is not a requirement that companies must hire an outside third party to assist in the valuation. Further, it is permissible to use different valuation techniques for awards with different characteristics, and to change valuation techniques without being considered a change in accounting principle (although the SEC staff does not expect companies to frequently switch between valuation techniques). Appropriate disclosure of any change in valuation technique should be made in financial statement footnotes (refer to *Footnote Disclosures* below).

Option-Pricing Model Inputs – Statement 123R provides extensive guidance for companies when selecting option-pricing model inputs, and states that estimates should be reasonable, supportable, and determined in a consistent manner from period to period. The FASB and SEC staff guidance is briefly summarized below:

<i>Current stock price:</i>	<ul style="list-style-type: none"> Market value of underlying stock at measurement date (grant date for equity awards, and end of each reporting period until settlement for liability awards)
<i>Exercise price of option:</i>	<ul style="list-style-type: none"> At-the-money, premium, or discount exercise price inputs (for indexed exercise prices, refer to <i>Compensation Cost for Other Design Features</i> below)
<i>Expected term of option:</i>	<ul style="list-style-type: none"> Based on contractual term, vesting period (expected term must at least include the vesting period), expected early exercise and post-vesting employment termination behavior, expected volatility, black-out periods, and employee age, length of service, and location demographics; expected term is a direct input in a closed-form model, and is inferred based on the output of a lattice model The SEC staff in SAB 107 provides additional guidance for companies when estimating an option's expected term. In general, companies are not allowed to consider additional term reductions for nonhedgability, nontransferability, or forfeitures, and the option term cannot be shorter than the vesting period. Companies are permitted to use historical stock option exercise experience to estimate expected term (with as few as one or two relatively homogenous employee groupings) if it represents the best estimate of future exercise patterns. SAB 107 provides a simplified method to estimate expected term for "plain vanilla" stock options (as defined by SAB 107) that is calculated as the vesting period plus the original contractual option term divided by two. The SEC staff in SAB 110 provides that the SEC will continue to accept use of the simplified method on an interim basis, provided a company concludes that its own historical option exercise experience does not provide a reasonable basis for estimating expected term
<i>Risk-free interest rate(s):</i>	<ul style="list-style-type: none"> Implied yield(s) on U.S. Treasury zero-coupon issues, using yield curve over contractual option term for lattice models and current yield with remaining term equal to expected option term for closed-form models (special guidance is provided for jurisdictions outside the U.S.)
<i>Expected stock price volatility:</i>	<ul style="list-style-type: none"> Generally based on historical price observations commensurate with contractual term for lattice models or expected term for closed-form models, as adjusted for supportable future expectations; other factors to consider in estimating volatility include, “mean reversion” tendencies, “implied” volatility of traded options or convertible debt (if any), “term structure” of expected volatility (if using a lattice model), and expected volatility of similar companies (for newly public or nonpublic companies) Nonpublic companies may use the historical volatility of an appropriate industry index in certain situations (refer to <i>Compensation Cost for Nonpublic Companies</i> below) The SEC staff in SAB 107 provides extensive guidance on how companies should estimate expected volatility, particularly in regard to historical and implied volatility. In general, historical volatility should be measured on an unweighted basis over a period equal to or longer than the expected option term for closed-form models or contractual option term for lattice models based on daily, weekly, or monthly stock price observations. Future events should be considered to the extent other marketplace participants would likely consider them, and prior periods may be excluded in rare circumstances. Implied volatility is based on the market prices of a company's traded options or other financial instruments with option-like features, and can be derived by entering the market price of the traded option into a closed-form model and solving for the volatility input. The SEC staff believes that companies with actively traded options or similar financial instruments generally should consider implied volatility, and even place greater or exclusive reliance on it, taking into consideration (1)

volume of market activity, (2) synchronization of variables, and (3) similarity of exercise prices and option terms. SAB 107 also provides guidance for companies that wish to place exclusive reliance on either historical or implied volatility, and for newly public companies. Appropriate disclosure of the method used to estimate expected volatility should be made in the Management's Discussion and Analysis (MD&A) section of public filings

Expected dividends on stock:

- May be input as either an expected yield or dollar amount, taking into account supportable future expectations based on publicly available information (no single method of estimating fair value is specified for dividend-paying stock options and SARs)

When selecting option-pricing model inputs, the FASB instructs companies to use an *average* of the range of estimates when no amount within the range is more or less likely to occur, and cautions companies that unadjusted historical data may not be appropriate if future expectations are reasonably expected to differ from past experience.

