



Ernst & Young LLP
5 Times Square
New York, NY 10036

Phone: (212) 773-3000
www.ey.com

July 28, 2005

Letter of Comment No: 3
File Reference: FSP123R-A
Date Received:

Director, TA&I-FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

**Proposed FASB Staff Position No. FAS 123(R)-a
“Classification and Measurement of Freestanding Financial Instruments
Originally Issued as Employee Compensation”**

We appreciate the opportunity to comment on the Proposed FASB Staff Position No. FAS 123(R)-a “Classification and Measurement of Freestanding Financial Instruments Originally Issued as Employee Compensation.” We commend the FASB on its efforts to promptly address the unique issues that arise when freestanding financial instruments originally subject to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, subsequently become subject to other generally accepted accounting principles (GAAP), as required by paragraphs A230 and A231 of Statement 123(R). We agree with the objective of the proposed FSP that freestanding financial instruments originally issued as employee compensation should be subject to the recognition and measurement provisions of Statement 123(R) throughout the life of the instrument, unless modified subsequent to the time the rights conveyed by the instrument are no longer dependent on the holder being an employee. However, as discussed below, we think the proposed FSP should more clearly distinguish between awards *granted* in exchange for employee services and those *issued* in exchange for employee service. Additionally, we do not believe that a freestanding financial instrument should become subject to other GAAP if its terms are modified subsequent to the time the rights conveyed by the instrument are no longer dependent on the holder being an employee, provided that the individual is still an employee at the time of the modification.

The Meaning of Issued in Statement 123(R)

Paragraph 5 of the proposed FSP states “A freestanding financial instrument originally *issued* as employee compensation shall be subject to the recognition and measurement provisions of Statement 123(R) throughout the life of the instrument, unless its terms are modified subsequent to the time the rights conveyed by the instrument are no longer dependent on the holder being an employee (refer to the guidance in paragraph A231 of Statement 123(R)).” [Emphasis added]

Paragraph 6 of the proposed FSP states “Instruments must be *granted* for substantive employee service to be considered share-based payments to employees for purposes of applying Statement 123(R).” [Emphasis added]

The definition of the term *issued*, included in the glossary of Statement 123(R), differentiates between the meaning of *issued* and the meaning of *granted*:

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. 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 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. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to vesting conditions. [Statement 123(R), Appendix E].

A question arises as to the applicability of the proposed FSP to an award that is granted to an employee in exchange for employee services, but permits the employee to continue to earn the award in exchange for nonemployee services (e.g., consulting services) if the employee terminates employment prior to the end of the requisite service period. In this example, if the individual terminates employment but continues to provide nonemployee services, the instrument ultimately will be issued in exchange for a combination of employee and nonemployee services.

Because Statement 123(R) does not use the term *issued* to mean *granted*, we believe the instruments granted in this example are not issued until the individual provides the requisite service. As such, we believe that when the individual terminates employment and begins providing nonemployee services, the award would become subject to the provisions of EITF Issue No. 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.” We believe the award would be accounted for in a manner similar to that described in Question 5(a) of FASB Interpretation 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25*. That is, only the portion of the award attributable to the requisite service period subsequent to the individual becoming a nonemployee would be accounted for in accordance with Issue 96-18. No adjustment would be made to the compensation cost recognized while the individual was an employee, unless the award is forfeited because the individual does not provide the requisite service.

However, because paragraph 6 of the proposed FSP states that “instruments must be *granted* for substantive employee services to be considered share-based payments to employees for purposes of applying Statement 123(R),” [emphasis added] we believe some may conclude that such an award should remain subject to the recognition and measurement provisions of Statement 123(R) throughout the life of the instrument.

We recommend that the proposed FSP clarify whether awards *granted* to employees should be subject to the recognition and measurement provisions of Statement 123(R) throughout the life of the award, or only those awards that are *issued* in exchange for employee services.

In addition to the previous example, we believe the staff should consider how the distinction between *granted* and *issued* may affect awards granted to a nonemployee (e.g., a consultant) that is permitted to continue vesting in an award if that individual subsequently becomes an employee. The award may be *granted* to a nonemployee and ultimately *issued* to an employee.

Modifications of Awards Originally Issued as Employee Compensation

Paragraph 5 of the proposed FSP states “A freestanding financial instrument originally issued as employee compensation shall be subject to the recognition and measurement provisions of Statement 123(R) throughout the life of the instrument, unless its terms are *modified subsequent to the time the rights conveyed by the instrument are no longer dependent on the holder being an employee* (refer to the guidance in paragraph A231 of Statement 123(R)).” [Emphasis added]

We recommend that this guidance be changed such that a freestanding financial instrument originally issued as employee compensation should only become subject to other GAAP if its terms are modified when the individual *is no longer an employee*. We believe that if the terms of an award held by an employee are modified, the modification is made in exchange for employee service, even if the rights conveyed by the instrument are no longer dependent on the holder remaining an employee.

The following example illustrates the accounting under the proposed FSP compared to the accounting under our suggested change:

Assume that Company X granted at-the-money options to two employees. The options vest at the end of four years; however, vesting will “accelerate” upon a valid retirement and the retiree may retain the options for their full contractual term. The first employee was retirement eligible at the time the grant was made, and the full grant-date fair value was recognized as compensation cost on the grant date. The second employee was not retirement eligible, and will not become so during the vesting period. The compensation cost related to the award granted to the second employee will be recognized over the four-year requisite service period.

During the first year subsequent to the grant date the company's stock price decreased significantly. At the end of that year, when both individuals are still employed by the company, the company decided to reprice the options granted to both employees.

Under the provisions of the proposed FSP, the modification will result in the award granted to the retirement eligible employee to become subject to other GAAP because at the time of the modification the rights conveyed by the instrument are no longer dependent on the individual being an employee (even though the grantee remains employed).

We believe that this result is inconsistent with the modification model described in paragraph 51 of Statement 123(R). Paragraph 51 provides that a modification is treated as an exchange of the original award for a new award. In our example, the modified award is granted to an individual in the exact same circumstances as the original award. That is, at the time of the original award and at the time of the modification, the individual is eligible for retirement and, therefore, the rights conveyed by the instrument are not dependent on the individual remaining an employee. We believe it would be inconsistent to account for the original award under Statement 123(R) and the modified award under other GAAP.

We believe the modified award should only be subject to other GAAP if the award is modified when the individual is no longer an employee (in this example, subsequent to the employee retiring).

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP