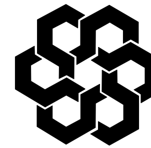

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**19 April 2007, London**
Project:	**Business Combinations II**
Subject:	**Replacement Awards – FASB Memorandum (Agenda Paper 2E(i))**

PURPOSE AND BOARD MEETING OBJECTIVE

Accounting for the Replacement of Acquiree Share-Based Payment Awards in a Business Combination

1. At the April 7 and June 9, 2004 meetings the Board discussed several issues relating to the fair value of outstanding share-based payment (SBP) awards granted by the acquiree, such as employee stock options, that are replaced by the acquirer as part of the business combination.

2. In developing the SBP proposals in the Exposure Draft for Statement 141(R), the Board agreed that it would be consistent with the principles in Statement 123(R), *Share-Based Payment*, if there was a conflict between the principles in the business combinations project and the principles in Statement 123(R). The Board discussed the accounting for replaced SBP awards before Statement 123(R) was finalized (during

redeliberations of the Statement 123(R) Exposure Draft). Therefore, some of the guidance proposed may not be consistent with what was finalized in Statement 123(R). In addition, the staff has become aware of some issues that have arisen in practice related to replaced SBP awards in light of the fact that Statement 123(R) nullified FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, and EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25," without providing equivalent guidance in some cases. Therefore, the purpose of this memo is to:

a. Clarify or revisit certain of the Board's previous decisions for the accounting for replaced SBP awards that were included in the Exposure Draft for Statement 141(R).

b. Address any inconsistencies in those decisions with the guidance in Statement 123(R).

c. Propose some additional guidance for accounting for replaced SBP awards due to practice issues that have come to the staff's attention since the issuance of Statement 123(R).

OUTLINE OF ISSUES

Issue 1 – How should any excess fair value in the acquirer's replacement award over the acquiree's award be accounted for?

Issue 2 – How should the acquirer allocate the remaining fair value of the acquirer award between consideration transferred in the business combination and compensation cost?

Issue 3 – How should the Statement define the "total service period" to be used in allocating the fair value of an acquirer replacement award classified as an equity instrument between consideration transferred in the business combination and compensation cost?

Issue 4 – How should an acquirer replacement award classified as a liability be allocated between consideration transferred in the business combination and compensation cost?

Issue 5 – How should an acquirer consider replacement awards with a graded vesting schedule with respect to measurement and allocation between past and future services?

Issue 6 – Should the portion of the replacement award attributable to past services (that is, the portion recognized as consideration transferred in the business combination) include a forfeiture assumption for awards for which the requisite service has not yet been provided?

Issue 7 – How should an acquirer account for postcombination forfeitures of awards considered to be consideration transferred in the business combination (or for changes in forfeiture estimates in the postcombination period)?

Issue 8 – How should an acquirer account for the postcombination effects of replacement SBP awards classified as liabilities that were issued in a business combination and included in the consideration transferred in the business combination?

Issue 9 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would result in a future tax deduction under existing tax law?

Issue 10 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would NOT result in a future tax deduction under existing tax law?

Issue 11 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a business combination and considered postcombination compensation cost?

Issue 12 – How should the pool of excess tax benefits be determined for replacement SBP awards?

BACKGROUND

3. As a reminder, the following are the key provisions of the Exposure Draft and other related Board conclusions:

a. When determining the value of replaced SBP awards in a business combination, the Statement 123(R) fair-value-based measurement model should be used.[1]

b. To the extent the acquiree's SBP award represents an equity interest in the acquiree (that is, the award or a portion thereof is attributable to past services), a portion of the fair value of the acquirer-replacement SBP award should be recognized as consideration transferred in the business combination rather than compensation cost in postcombination financial statements. To be considered part of the consideration transferred in a business combination, an acquirer must be obligated by the purchase agreement to replace outstanding SBP awards issued by the acquiree. If the acquirer does not have an obligation to replace the awards, then the replacement awards issued by the acquirer would result in compensation cost to the acquirer as opposed to consideration transferred in the business combination (purchase price).

c. There is a two-step process for determining the portion of replaced SBP awards that is consideration transferred in the business combination and the portion that is postcombination compensation cost. First, the acquirer should compare the fair value of the acquirer's replacement awards to the fair value of the replaced acquiree awards (referred to as Step 1 for the purposes of this memo). If the fair value of the acquirer's replacement awards exceeds the fair value of the replaced acquiree awards, the acquirer should recognize that excess fair value as compensation cost immediately in the postcombination financial statements, that is, on the acquisition date. The remainder is referred to as the "remaining fair value of the acquirer's replacement awards."