Not Possible to Estimate Fair Value – In the rare event that a company determines it is not possible to reasonably estimate fair value at grant date, Statement 123R requires equity awards to be accounted for at intrinsic value until award settlement (that is, variable intrinsic value accounting), even if fair value can be reasonably estimated at a subsequent date.

Compensation Cost for Liability Awards

Statement 123R requires liability awards to be calculated at fair value using the same methodology as for equity awards, except that fair value is remeasured at the end of each reporting period until award exercise or settlement (that is, variable fair value accounting), and the corresponding credit is a liability as opposed to equity. Thus, compensation cost for full-value awards is remeasured each period based on the market value of the underlying stock until award vesting or settlement. Likewise, compensation cost for appreciation awards is remeasured each reporting period using an option-pricing model until final measurement at intrinsic value upon award exercise or settlement. Statement 123R does not explicitly address dividend equivalents that are paid on liability awards, but accountants opine that all dividend equivalents paid on liability award should be accounted for as additional compensation cost, consistent with the requirements of Statement 150.

Compensation Cost for Nonpublic Companies

Equity Awards – Statement 123R requires nonpublic companies to value equity awards using the same grant-date fair value methodology that applies for public companies, unless it is not possible to calculate a reasonable fair value because of the inability to estimate expected volatility. In that case, nonpublic companies are instructed to calculate fair value using the historical volatility of an appropriate industry index (as opposed to a broad market index such as the *S&P 500*) as an input to the option-pricing model, and to appropriately disclose that index and how it was selected (referred to as the “calculated value” method). If a nonpublic company subsequently becomes public, the SEC staff in SAB 107 provides that stock options valued under the calculated value method prior to becoming public should continue to be valued under that method after becoming public, unless the awards are subsequently modified, repurchased, or canceled.

Liability Awards – Statement 123R allows nonpublic companies to make a policy decision as to whether to measure all liability awards at “preferable” fair value (or calculated value if it is not possible to estimate expected volatility) or intrinsic value until award settlement. Because the fair value method is regarded as preferable, once companies begin using it they generally may not revert to the intrinsic value method. If a nonpublic company subsequently becomes public, the SEC staff in SAB 107 provides that equity compensation liabilities valued under the intrinsic value method prior to becoming public should be measured at fair value subsequent to becoming public.

Compensation Cost for Other Design Features

Statement 123R provides extensive guidance on the treatment of other shared-based payment design features, which is briefly summarized below:

Mature Shares – There is no concept of “old-and-cold” or “mature” shares under Statement 123R, other than for determining liability award classification for puttable or callable repurchase provisions that can occur less than 6 months after option exercise or share vesting. Thus, “immaculate exercises” or “pyramiding” in connection with stock-for-stock exercises do not adversely affect the measurement or recognition of compensation cost.

Reload Stock Options – The “reload” feature is not directly considered when estimating grant-date fair value, although the feature may be indirectly considered via a shorter expected term assumption because reloads are designed to encourage early option exercise. Rather, each reload grant is accounted for as a separate award resulting in incremental compensation cost for each reload grant.

Clawback Provisions – Contingent features such as “clawback provisions” that may cause the recapture of equity compensation profits are not considered when estimating grant-date fair value. Rather, such features are accounted for *only if and when* the contingent event occurs by recognizing a credit to income equal to the lesser of the consideration received or previously recognized compensation cost.

Indexed and Step Exercise Prices – The guidance for valuation of stock options with an “indexed” (exercise price varies with a market index) or “stepped” (exercise price increases by constant percentage) exercise price requires a leap of statistical faith. Indexed stock options may be valued by substituting “cross-volatility” (the relationship between the volatility of the company’s stock and the volatility of the index stocks) for the company’s volatility, and by substituting the dividend yield on the index stocks for the risk-free interest rate assumption. Stepped exercise price stock options may be valued using lattice models adapted for such features, or by deducting from the risk-free interest rate the annual percentage increase in exercise price.

Tandem and Combination Awards – A tandem award consists of two or more grant types in which the exercise or vesting of one cancels the other(s). A combination award also consists of two or more grant types, but each award can be separately exercised. Valuation complexities with these types of arrangements can arise when there are differing grant types, such as equity versus liability awards and appreciation versus full-value awards.

