

Sidebar 2

Standard Example of Accounting for Stock Options: Performance Condition

Company D issues a grant of share-based compensation on January 1, 2006 (service inception date), which vests when certain new software becomes ready for market (a performance condition). Eligible individuals must be Company D employees at the vesting date in order to exercise the award (a service condition). At the service inception date, Company D expected the software to be ready for market on June 30, 2008, or 30 months after the service inception date. Company D estimates the total cost of the award to be \$1 million. If only a service condition existed for this award, Company D would recognize \$400,000 ($\$1 \text{ million} \div 2.5 \text{ years}$) as compensation cost for each of the years ended December 31, 2006, and 2007, and \$200,000 for the year ended December 31, 2008.

At December 31, 2006, Company D concluded that the software was unlikely to be marketable. Company D can recognize compensation cost only if it concludes that the performance condition is probable of being satisfied, and, accordingly, did not recognize any compensation cost during 2006. Members of Company D's board of directors, however, voted to continue the project on the belief that the software may be applicable to internal operations. During 2007, Company D concluded that the software could be marketable by December 31, 2008. Because the performance condition is now expected to be met, Company D recognizes accumulated compensation cost at December 31, 2007, as if it had recognized compensation cost during both 2006 and 2007. During this time, unanticipated employee resignations resulted in forfeitures that reduced the total compensation cost to \$900,000. Therefore, Company D recognizes a compensation cost of \$600,000 in 2007, which is the cumulative amount that would have been recognized if it knew the project would take three years. Company D would not recognize the total compensation cost (\$900,000) over the remaining two years of the requisite service period.

The journal entries recording compensation cost and the related tax effects are similar to those in Sidebar 1.