[1] The remainder of this memo will refer to the required measure for replaced SBP awards as "fair value" for convenience. All references to fair value in this memo should be read to mean "fair-value-based measure determined in accordance with the requirements of Statement 123(R)." This should not be confused with a strict definition of fair value or with any definition of fair value included in other sources of generally accepted accounting principles.

d. Second, the acquirer shall allocate the remaining fair value of the acquirer's replacement award between amounts attributable to past and future service (referred to as Step 2 for the purposes of this memo). The remaining fair value of the acquirer's replacement award attributable to past service is part of the consideration transferred. The remaining fair value of the acquirer's replacement award attributable to future service is compensation cost to be recognized in accordance with Statement 123(R) over the future service period of the acquirer's replacement award.

- The remaining fair value of the acquirer's replacement award attributable to past services is equal to the remaining fair value of the replacement award multiplied by the ratio of the past service period to the total service period.

  The acquirer should classify the remaining fair value of the acquirer's replacement award attributable to past services as a liability or equity instrument based on the guidance in Statement 123(R).

  The total service period is the period that begins with the service inception date[2] for the acquiree's award and ends with the service completion date for the replacement award. The future service period begins on the acquisition date.

- The remaining fair value of the acquirer's replacement award attributable to future service is the difference between the remaining fair value of the acquirer's replacement award and the remaining fair value of the acquirer's replacement award attributable to past services. The acquirer recognizes the remaining fair value of the acquirer's replacement award attributable to future service as compensation cost over the future service period of the acquirer's replacement award in accordance with Statement 123(R).

e. Other assumptions:

[2] Appendix E of Statement 123(R) defines the "service inception date" as the date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date.

- Events that occur after the acquisition date should not change the amounts recognized as consideration for the business combination as of the acquisition date. Therefore, any subsequent changes (for example, forfeitures, modifications, or ultimate outcome of performance awards) should be accounted for in accordance with Statement 123(R) solely in the postcombination period.

- The future service or postcombination requisite service period of awards issued by the acquirer should reflect any explicit, implicit, and derived service periods consistent with the requirements of Statement 123(R).

CONSIDERATION OF COMMENTS RECEIVED

4. The issues included in this memo are the result of the staff's review of the accounting model for replaced SBP awards as discussed in the Exposure Draft, comment letters received, practice issues noted in previous memos from the SBP project, as well as staff conversations with some members of the Statement 123(R) Resource Group.

5. Only one comment letter on the Exposure Draft contained a comment addressing accounting for replaced SBP awards. That respondent disagreed with recognizing compensation cost on the acquisition date for any excess fair value of an acquirer's replacement award over the acquiree award. This issue is discussed below in Issue 1.

6. Due to the lack of comments in this area, the staff contacted some of the members of the Statement 123(R) Resource Group from the large accounting firms to solicit their views on the accounting for replacement SBP awards in the Exposure Draft and other practice issues that currently exist in this area. Their comments included the following issues:

a. Accounting for income tax effects of SBP awards issued in a business combination (discussed below in Issues 9–12)
b. Accounting for excess fair value of a replacement SBP award (Issue 1)
c. Accounting policies regarding replacement awards with graded vesting (Issue 5).

IASB CONSIDERATION

7. These issues will be addressed by the IASB staff and the IASB after completion of the FASB's consideration of the area.

DISCUSSION OF ISSUES AND ALTERNATIVES

Issue 1 – How should any excess fair value in the acquirer's replacement award over the acquiree's award be accounted for?