Restrictions After Vesting – Restrictions on vested shares such as stock ownership guidelines or mandatory holding periods should have “little or no effect” on grant-date fair value for actively traded stocks.

Noncompete Agreements – Depending on the facts and circumstances, certain legally enforceable noncompete provisions may be substantive service conditions requiring the recognition of compensation cost over that period (even if the awards are fully vested at grant).

Book Value Plans – Book value share purchase plans are generally treated as liability awards for public companies (because they are generally indexed to something other than the company’s stock price), and as equity awards for nonpublic companies (with compensation cost recognized for any discount from book value).

Vesting Conditions

In General – Statement 123R distinguishes between service, performance, and market conditions for purposes of determining (1) the fair value of an award, (2) the period over which compensation cost is recognized (refer to *Recognizing Compensation Cost* below), and (3) whether previously recognized compensation cost can be reversed if an award fails to vest. If a vesting condition is something other than a service, performance, or market condition (Statement 123R uses as an example vesting or exercise price indexed to the value of a commodity), the share-based payment arrangement is classified as a liability award taking into consideration the non-service/performance/market condition(s) in the estimate of fair value.

Service and Performance Conditions – A service condition is defined solely by reference to an employee rendering services to the company, including accelerated vesting conditions in event of death, disability, or termination without cause. A performance condition is dependent on both the employee rendering services and the attainment (by the employee or company) of a specified performance target(s) defined solely by reference to the company’s operations, either on an absolute basis or relative to other companies (including events such as an initial public offering or change in control). Service and performance conditions that affect vesting are not considered when estimating grant date fair value. Rather, previously recognized compensation cost is reversed if the service or performance conditions are not satisfied and the award is forfeited. Conversely, service and performance conditions that affect factors other than vesting (such as exercise price, number of shares, or contractual term) are considered when estimating grant date fair value by considering each possible outcome. For example, if the number of shares may double or the exercise price be halved based on a performance condition, the fair value of the award is estimated for each possible outcome and initially accrued based on the most probable outcome (refer to *Recognizing Compensation Cost* below).

Market Conditions – A market condition is defined as a condition affecting exercise price, exercisability, or any other factor used in estimating fair value that relates to the attainment of a specified stock price or amount of intrinsic value (including, presumably, total shareholder return), either on an absolute basis or relative to other companies. Market conditions are always considered when estimating fair value. However, previously recognized compensation cost is not reversed if the employee satisfies the requisite service period but the award is nevertheless forfeited because the market condition is never satisfied (refer to *Recognizing Compensation Cost* below). Conversely, previously recognized compensation cost is reversed if the employee fails to satisfy the requisite service period, unless the market condition is satisfied prior to the award forfeiture.

Recognizing Compensation Cost

Requisite Service Period – Statement 123R introduces the notion of “requisite service period” for determining the period over which compensation cost should be recognized. The requisite service period may be explicit, implicit, or derived, as follows:

<i>Explicit:</i>	• Explicitly stated in the award agreement
<i>Implicit:</i>	• May be inferred from service or performance conditions
<i>Derived:</i>	• Derived from valuation of a market condition when estimating fair value

Statement 123R provides complex guidance for determining the requisite service period, which can be deciphered as follows:

- If an equity award includes no substantive service, performance, or market conditions, the entire amount of measured compensation cost is recognized at grant date, such as an award granted to a retirement-eligible employee that includes an explicit service period (for example, the award vests after 3 years of service) but provides for accelerated or continued vesting upon retirement
- Nonsubstantive explicit vesting provisions (or the acceleration of explicit vesting provisions) are ignored when estimating the requisite service period for deep “out-of-the-money” stock options that are deemed to have a market condition derived service period
- If a vesting condition requires the performance of future services, the initial estimate of the requisite service period is presumed to be the vesting period (unless there is clear evidence to the contrary), and cannot be a prior period
- If service condition vesting may be accelerated by a performance condition that is probable of attainment, the initial estimate of the requisite service period is based on the shorter performance period (otherwise, vesting is based on the service period)
- If vesting is based on *both* market *and* service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the *longest* measurement period
- If vesting is based on *either* market *or* service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the *shortest* measurement period

Companies are to base initial accruals of compensation cost on the initial estimate of the requisite service period. If the initial estimate of the requisite service period is based on service or performance conditions, companies are to revise that estimate and recognize remaining compensation cost *prospectively* if subsequent information indicates a different measurement period is more appropriate. Conversely, if the initial estimate of the requisite service period is based on market conditions, that estimate is generally not revised unless the market conditions are satisfied prior to the end of the initial measurement period.

