

FASB Statement 123(R) Resource Group Meeting
May 26, 2005
FEI Summary

On May 26, 2005, the FASB staff held a meeting with the FASB Statement 123(R) Resource Group (the "Group") to discuss several issues relating to the implementation of Statement 123(R), *Share-Based Payment*. The information below summarizes the issues and discussion of the Group.

1. Foreign Private Issuers (FPI) that reconcile to U.S. GAAP in accordance with Item 17 of Form 20-F. FASB Statement No. 123(revised 2004), *Share-Based Payment*, requires application of modified prospective or retrospective application for most entities. Some FPI, as defined by U.S. securities law, have not historically been required to apply the disclosure requirements of U.S. GAAP in preparing a reconciliation to U.S. GAAP in accordance with Item 17 of Form 20-F.

FPI that reconcile to U.S. GAAP under Item 17 may not have historical information about the fair value of compensation awards necessary for either modified prospective or retrospective application because they were not required to provide such information in their filings.

How should such FPI apply the transition provisions of Statement 123(R)?

Group Discussion: The Group was unable to reach consensus on this issue. The FASB staff plans to discuss this issue with the SEC. An update will be provided at the next Group meeting.

2. Modifications of minimum value awards (for Private Companies). Transition for awards recognized or disclosed under the minimum value method is addressed in paragraph 83 of Statement 123(R). Per that guidance, minimum value awards should continue to be accounted for using the principles originally applied to the awards (either FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or APB Opinion No. 25, *Accounting for Stock Issued to Employees*) unless the award is modified, repurchased, or cancelled.

How should the modification of a minimum value award be recognized under Statement 123(R)?

Example 1

On January 1, 2005, a calendar year-end nonpublic company issues 1,000 at-the-money employee stock options with a \$10 exercise price, a 4-year service period, and a minimum value of \$1.50. The options are accounted for as fixed awards under Opinion 25. On January 1, 2006, the company adopts Statement 123(R). On December 31, 2006, the company re-prices the award to \$5, the current fair value of the company's shares. The fair value of the award immediately before the modification is \$1. The fair value of the award immediately after the modification is \$3.

Group Discussion: The FASB staff and Group agreed that for fully vested options there should be a charge of \$2 recognized immediately. For non-vested options, the \$2 additional cost is

added to the remaining unamortized intrinsic value (zero in this example) and spread over the remaining vesting period of two years. As reflected in this example, the FASB staff and Group agreed that a private company should continue attributing any unrecognized historical value (i.e. the unamortized minimum value if the company applied FAS 123 in the financial statements, or intrinsic value if they applied APB 25) and recognize the incremental fair value of the modification as determined through application of the guidance in FAS 123R.

Example 2

Assume the same fact pattern as in Example 1, except the original options are accounted for as variable awards under Opinion 25 because they allow for settlement in net shares.

Group Discussion: The FASB staff and Group agreed that the provisions of FAS 123R would require a private company to continue to apply the intrinsic value method until the award is modified, repurchased or cancelled after the effective date of FAS 123R. Once the award is modified, the modification accounting would be the same as example 1 but the award would change from being a “variable award” under APB No. 25 to an “equity award” under FAS123R. Essentially, there would be a final measurement of the intrinsic value and any unamortized intrinsic value plus any incremental fair value would be recognized over the remaining service period, if any.

3. The impact of excess tax benefits or deficiencies on calculating earnings per share (EPS). In calculating EPS under FASB Statement No. 128, *Earnings per Share*, the assumed proceeds in the treasury stock calculation are adjusted for any excess deferred tax benefits or deferred tax asset write-offs that would be credited or debited, respectively, to additional paid-in capital (APIC). For awards granted prior to the transition to Statement 123(R), the issue is whether these adjustments would be (a) based on amounts that would actually be recognized on the balance sheet or (b) adjusted for any “pro forma deferred tax assets.”

