Notice for Recipients
of This Proposed FASB Staff Position

This proposed FASB Staff Position (FSP) addresses the classification of options or similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this proposed FSP would amend paragraphs 32 and A229 of FASB Statement No. 123 (revised 2004), *Share-Based Payment*.

The Board invites individuals and organizations to send written comments on all matters in this proposed FSP, particularly on the issues discussed below. Comments are requested from those who agree with the provisions of this proposed FSP as well as from those who do not. Comments are most helpful if they identify the issues or specific paragraph or group of paragraphs to which they relate and clearly explain the issue or question. Those who disagree with provisions of this proposed FSP are asked to describe their suggested alternatives, supported by specific reasoning.

Issue 1: The proposed FSP provides amended classification guidance for options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of contingent events. This FSP stipulates that entities must assess the probability of the contingent cash settlement event occurring in determining the classification of the option or similar instrument. Do you think the Board should restrict the guidance in this FSP only to specific types of contingent events (for example, a change in control)?

Issue 2: As part of the process of issuing this proposed FSP, the Board considered an alternate approach of grandfathering existing options and similar instruments under pre-existing accounting standards while maintaining the existing requirement of paragraphs 32 and A229 of Statement 123(R) for options or similar instruments granted in the future. Do you believe the grandfathering approach more appropriately addresses this issue?

PROPOSED FASB STAFF POSITION

No. FAS 123(R)-d

Title: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event

Comment Deadline: January 31, 2006

Introduction

1. This FASB Staff Position (FSP) addresses the classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this FSP amends paragraphs 32 and A229 of FASB Statement No. 123 (revised 2004), *Share-Based Payment*.

Background

2. The FASB staff and Board were recently made aware of certain provisions in some share-based payment plans that require an entity to settle outstanding options in cash upon the occurrence of certain contingent events. Generally, the provisions require or permit, at the holder's election, cash settlement of the option or similar instrument upon (a) a change in control or other liquidity event of the entity or (b) death or disability of the holder.

3. Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, as interpreted, an entity would assess the probability of a cash settlement upon the occurrence of a contingent event (for example, a cash settlement upon a change in control). If the contingent cash settlement event is (a) not considered probable of occurring and (b) outside the control of the employee, then equity classification of the option or similar instrument pursuant to Opinion 25, as interpreted, is appropriate.

4. Paragraphs 32 and A229 of Statement 123(R) require options or similar instruments to be classified as liabilities if "the entity can be required *under any circumstances* to settle the option or similar instrument by transferring cash or other assets" (emphasis added). Since an entity may be required in at least one circumstance (that is, a change in control) to settle its options or similar instruments issued as employee compensation in cash, the option or similar instrument would be classified as a liability pursuant to paragraphs 32 and A229 of Statement 123(R).

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5. Paragraphs 32 and A229 of Statement 123(R) are amended to incorporate the concept articulated in footnote 16 of that Statement. That is, a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control does not meet the condition in paragraphs 32 and A229 until it becomes probable that the event will occur. (See Appendix A for specific amendments to Statement 123(R).)

6. An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability) the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date.

Effective Date and Transition

7. The guidance in this FSP shall be applied upon initial adoption of Statement 123(R). An entity that adopted Statement 123(R) prior to the issuance of this FSP shall apply the guidance in this FSP in the first reporting period beginning after the date the FSP is posted to the FASB website. If in applying Statement 123(R) an entity treated options or similar instruments that allow for cash settlement upon the occurrence of a contingent event in a manner consistent with the guidance in this FSP, then that entity would not be required to retrospectively apply the guidance in this FSP to prior periods. However, if in applying Statement 123(R) an entity treated options or similar instruments that allow for cash settlement upon the occurrence of a contingent event in a manner inconsistent with the guidance in this FSP, then that entity would be required to retrospectively apply the guidance in this FSP to prior periods. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

Appendix A

PROPOSED AMENDMENTS TO OTHER PRONOUNCEMENTS

A1. Statement 123(R) is amended as follows [added text is underscored]:

a. Paragraph 32:

> Options or similar instruments on shares shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets.[18a] For example, an entity may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.
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> [18a]A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (b) until it becomes probable that event will occur.

b. Paragraph A229:

> Options or similar instruments on shares (for example, options on puttable or mandatorily redeemable shares) shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instruments by transferring cash or other assets.[121a] For example, an entity may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.
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> [121a]A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (b) until it becomes probable that event will occur.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this FSP. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

B2. This FSP was issued because the Board recently was informed that some entities were apparently unaware of the implications of the provisions within their share-based payment plans that may require cash settlement of outstanding employee share options upon the occurrence of certain contingent events (for example, upon a change in control or other liquidity event). Some Board members indicated that had they been made aware of the prevalence of such provisions during the Board's deliberations of Statement 123(R), they likely would have included a practical accommodation similar to the probability approach currently provided in footnote 16 of Statement 123(R) for shares subject to contingent cash settlement features, which is the approach proposed in this FSP.

Grandfathering Approach

B3. In arriving at the conclusion in this FSP, the Board considered the probability approach, which is included in this FSP, as well as a grandfathering approach. The grandfathering approach would have allowed entities to continue assessing the probability of the contingent cash settlement event occurring throughout the remaining life of all existing options or similar instruments outstanding as of the end of the first reporting period ending after the final FSP was posted to the FASB website. The grandfathering approach would have retained the principle established in paragraphs 32 and A229 of Statement 123(R) for newly issued options and similar instruments while allowing entities sufficient time to adjust their share-based payment plans to remove the cash settlement provision if they so desired. Options or similar instruments granted in reporting periods beginning after the end of the reporting period in which the FSP was issued would have had to follow the provisions of paragraphs 32 and A229 of Statement 123(R). The rationale for retaining the guidance in paragraphs 32 and A229 of Statement 123(R) is based on a desire to have options and similar instruments issued as employee compensation treated in the same manner as financial instruments not issued as employee compensation.

Probability Approach

B4. The majority of the Board supported the probability approach because they (a) sought internal consistency between the classification of shares and options or similar instruments when the instruments are issued as employee compensation and embody a conditional obligation to transfer assets and (b) are awaiting the outcome of the ongoing liabilities and equity project. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets (puttable shares). Therefore, as long as (a) the puttable share does not permit the employee to avoid bearing the risks and rewards of equity ownership for a reasonable period of time or (b) it is not probable the employer would prevent the employee from bearing the risks and rewards of equity ownership for a reasonable period of time, a puttable share is classified as equity under paragraph 31 of Statement 123(R). The majority of the Board did not believe an entity should arrive at a different classification (that is, equity versus liability) based on whether the exchange for employee services was in the form of shares versus an option to purchase shares (that allow for cash settlement upon the occurrence of a contingent event).

B5. The guidance in this FSP is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this FSP is not applicable, by analogy or otherwise, to instruments outside of share-based payment arrangements.