Accrual of Compensation Cost – Compensation cost begins to be recognized on what is referred to as the “service inception date,” which is usually the grant date but in certain circumstances may precede or be subsequent to the date of grant (but can never be prior to shareholder approval). The service inception date precedes the grant date if an authorized award contains performance conditions that if not satisfied during the service period preceding (and following, if applicable) the grant date results in forfeiture of the award. For example, if nonvested awards that cliff vest after 2 years are granted as consideration for the prior year annual incentive payment, compensation cost is recognized over the 3-year period beginning with the annual incentive plan year and including the 2-year vesting period. Compensation cost is recognized ratably over the requisite service period based on the number of awards that are expected to vest due to a service condition and/or the “probable outcome” of a performance condition, with *cumulative adjustments* in later periods to the extent actual forfeitures differ from prior period estimates.

For awards with only a service condition that is based on a “graded” (as opposed to “cliff”) vesting schedule, companies are to make a policy decision as to whether to recognize compensation cost ratably over the service period or on a more complex accelerated accrual basis that assumes each vesting tranche is a separate award (as originally prescribed by FASB Interpretation No. 28). This policy decision is *not* dependent on how the company estimates fair value for the award (such as using tranche-specific option lives in a lattice model), and neither approach is regarded as preferable. Regardless of which method is chosen, the amount of compensation cost recognized at any date must at least equal the vested portion of the award.

Option Expires Unexercised – Previously recognized compensation cost is not reversed if a vested stock option or stock-settled SAR expires unexercised, such as when the award is “underwater.”

Award Modifications, Cancellations, and Settlements

Modifications – In general, modifications are relevant only in regard to equity awards because the final measure of compensation cost for liability awards does not occur until the awards are vested or exercised, regardless of whether the awards are modified or not. Statement 123R broadly defines a modification as *any* change to an award’s terms, including number of shares, exercise price, transferability, settlement provisions, and vesting conditions. Also included as modifications are certain “inducements” to encourage option exercises, and exchanges of awards in connection with a business combination (refer to *Business Combinations* below) or changes to award terms in connection with a nonreciprocal equity restructuring (such as a stock dividend, stock split, spinoff, rights offering, or large nonrecurring cash dividend). In regard to nonreciprocal equity restructurings, Statement 123R states that changes to the terms of an award in accordance with properly structured “antidilution provisions” generally should *not* result in additional compensation cost. In practice, companies likely will continue to rely on the guidance prescribed by Interpretation 44 (that is, the aggregate intrinsic value is not *increased* and the ratio of exercise price to market price is not *reduced*), because to do otherwise may be problematic with other rules dealing with incentive stock options (ISOs), nonqualified deferred compensation, and stock exchange listing standards.

At a minimum, compensation cost is *always* recognized for the original grant date fair value of the equity award, unless at the modification date the original service or performance conditions are not expected to be satisfied. In addition, compensation cost is recognized for any incremental fair value (or intrinsic value, if applicable) resulting from the modification, measured as the difference between the estimated fair value of the modified award and the original award at the modification date. Modifications that relax a vesting condition that was not probable of attainment at the modification date result in a final measure of compensation cost equal to the fair value of the award at the modification date, as summarized below:

Modifications to Service and Performance Vesting Conditions	
<u>Type I Modifications</u> Probable to Probable -- and -- <u>Type II Modifications</u> Probable to Improbable (not likely to be common)	<ul style="list-style-type: none"> • Awards <i>are</i> expected to vest under original service or performance conditions at modification date • Modification does <i>not</i> result in incremental compensation cost • Original grant date fair value is recognized as compensation cost if awards ultimately vest under original or modified conditions
<u>Type III Modifications</u> Improbable to Probable (likely to be common) -- and -- <u>Type IV Modifications</u> Improbable to Improbable	<ul style="list-style-type: none"> • Awards are <i>not</i> expected to vest under original service or performance conditions at modification date • Modification results in final measure of compensation cost equal to fair value of award at modification date • Compensation cost recognized only if award vests under the modified vesting conditions (original vesting conditions are no longer relevant)

Cancellations – Cancellation of an award accompanied by the concurrent grant of a replacement award (or other valuable consideration) is accounted for as a modification. Cancellation of an award *not* accompanied by the concurrent grant of a replacement award is accounted for as a repurchase for no consideration. Accordingly, there is no reversal of previously recognized compensation cost, and any previously measured but unrecognized cost is accelerated at the cancellation date.