8. The staff would like to revisit the accounting for any excess fair value of the acquirer's replacement awards over the fair value of the replaced acquiree awards, specifically, whether that excess fair value should be recognized immediately in the postcombination financial statements (as proposed in the Exposure Draft for Statement 141(R)) or over the postcombination requisite service period of the replaced SBP award.

9. *View A*: Any excess fair value from Step 1 should be recognized over the postcombination requisite service period of the acquirer's replacement awards along with any portion of the award attributable to future services. Proponents of this view note that paragraph 53 of Statement 123(R) states that "exchanges of share options or other equity instruments or changes to their terms in conjunction with . . . a business combination are

modifications for purposes of this Statement." Accordingly, they believe that the accounting for replacement SBP awards should be based on the guidance in paragraph 51 and related illustrations of Statement 123(R). Excess fair value generated in Step 1 is equivalent to "incremental compensation cost" discussed in paragraph 51(a) of Statement 123(R). Illustration 12(c) in Appendix A of Statement 123(R) discusses the repricing of an unvested award that results in incremental fair value. That is, the fair value of the modified award is greater than the fair value of the original award immediately before the repricing. The resulting incremental compensation cost in that example is recognized over the remaining requisite service period.

10. *View B*: Any excess fair value from Step 1 should be recognized immediately in the postcombination financial statements regardless of the requisite service period of the acquirer's replacement award. Proponents of this view note that it is consistent with current practice and believe that the excess fair value is equivalent to a "Day 1 gain" for the employees and should be reflected as an equivalent expense for the acquirer.

11. Opponents of View B note that many factors could cause excess fair value in Step 1, including the acquirer increasing the requisite service period of the award. For example, if acquirer replacement awards that require two years of additional service are exchanged for acquiree awards for which the required services were rendered before the acquisition date, the fair value of the acquirer replacement awards may exceed the fair value of the acquiree awards solely because the acquirer awards would have a greater expected term input in a closed-form model[3]. When all other factors are held constant, a greater expected term will result in a greater option value, even in situations in which the exercise price and the total number of shares are adjusted based on the exchange ratio for the transaction as a whole. In this case, it is clear that the increased fair value is directly related to the acquirer's desire to benefit from the employee services in the postcombination period. In other situations, the acquirer may intentionally give the employee SBP award holders a premium conversion ration in order to provide incentive for them to remain with the combined entity.

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[3] Paragraph A28(a) of Statement 123(R) notes that an option's expected term must at least include the vesting period.

12. As it would be impracticable to isolate the causes of any excess fair value, opponents of View B (and supporters of View A) believe that all excess fair value resulting from the Step 1 analysis should be recognized over the requisite service period of the acquirer's replacement award.

13. The conclusions resulting from this issue would be applicable to SBP awards classified as either an equity or liability instrument based on the guidance in Statement 123(R).

Discussion Question No. 1: How should any excess fair value in the acquirer's replacement award over the acquiree's award be accounted for?

14. *Staff Recommendation:* The staff recommends View A, because that approach is more consistent with the accounting for modifications in Statement 123(R). In addition, the staff believes that if the excess fair value has to be earned by the employees in multiple postcombination periods, then the appropriate postcombination periods should reflect that compensation cost.

Issues 2–4

15. Issues 2–4 relate to the allocation of the fair value of the replacement award to consideration transferred in the business combination and postcombination compensation cost. Issue 2 discusses the allocation approach between consideration transferred and compensation cost. Issue 3 discusses whether liability awards should have a separate allocation methodology. Issue 4 discusses a convergence issue with the IASB with respect to the definition of the "total service period."