Group Discussion: In applying the treasury stock method, the assumed proceeds for stock-based compensation arrangements is the sum of (a) the amount, if any, the employee must pay on exercise (b) the amount of compensation cost deferred for future recognition and (c) the amount of tax benefits (both current and deferred), if any, that will be credited to additional paid-in-capital assuming exercise of the options or lapsing of the restrictions on nonvested stock. In some instances, the tax benefits related to an award may be less than book compensation expense. If additional paid-in capital has been recognized for excess tax deductions from previous employee awards, such taxes are deducted from the assumed proceeds. The FASB staff and Group agreed that the calculation of any excesses or deficiencies that must be included in (a) the assumed proceeds of option exercise and (b) the cash flows from excess tax benefits must be based on the pro forma deferred tax asset and the pro forma pool of excess tax benefits. To the extent there is a decrease to equity, one would need more information and analysis on the total APIC pool at the time of adoption (i.e. if there are sufficient credits to offset the decrease to equity) then suggested under SEC Staff Accounting Bulletin No. 107, although it likely will fall short of requiring company to go back and calculating entire APIC pool.

EXAMPLE: If the fair value of an option is \$10 and 100 options were granted, the total expense over the vesting period would be \$1,000. Assuming a 40% effective tax rate, the tax benefit that would be recorded is \$400. If the options were exercised and the employer received a tax benefit of \$500, the additional \$100 would be credited to APIC and added to the assumed proceeds. However, if the options were exercised and the employer received a tax benefit of \$300, the write off of the \$100 deferred tax asset would reduce APIC (assuming one had enough credits in their APIC pool) and be deducted from the assumed proceeds. The treatment of the tax excess or deficiency is the same whether the options were granted prior or subsequent to the adoption of Statement 123R, though the actual deferred tax asset recorded may be different.

4. Determining whether a noncompete provision or another type of provision represents an in-substance service condition. Paragraph A192 of Statement 123(R) indicates that determining whether a noncompete provision is an in-substance service conditions is a matter of judgment. Paragraph A196 provides examples of the factors that provide evidence about whether a noncompete provision is an in-substance service period. What other factors may be relevant in making this judgment?

Group Discussion: The FASB staff viewed illustration 16 (paragraph A196) as a narrow example. In determining if a noncompete provision is substantive, companies should look to the specific terms of the non-complete and note 112 of FAS 123R. The FASB staff agreed to discuss this issue further with the FASB Board to determine whether additional guidance, perhaps in the form of a FASB Staff Position (FSP), should be provided to clarify when a noncompete agreement or similar provision may create an in-substance service period.

5. Awards that become exercisable based on achievement of either a service/performance condition or a market condition. Assume Company A issues an at-the-money option that vests and becomes exercisable only if the share price doubles within the next 10 years.

Using a binomial model, Company A determines the option has a derived requisite service period of three years and an expected term of, say, four years. The fair value of the option is \$10.

Further assume that Company A issues a second at-the-money option that cliff vests in seven years. The expected term is eight years. The fair value of the option is \$14 (otherwise identical to the first option, just a different vesting provision, resulting in a longer expected term).

Now assume that, rather than granting either of the above options, Company A grants 1 at-the-money option that will vest if EITHER the share price doubles within the next 10 years OR the employee stays with the company for 7 years. How should such an award be valued? Over what period should the cost of the award be attributed?

Group Discussion: The FASB staff and Group agreed that such awards should be valued as a single award and attributed over the shorter of the derived or explicit service period. The Resource Group believed that restricted shares issued subject only to a market condition would

be valued in a manner similar to an option subject to a market condition (i.e., a restricted share is an option with a zero strike price). However a restricted share issued subject to both a market and a service condition would be valued based on the grant date stock price without regard to the market condition (because failure to achieve the market condition will not cause the employee to lose the award provided they remain for the explicit service period).

6. Valuation of nonvested shares with a limited population of potential transferees. A restriction is defined in Statement 123(R) as:

A contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time. [Paragraph E1]

Paragraph 21 of Statement 123(R) specifies that a nonvested equity share should be measured at its fair value as if it were vested and issued on the grant date. Further, paragraph 21 indicates that a restricted share should be measured at its fair value; this is the same amount a similarly restricted share would issue to third parties.