Settlements – The amount of cash or other assets paid to repurchase an equity award is accounted for as a reduction in equity, provided the repurchase amount does not exceed the fair value of the award at the repurchase date. Any excess of the repurchase price over the fair value of the award at repurchase is recognized as additional compensation cost. Settlement of a nonvested award results in the recognition of previously measured but unrecognized compensation cost.

Business Combinations

As stated above, Statement 123R requires that exchanges of equity or liability share-based payment awards in connection with a business combination should be accounted for as modifications. Accordingly, the acquirer should measure both the replacement awards granted by the acquirer and the replaced acquiree awards as of the acquisition date in accordance with Statement 123R. FASB Statement No. 141 (revised 2007) provides that if an acquirer is not contractually obligated to replace outstanding acquiree awards but nevertheless chooses to do so, the fair value of the acquirer's replacement awards is allocated entirely to postcombination compensation cost. If an acquirer is contractually obligated by the purchase agreement (or otherwise) to replace outstanding acquiree awards, the fair value of the acquirer's replacement awards (regardless of whether equity or liability awards) is allocated between purchase price consideration and postcombination compensation cost, as described below.

The portion of the acquirer's replacement awards that is allocated to purchase price consideration is equal to the fair value of the replaced acquiree awards multiplied by the ratio of the precombination employee service period to the greater of the "total service period" or the original service period of the replaced acquiree awards. The total service period is the sum of the requisite service period for the replaced acquiree awards completed prior to the acquisition date and any postcombination requisite service period for the acquirer's replacement awards, taking into consideration any explicit, implicit, and derived service periods in accordance with Statement 123R.

The portion of the acquirer's nonvested replacement awards that is allocated to postcombination compensation cost is equal to the fair value of the acquirer's replacement awards less the portion attributable to precombination employee services, including any excess of the fair value of the acquirer's replacement awards over the replaced acquiree awards. The portion of the acquirer's nonvested replacement awards attributable to precombination and postcombination employee services should be recognized net of estimated forfeitures.

Events that occur subsequent to the acquisition date, such as forfeitures, modifications, changes in liability award fair value, or the ultimate outcome of performance awards, do not affect the purchase price. Rather, such events are recognized through adjustments to compensation cost and income tax expense in accordance with Statement 123R during the postcombination period.

Income Tax Effects

Statement 123R requires fair value (or calculated or intrinsic value) compensation cost to be recognized net-of-tax for share-based payments that normally give rise to tax deductions, such as nonqualified stock options. Conversely, compensation cost is not tax effected for awards that normally are not tax deductible, such as the exercise of an ISO without a related disqualifying disposition. If the deduction reported on the company's tax return is *more* than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise exceeds fair value at grant), the effect of the "excess tax benefit" is reported as an increase to equity on the balance sheet and as both a financing cash receipt and operating cash payment on the statement of cash flows (on a "gross" basis, not net of "tax deficiencies"). If the deduction reported on the company's tax return is *less* than the amount of compensation cost recognized in its financial

statements (such as when the option profit at exercise is less than fair value at grant), the effect of the tax deficiency is first offset against any net excess tax benefit credits to equity accumulated since the original December 15, 1994 effective date of Statement 123, and the remainder (if any) is recognized as an increase to income tax expense on the income statement.

The SEC staff in SAB 107 provides that companies need to calculate additional paid-in capital available for offset *only if and when* a tax deficiency occurs (that is, when tax return deductions are less than reported compensation cost). The FASB staff in FSP FAS 123(R)-3 provides a practical transition election for companies that are unable to reconstruct the beginning balance of available paid-in-capital available for offset. Under that guidance, companies may make a one-time election to calculate the beginning balance as the difference between (1) all net excess tax benefit credits to equity recognized since the original effective date of Statement 123, and (2) the tax effect of cumulative incremental pretax compensation cost disclosed pro forma under Statement 123.

