

**PROPOSED FASB STAFF POSITION**

**No. FAS 123(R)-a**

**Title:** Classification and Measurement of Freestanding Financial Instruments Originally Issued as Employee Compensation

**Comment Deadline:** July 29, 2005

**Introduction**

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) to defer at this time the requirement of FASB Statement No. 123 (revised 2004), *Share-Based Payment*, that a freestanding financial instrument originally subject to Statement 123(R) becomes subject to the recognition and measurement requirements of other applicable generally accepted accounting principles (GAAP) when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity.

**Background**

2. Paragraphs A230–A232 of Statement 123(R) require that a freestanding financial instrument originally subject to Statement 123(R) become subject to the recognition and measurement requirements of other applicable GAAP when the rights conveyed by the instrument are no longer dependent on the holder being an employee. Those paragraphs also provide guidance about when an award is no longer linked to employment.

3. Paragraphs B119–B135 of Statement 123(R) discuss examples of differences between Statement 123(R) and other GAAP in determining whether a financial instrument should be classified as a liability or as equity. The result of differences such as these is that the classification of freestanding financial instruments originally subject to Statement 123(R) as equity or as a liability may change when the instrument becomes subject to other GAAP. Frequently, those differences are related to practical exceptions that the Board provided in Statement 123(R). Paragraphs B134 and B135 explain that certain practical exceptions were carried over from existing stock compensation literature as

interim guidance pending the Board's consideration of the distinction between liabilities and equity as part of its liability and equity project. Additionally, the unique nature of the relationship between an employer and its employees was fundamental to each of the practical classification exceptions. The Board's conclusion in Statement 123(R) to require evaluation, under other applicable GAAP, of instruments no longer tied to employment was based on the concept that once the unique employee-employer relationship is no longer present, the recognition and measurement of freestanding financial instruments should be the same regardless of whether they were issued in share-based payment transactions with employees or other third parties or as consideration in a financing transaction. That is, instruments should receive the same accounting once they are paid for, either by cash from an investor, goods and services received from a third party, or services received from an employee.

4. The Board continues to believe that freestanding financial instruments should be accounted for consistently, irrespective of how they were purchased. However, because the Board has on its agenda a project to consider broadly the distinction between liabilities and equity, which could significantly change other applicable GAAP, the Board has decided to defer at this time the requirements of Statement 123(R) that make freestanding financial instruments subject to the recognition and measurement requirements of other GAAP when the rights conveyed by the instrument are no longer dependent on the holder being an employee.

### **FASB Staff Position**

5. A freestanding financial instrument originally issued as employee compensation<sup>1</sup> 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)). Modifications

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<sup>1</sup>This FSP is intended to apply to those instruments issued in share-based payment transactions with employees accounted for under Statement 123(R), FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and to instruments issued in a business combination in exchange for share-based payment awards of the acquired business that are held by employees of that business.

of such instrument shall be subject to the modification guidance in paragraph A232 of Statement 123(R). Following such modification, recognition and measurement of the instrument should be determined through reference to other applicable GAAP.

6. Instruments must be granted for substantive employee service to be considered share-based payments to employees for purposes of applying Statement 123(R). That is, instruments granted as consideration for goods or services other than employee service shall not be considered share-based payments to employees, irrespective of the legal status of the recipient of the award on the grant date.

#### **Effective Date and Transition**

7. The guidance in this FSP shall be applied upon initial adoption of Statement 123(R).