16. The staff observes that the concepts of allocating fair value between consideration transferred in a business combination and postcombination compensation cost may not always be consistent with a strict application of Statement 123(R). The model for accounting for modifications under Statement 123(R) is primarily focused on the fair value of an award before and after a modification, while the model included in the Exposure Draft for Statement 141(R), and further developed in this memo, considers both the fair value of the awards, as well as the service periods over which the awards are

earned to determine the measurement and attribution of the fair value of those awards. To illustrate the staff's observation, consider a fully-vested award of options to purchase 100 shares of stock that are out-of-the-money. The options have an aggregate fair value of $500. Assume that this award is exchanged for at-the-money options to purchase 70 shares of stock that also have an aggregate fair value of $500. The new options also include a three-year service condition. Absent a business combination, Statement 123(R) would not give accounting recognition to this modification, because there is no incremental fair value transferred. Under the model included in the Exposure Draft for Statement 141(R) and further developed below, a portion of the $500 fair value would be "re-recognized" as compensation by the acquirer cost in the postcombination period. The staff believes that these differences between modifications under Statement 123(R) and modifications through a business combination are justified. Any modifications made by an acquirer to attempt to require postcombination services from the acquiree's employees should result in recognition of compensation cost in the acquirer's postcombination financial statements.

Issue 2 – How should the acquirer allocate the remaining fair value of the acquirer award between consideration transferred in the business combination and compensation cost?

17. The staff would like to clarify how the acquirer should allocate the remaining fair value of the acquirer award between consideration transferred as part of the business combination and compensation cost, in particular, how to identify the portion of the replacement award attributable to past services. The staff recommends revising the description of the calculation of amounts attributable to past services as follows (changes to the previous allocation method are noted via underline):

> The portion of the replacement award attributable to past services is equal to the remaining fair-value-based measure of the replacement award (or settlement) multiplied by the ratio of the past service period to the greater of the total service period or the original service period of the acquiree award.

The staff believes that this qualification is important to clarify the accounting in situations in which the acquirer reduces the required service period or accelerates the vesting, as noted in the following example.

18. Assume that the acquiree award had a requisite service period of four years based on a service condition only. A business combination occurs at the end of the second year, and the acquirer replaces the awards but does not require any future service (that is, the replacement awards are fully vested). The description of the allocation methodology in the ED, combined with past practice under Interpretation 44,[4] has lead constituents to conclude that the total service period is only two years, and that the employee had satisfied that total service period. Thus, the entire fair value of the acquirer award should be considered purchase price. Changing the denominator of the ratio to "the greater of the total service period or the original service period of the acquiree award" clarifies that the amount attributable to past services (and thus purchase price) in this example should only be 50 percent (2 years served out of the acquiree award's requisite service period of 4 years, which is greater than the award's new total service period of 2 years) of the acquirer award's remaining fair value.

19. The portion of the acquirer replacement award attributable to future services is dependent on the outcome of Issue 1 above. If the Board decides on View A, then the portion of the award attributable to future services (that is, the portion that will be postcombination compensation cost) will be equal to the total fair value of the acquirer replacement award less the portion attributable to past services as discussed above in paragraphs 14 and 15. If the Board decides in favor of View B, then the portion of the award attributable to future services will be equal to the total fair value of the acquirer replacement award less the portion attributable to past services and less any excess fair value identified in Step 1 as discussed above in Issue 1.

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[4] Interpretation 44 focused on the vested or unvested status of the acquirer replacement awards and not on whether the acquiree awards represent an equity instrument in the aquiree. Paragraph 84 states

> In a business combination, vested stock options or awards issued by an acquirer in exchange for outstanding awards held by employees of the acquiree shall be considered to be part of the purchase price paid by the acquirer for the acquiree and accounted for under Statement 141. Accordingly, the fair value of the new (acquirer) awards shall be included as part of the purchase price.

20. The conclusions resulting from this issue would be applicable to SBP awards classified as either an equity or liability instrument based on the guidance in Statement 123(R).

Discussion Question No. 2: Does the Board agree with the staff's revised description of the calculation of amounts attributable to past services?

Issue 3 – How should the Statement define the "total service period" to be used in allocating the fair value of an acquirer replacement award classified as an equity instrument between consideration transferred in the business combination and compensation cost?