Earnings per Share

FASB Statement No. 128 requires that employee share-based payments be treated as “potential common shares” in computing diluted earnings per share (EPS), based on the actual number of equity awards granted and still outstanding, unless doing so would be “antidilutive.” Stock options and nonvested awards are included in diluted EPS using the “treasury stock method,” which assumes that all awards are exercised or converted at the *beginning* of the reporting period (or at actual issuance, if later), and the proceeds received from such hypothetical exercise or conversion are applied to repurchase outstanding common stock at the *average* market price during the period. “Proceeds” include not only the exercise price, but also any unrecognized compensation cost and excess tax benefits resulting from the assumed exercise. Equity compensation that is subject to a performance or market condition (such as earnings or stock price goals) are treated as “contingently issuable shares” and are included in diluted EPS via the treasury stock method *only if and when* the relevant performance criteria are currently being satisfied, assuming the end of the reporting period is the end of the performance period.

Footnote Disclosures

The objective of Statement 123R’s footnote disclosure requirements is to enable financial statement users to understand the nature and terms of share-based payments, the method of estimating fair value, and the effect of compensation cost on the income and cash flow statements. To this end, Statement 123R sets forth the following “minimum disclosure requirements” and reminds companies that they may disclose supplemental information if it is useful to users and does not lessen the prominence and credibility of the minimum required disclosures:

- Description of general terms and substantive conditions of share-based payments, such as requisite service periods, vesting schedules, maximum contractual terms, number of shares authorized, and methods used for measuring compensation cost
- Description of the company’s policy (if any) for issuing shares upon option exercise or share unit conversion (and the source of those shares), and an estimate of the number of shares expected to be repurchased during the *following* annual period in connection with its equity compensation programs

- The following information for *each year* an income statement is presented:

Each Year for Which an Income Statement is Presented			
	Year 1	Year 2	Year 3
Expected volatility	} Must disclose the assumption input (or range of inputs), the method used to estimate the input, and the method used to estimate fair value; a nonpublic company that uses the calculated value method must disclose why it cannot estimate its own volatility, the industry sector index it selected, and the rationale for selecting it		
Expected dividends			
Expected exercise term			
Risk-free interest rates			
Discount for post-vesting restrictions (if any)			
Weighted-average grant-date fair value (or calculated or intrinsic value)			
Total intrinsic value of options exercised			
Total intrinsic value of share-based liabilities paid			
Total fair value of shares vested			
Total compensation cost recognized in income			
Total recognized tax benefit			
Total compensation cost capitalized			
Description of significant award modifications			
Total amount of cash received from option exercise	} If not separately disclosed elsewhere		
Total tax benefit realized from option exercise			
Total amount of cash paid to settle equity awards			

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

- The following information for the *most recent* fiscal year:

Most Recent Fiscal Year Stock Option Activity	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (except for nonpublic companies per FSP FAS 123(R)-6)	Total Unrecognized Compensation Cost Related to Nonvested Awards	Weighted-Average Period Over Which Cost is Expected to be Recognized
Outstanding at beginning of year					--	--
Granted			--	--	--	--
Exercised			--	--	--	--
Forfeited or expired			--	--	--	--
Outstanding at end of year					--	--
Vested and expected to vest					--	--
Exercisable at end of year					--	--

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

Most Recent Fiscal Year Nonvested Share Activity	Number of Shares	Weighted-Average Grant-Date Fair Value (or Calculated or Intrinsic Value)	Total Unrecognized Compensation Cost Related to Nonvested Awards	Weighted-Average Period Over Which Cost is Expected to be Recognized
Nonvested at beginning of year			--	--
Granted			--	--
Vested			--	--
Forfeited			--	--
Nonvested at end of year			--	--

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

The SEC staff in SAB 107 provides that companies should enhance MD&A disclosure related to share-based payments subsequent to adoption of Statement 123R, and suggests discussion of the following:

- Transition method and effect on current and future financial statements, including cumulative adjustments
- Method used to account for share-based payments prior to adoption of Statement 123R
- Modifications to outstanding stock options made prior to effective date of Statement 123R, including rationale for such modification
- Differences in valuation methodologies or assumptions (if any) compared to those used under original Statement 123
- Changes in the quantity, type, or design of equity compensation programs, such as shifting from stock options to restricted stock or the introduction of a performance vesting condition

In addition, SAB 107 provides that companies (1) should provide all disclosures required by Statement 123R in the first 10-Q filed after adoption of the new rules, (2) can disclose the amount of non-cash equity compensation cost included in specific line items in financial statements, footnotes, or within MD&A, and (3) can disclose non-GAAP financial measures (such as net income excluding equity compensation cost) within MD&A, provided they are accompanied with appropriate descriptive disclosures (but pro forma presentations excluding equity compensation cost are prohibited).