Based on the definition of a restriction and the guidance in paragraph 21 of Statement 123(R), at what value should a nonvested share with a limited population of potential transferees (such as in an offering under Rule 144A) be valued?

Group Discussion: The FASB staff and Group agreed that a limited population of transferees is not a prohibition (as discussed in note 11 of FAS 123R). As such, a company should not discount the value of a nonvested share granted to an employee due solely to fact the share could be transferred only to a limited population of investors.

7. Accounting for a modification that results in incremental value and reduced probability of vesting. Paragraph A160 of Statement 123(R) states: “If awards are expected to vest under the original vesting conditions at the date of the modification, an entity should recognize compensation cost if either (a) the awards ultimately vest under the modified vesting conditions or (b) the awards ultimately would have vested under the original vesting conditions.” Issues arise when modifications occur that result in incremental value and a reduced probability that the vesting conditions will be satisfied. Some have questioned whether, under scenario (b) (that is, an award would have vested under the original vesting conditions, but not under the modified vesting conditions) a company is required to recognize the original grant-date fair value as minimum compensation cost or whether the sum of the original grant-date fair value and the incremental value is the minimum compensation cost.

Example

A company previously granted at-the-money options subject to a 3-year service vesting period with a grant-date fair value of \$9. After two years, the options are deeply out-of-the-money and the company decides to re-price those options and reduce the exercise price to equal the current stock price. However, in exchange for the reduction in exercise price, the company increases the

vesting term from the remaining one year of the original vesting requirement to three years. The incremental fair value associated with the re-pricing is \$4. The company concludes that based on its historical termination rates, 10 percent of the employees who received re-priced awards will terminate between 1 and 3 years from the modification date and, therefore, will not receive the right to exercise the options.

What is the minimum compensation cost that should be recognized for this award (assuming actual terminations are consistent with the expectation at the modification date)? Over what period should the portion of the award that was unvested prior to modification be attributed? Over what period should the incremental compensation cost arising from the modification be attributed?

Group Discussion: The FASB staff and Resource Group agreed that the minimum compensation cost to be recognized in the above situation would be the original grant date fair value. If the original vesting condition is achieved but the modified vesting condition is not, total compensation cost recognized would equal the original grant date fair value. If the modified vesting condition is achieved, compensation cost recognized would equal the sum of the grant-date fair value and the incremental fair value resulting from the modification. The FASB staff noted that how the total compensation is attributed (i.e. the remaining unamortized amount under the original award plus incremental amount under the modified award) is a policy decision. That is, a company can attribute the total compensation (a) over the revised service period (which in some circumstances could require acceleration of compensation cost upon termination) or (b) as a bifurcated award with the remaining unamortized amount recognized over the original award period and the incremental amount for the modified award attributed over the revised service period. The policy selected should be disclosed in the notes to the financial statements.

8. Treatment of pro forma balance sheet amounts under modified prospective application. To appropriately calculate pro forma net income and EPS under Statement 123 it was necessary for a preparer to develop a pro forma balance sheet. How should amounts included in the pro forma balance sheet be treated under modified prospective application?

Consider the following types of example costs:

- a. Inventory, including construction contracts in progress
- b. Deferred loan origination costs
- c. Deferred acquisition costs in the insurance industry
- d. Internally-developed software
- e. Internally constructed fixed assets
- f. Capitalized exploration costs in the oil and gas industry
- g. Contract accounting costs.

Resource Group Discussion: There were differing views expressed by the Group and FASB staff on this matter. The FASB staff agreed to further discuss this issue with the FASB Board. An update will be provided at the next Group meeting.

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The FASB staff does not intend to issue further authoritative guidance about the issues the Group reached consensus on. Should you have any questions or comments please contact Christine DiFabio (cdifabio@fei.org), Edith G. Orenstein (eorenstein@fei.org) or Allan Cohen (Allan.Cohen@TimeWarner.com).