21. The staff would like to revisit the definition of "total service period" used in the Exposure Draft for Statement 141(R) to address a possible difference from the IASB's business combinations Statement. "Total service period" is currently defined in the Exposure Draft as "the period that begins with the service inception date for the award of the acquiree and ends with the service completion date for the replacement award." As defined in the Exposure Draft, this period also includes periods of employee service that were not required in order to vest in the award. The following is from Example 17 in the Exposure Draft:

> AC exchanges replacement awards that require three years of future service for share-based payment awards of TC, for which the requisite service period was completed before the business combination. When originally granted, the share-based payment awards of TC had a requisite service period of four years. The TC employees had rendered a total of seven years of service as of the acquisition date. Because all requisite service was rendered, the TC awards represent an equity interest. However, because the replacement awards require three years of future services, a portion of the replacement award is to be attributed to compensation cost in accordance with the provisions of paragraph A103(b). In this case, the total service period is 10 years—the period that begins with the service inception date for the acquiree's award and ends with the service completion date for the replacement award. [Paragraph A106; emphasis added.]

22. The corresponding concept in the IASB's Exposure Draft is the "total vesting period." Paragraph A103(d) of the IASB Exposure Draft defines the "vesting period" as the "period during which all the specified vesting conditions are to be satisfied." Based on the example corresponding to the FASB Exposure Draft's Example 17, the total vesting period would not include employee service that did not directly contribute to meeting the specified vesting conditions of the award. As a result, the IASB's Example 17 concludes that "the total vesting period is <u>seven years</u>—the vesting period of the original award and the vesting period of the replacement award" (emphasis added).

23. *View A*: The total service period should remain the period that begins with the service inception date for the award of the acquiree and ends with the service completion date for the replacement award. That is, the FASB should retain the definition in its Exposure Draft. This period may also include a period of "unrequired" service, for example, the intervening three years in the FASB's Example 17. Proponents of this view note that all of the service rendered by the employee up to the acquisition date contributes to the fair value of the award as of the acquisition date, and that full-time period should be considered in allocating the award, not just the minimum that may have been required to vest in the award.

24. *View B*: The total service period should only include periods of employee service that were required in order to vest in the award. That is, the definition should be aligned with that of the IASB. Supporters of View B believe that the allocation of the fair value of replacement awards to consideration transferred and future compensation cost should not be skewed by including extraneous time periods. They note the following example. In contract to the facts in Example 17, consider an employee that received identical options from TC exactly one year later. Employee #2's awards would be allocated 6/9 (67 percent) to consideration transferred in the business combination and 3/9 (33 percent) to postcombination compensation costs. Employee #1's award would be allocated 7/10 (70 percent) to consideration transferred in the business combination and 3/10 (30 percent) to postcombination compensation costs. Because both employees have the same postcombination requisite service period, supporters of View B believe that proportion of the replacement award allocated to postcombination compensation cost should be the same, which would be the case under a View B approach.

Discussion Question No. 3: How should the Statement define the "total service period" to be used in allocating the fair value of an acquirer replacement award classified as an equity instrument between consideration transferred in the business combination and compensation cost?

25. *Staff Recommendation:* The staff recommends View A.

Issue 4 – How should an acquirer replacement award classified as a liability be allocated between consideration transferred in the business combination and compensation cost?

26. If the allocation methodology for a liability instrument followed either view discussed in Issue 3 above, there could be circumstances in which the acquirer would record a liability that is less than the precombination liability on the acquiree's balance sheet. For example, if a fully vested liability award is exchanged for a similar instrument with the same fair value except for an additional service condition, the allocation methodologies would result in the acquirer recording less of a liability than was on the acquiree's balance sheet. If the Board agrees with the staff's views in paragraph 13 above, then the allocation between consideration transferred and compensation cost for an equity instrument and a liability instrument should be the same. If, however, the Board believes that either (a) the model developed for exchanges of SBP awards in a business combination or (b) equity and liability SBP awards should have different allocation models in a business combination, then the Board should consider the allocations of liability awards as discussed in this Issue.

27. *View A*: The allocation methodology adopted by the Board in Issue 3 above should apply to awards classified as both equity and liability instruments. The amounts in the acquiree's precombination balance sheet are irrelevant to the acquirer's accounting for the acquisition, and the acquirer should account for the terms of the awards that it issues. If the acquiree employee is obligated to earn the award by fulfilling an additional service condition, then a portion of the award should be recognized as postcombination

compensation cost, and that amount is independent of any amount on the acquiree's balance sheet.

