PROPOSED FASB STAFF POSITION

No. FAS 123(R)-c

Title: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards

Comment Deadline: October 8, 2005

Introduction

1. This FSP provides a practical transition election related to accounting for the tax effects of share-based payment awards to employees.

Background

2. Paragraph 81 of FASB Statement No. 123 (revised 2004), *Share-Based Payment*, indicates that, for purposes of calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of Statement 123(R) (APIC pool), an entity shall include the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes. A fundamental assumption underlying the Board's conclusion in paragraph 81 was that, for public entities, implementation of the disclosure provisions of Statement 123 resulted in information about the amounts that would have qualified as excess tax benefits had the entities adopted Statement 123 for recognition purposes. The Board believed that preparers would have the information necessary to comply with the transition requirements of Statement 123(R). The Board did not receive feedback in the public comment period indicating that the information was not, in fact, available. However, subsequent discussions with constituents on certain implementation matters associated with Statement 123(R) have made it clear that a significant number of constituents do not have that information readily available and, in some cases, they may not be able to recreate that information.

3. Because discussions with constituents have revealed that some entities do not have, and may not be able to recreate, information about the net excess tax benefits that would have qualified as such had those entities adopted Statement 123 for recognition purposes, this FSP provides an elective alternative transition method. That method comprises (a) a

computational component that establishes a beginning balance of the APIC pool and (b) a simplified method to determine the subsequent impact on the APIC pool of awards that are fully vested and outstanding upon the adoption of Statement 123(R). The impact on the APIC pool of awards partially vested upon, or granted after, the adoption of Statement 123(R) should be determined in accordance with the guidance in Statement 123(R).

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4. An entity shall follow either the transition guidance for the APIC pool in paragraph 81 of Statement 123(R) or the alternative transition method described in this FSP.

5. Upon adoption of Statement 123(R), the beginning balance of the APIC pool shall be calculated as follows:

> All increases of additional paid-in capital recognized in an entity’s financial statements related to tax benefits from stock-based compensation during fiscal periods subsequent to the adoption of Statement 123 but prior to the adoption of Statement 123(R).
>
> Less:
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> The product of the cumulative gross compensation cost either (1) recognized in the entity’s financial statements pursuant to Statement 123 or (2) disclosed in the entity’s financial statements pursuant to the provisions of Statement 123, and the entity’s current blended statutory tax rate, inclusive of federal, state, local, and foreign taxes.

6. Tax benefits related to an award that is fully vested prior to the adoption of Statement 123(R) that have been both (a) realized in accordance with footnote 82 of Statement 123(R) and (b) recognized in equity subsequent to the adoption of Statement 123(R) shall increase the APIC pool.

7. The impact on the APIC pool of an award that is partially vested upon or granted after the adoption of Statement 123(R) should be determined in accordance with the

guidance in Statement 123(R). That is, the compensation deduction for tax purposes for a partially vested award should be compared with the sum of compensation cost recognized or disclosed for that award under Statement 123 and Statement 123(R). The tax benefit of any resulting excess tax deduction should increase the APIC pool; any resulting tax deficiency should be deducted from the APIC pool.

8. An entity that elects the alternative transition method described in this FSP shall classify the tax benefits related to an award that is fully vested prior to the adoption of Statement 123(R) that have been both (a) realized in accordance with footnote 82 of Statement 123(R) and (b) recognized in equity subsequent to the adoption of Statement 123(R) as a cash inflow from financing activities and a cash outflow from operating activities within the statement of cash flows. The impact on cash flows of an award that is partially vested upon or granted after the adoption of Statement 123(R) should be determined in accordance with the guidance in Statement 123(R). That is, any tax benefit excess should be determined as if the entity had always followed a fair-value-based method of recognizing compensation cost in its financial statements and should be included as a cash inflow from financing activities and a cash outflow from operating activities within the statement of cash flows.