Effective Dates and Transition Methods

In General – The various effective dates and transition methods for adopting Statement 123R, as amended by the SEC, are summarized below:

	Required Effective Date (Periods Beginning After) ⁽¹⁾	First Applicable Reporting Period		Required Transition Method	Optional Transition Method (Modified Retrospective)	
		As Originally Required by Statement 123R	As Revised by the SEC		All Periods ⁽²⁾	Year of Adoption ⁽³⁾
Public Companies	6/15/05	<i>First quarter</i> beginning after effective date	First quarter of <i>first fiscal year</i> beginning after effective date	Modified Prospective Application	Yes	Yes
Small Business Issuers ⁽⁴⁾	12/15/05	<i>First quarter</i> beginning after effective date	First quarter of <i>first fiscal year</i> beginning after effective date	Modified Prospective Application	Yes	Yes
Nonpublic Companies - Fair Value ⁽⁵⁾	12/15/05	First quarter of <i>first fiscal year</i> beginning after effective date	No change	Modified Prospective Application	Yes	Not Applicable
Nonpublic Companies - Minimum Value ⁽⁵⁾	12/15/05	First quarter of <i>first fiscal year</i> beginning after effective date	No change	Prospective Application	Not Applicable	Not Applicable

⁽¹⁾ Early adoption of Statement 123R is encouraged for quarterly or annual financial statements that have not been issued before the required effective date

⁽²⁾ Modified retrospective application to all prior years beginning after the original December 15, 1994 effective date of Statement 123

⁽³⁾ Modified retrospective application only for the annual period in which Statement 123R is initially adopted (for early adopters)

⁽⁴⁾ Generally, a public company with revenues and market capitalization of less than \$25 million

⁽⁵⁾ Nonpublic company that previously adopted the “fair value” or “minimum value” (volatility input of zero) provisions of original Statement 123 for recognition or pro forma footnote disclosures

Modified Prospective Application – Modified prospective application means that Statement 123R applies to all equity compensation granted, modified, repurchased, or canceled after the applicable effective date. Statement 123R also applies to the nonvested portion of equity compensation outstanding as of the effective date, provided the awards were granted, modified, or settled in cash during fiscal years beginning after the original December 15, 1994 effective date of Statement 123. Compensation cost for outstanding nonvested awards is based on previously estimated grant date fair values and attribution methods used for recognition or pro forma footnote disclosures under Statement 123, except that forfeitures must be estimated over the vesting period (and not simply recognized as they occur) and liability awards must be measured at fair value (as opposed to intrinsic value). Changes to previously reported footnote costs are precluded, unless the company needs to correct an error. The pro forma disclosures currently required by Statement 123 as amended by FASB Statement No. 148 (Statement 148) continue to be required until all presented periods are accounted for under Statement 123R. Importantly, these transition provisions apply to all companies, regardless of whether Statement 123 was previously adopted using the “prospective” transition method permitted under Statement 148.

Modified Retrospective Application – Modified retrospective application means that Statement 123R applies to periods before the required effective date on a basis consistent with the pro forma footnote disclosures required by Statement 123. Modified retrospective application may be applied either (1) to all prior years for which Statement 123 was effective (awards granted, modified, or settled in cash in fiscal years beginning after the original December 15, 1994 effective date of Statement 123), or (2) only to quarterly periods in the initial year of adoption that occur prior to the date of adoption (for early adopters).

Prospective Application – Prospective application means that Statement 123R applies only to equity compensation granted, modified, repurchased, or canceled after the required effective date. There is no cost recognition for the nonvested portion of awards outstanding as of the effective date, and the modified retrospective application method is not permitted. Pro forma footnote disclosures reflecting prior minimum value calculations should be discontinued.

Variable Awards Under Opinion 25 – Under the modified prospective and retrospective application methods, equity compensation previously accounted for as “variable” under Opinion 25 (such as repriced stock options, stock-settled SARs, and awards with performance vesting criteria) effectively become “fixed” as of the effective date based on previously estimated grant date fair values and attribution methods used for pro forma footnote disclosures under Statement 123. Compensation cost for cash-settled liability awards continues to be based on variable fair value accruals until award settlement.

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General questions about this summary can be addressed to Thomas M. Haines in our Chicago office at 312-332-0190 or by email at tmhaines@fwcook.com. Specific questions should be referred to the company’s professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com.