Effective Date and Transition

9. The guidance in this FSP is effective after the date the FSP is posted to the FASB website. Entities that adopt Statement 123(R) using either modified retrospective or modified prospective application, as described in paragraphs 74–78 of that standard, may make a one-time election to adopt (a) the transition method described in this FSP or (b) the transition method described in paragraph 81 of Statement 123(R) upon the later of initial adoption of Statement 123(R) or the date this FSP is finalized and posted to the FASB website. An entity may take up to one year from the later of its initial adoption of Statement 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election.

Illustrative Example

Background

Entity A, a calendar year company, adopted Statement 123 for disclosure purposes on January 1, 1996, and elected to continue to apply the recognition provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, for purposes of determining its net income. From January 1, 1996, through December 31, 2005, Entity A recognized the following increases in additional paid-in capital (that is, the amounts that have been included in its statement of changes in stockholders' equity for each of the respective years) in connection with its stock-based compensation plans.

	Years										
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**Total**
Tax Benefits from Stock-Based Compensation Plans	-	$100	$120	-	$180	$480	-	$180	$150	-	$1,210

During the same period, Entity A disclosed the following amounts of pre-tax compensation cost related to its stock-based compensation plans. The company's current blended statutory tax rate is percent.

	Years										
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**Total**
Pro Forma Stock-Based Compensation Cost	$100	$100	$200	$200	$200	$300	$300	$300	$200	$200	$2,100

Beginning Balance

On January 1, 2006, Entity A adopts Statement 123(R) and elects the alternative transition provisions described in this FSP. Entity A would compute the beginning balance of its APIC pool as the cumulative credits recognized in additional paid-in capital from the effective date of Statement 123 until the adoption of Statement 123(R) ($1,210) less the tax effect of stock-based compensation cost disclosed in the entity's pro forma footnote disclosure in the financial statements ($2,100 × 40%).

Beginning balance of APIC pool = [$1,210 – ($2,100 × 40%)] = $370

Fully Vested Awards

Assuming all the same facts as above, on January 1, 1998, Entity A grants 100 employee share options each with a grant-date fair value of $6 and a 10-year contractual term. The awards vest at the end of 3 years of service and have an exercise price of $20 (the entity's closing share price on the date of grant). The awards are exercised in 2006 when the share price is $30, resulting in an aggregate tax deduction of $1,000 (($30 – $20) × 100). Because the award qualifies as a fixed award under Opinion 25, no compensation cost or associated deferred tax asset was recognized in the financial statements prior to the adoption of Statement 123(R). As a result, the tax benefit of the deduction ($400 = $1,000 × 40%) is recognized in APIC in 2006. Under the alternative transition method the exercise would increase the APIC pool by the same amount ($400).

Partially Vested Awards

Assuming all the same facts as above, on January 1, 2004, Entity A grants 100 employee share options each with a grant-date fair value of $6. The awards vest at the end of 3 years of service and have an exercise price of $25 (the entity's closing share price on the date of grant). The awards are exercised in 2009 when the share price is $32, resulting in an aggregate tax deduction of $700 (($32 – $25) × 100). Because Entity A adopted Statement 123(R) on January 1, 2006, 33.3 percent (1 of 3 years) of the award will be recorded as compensation cost in the financial statements with a corresponding deferred tax asset. Pursuant to the provisions of Statement 123(R), upon exercise of the award Entity A would record an excess tax benefit or tax deficiency as if it had always followed the fair value measurement principles for recognition purposes. That is, the aggregate tax deduction ($700) less the cumulative compensation cost recognized or disclosed for the award under Statement 123 and Statement 123(R) ($600 = $400 + $200) is $100. The tax benefit of the excess deduction ($40 = $100 × 40%) increases the entity's APIC pool. The total tax benefit of the award ($280 = $700 × 40%) in excess of the deferred tax asset related to compensation recorded in earnings ($80 = $200 × 40%), or $200, is recognized in APIC.