28. *View B*: The allocation methodology adopted by the Board in Issue 3 above should apply only to awards classified as equity instruments. Liability instruments should follow the allocation methodology subject to recognizing a minimum liability in purchase accounting equal to the liability on the acquiree's precombination balance sheet. Supporters of View B believe that this "walk-away liability" (that is, the amount the employee could have walked away with) represents a liability to the acquirer that should be fully reflected in the acquiree's postcombination balance sheet.

Discussion Question No. 4: How should an acquirer replacement award classified as a liability be allocated between consideration transferred in the business combination and compensation cost?

29. *Staff Recommendation*: Consistent with its views expressed in paragraphs 13 and 23 above, the staff supports View A.

Issue 5 – How should an acquirer consider replacement awards with a graded vesting schedule with respect to measurement and allocation between past and future services?

30. Statement 123(R) provides an accounting policy election with respect to the measurement and recognition of awards with only service conditions that have a graded vesting schedule. Awards may be measured as if they were a single award, or they may be measured as if they are multiple awards, reflecting the multiple requisite service periods in the award. Independently of the measurement policy election, entities may recognize an award over a single requisite service period (the longest contained in the award) or over the multiple requisite service periods in the award. The issues in business combinations relate to measurement and attribution of an acquirer's replacement award with graded vesting. That is, should it be measured as a single award or multiple awards? For purposes of allocating the fair value of the acquirer award between past and future

services, should the acquirer consider one requisite service period or multiple requisite service periods?

31. *View A*: The measurement and attribution of acquirer replacement awards with graded vesting should follow the acquirer's accounting policy elections under Statement 123(R) for such awards. Proponents of this view believe that since the awards are being issued by the acquirer, the acquirer's accounting policy should dictate the measurement and attribution of those awards. Maintaining this consistent approach will avoid mixed attribution methods in the postcombination period, for example, between the acquirer's normal awards and those issued in business combinations.

32. View A is also consistent with another decision related to employee benefits that the Board made in the business combinations project. The Board decided that all employee benefit obligations should be measured based on guidance in existing standards rather than at fair value. If a standard allows employee benefit obligations to be measured or recognized in various ways, the acquirer should be required to measure those assumed obligations in a manner consistent with its existing accounting policies rather than based on the acquiree's policies.

33. *View B*: The measurement and attribution of acquirer replacement awards with graded vesting should follow the acquiree's accounting policy elections under Statement 123(R) for such awards. Proponents of this view believe that this approach will more closely align the values and allocation of the awards with the historical acquiree accounting. In other words, the portions of the awards considered to be equity instruments in accounting for the business combination will be better aligned with the portions that the acquiree considered to have been earned by the employee or other SBP award holder.

34. *View C*: An acquirer should be permitted to make an accounting policy election for the measurement and attribution of awards with graded vesting issued as replacement awards in a business combination. Proponents of this view consider business combinations to be unique transactions that should have their own unique accounting policies. As such, they think that an acquirer should be able to select accounting policies for the measurement and attribution of awards with graded vesting issued in a business

combination independent of either the acquirer's or acquiree's historical accounting policy elections.

35. The conclusions resulting from this issue would be applicable to SBP awards classified as either an equity or liability instrument based on the guidance in Statement 123(R).

Discussion Question No. 5: How should an acquirer consider replacement awards with a graded vesting schedule with respect to measurement and allocation between past and future services?

36. *Staff Recommendation:* The staff recommends View A. The staff believes that since these awards are within the scope of Statement 123(R), the acquirer's accounting policies should be consistent for all awards issued, regardless of whether they are issued to existing employees or employees "acquired" in a business combination.

Issues 6–8

37. Issues 6–8 all deal with the impact of forfeitures or other postcombination events on the accounting for replacement SBP awards. Issue 6 deals with whether the amounts allocated to consideration transferred in the business combination should include an estimate of future forfeitures. Issue 7 addresses whether the purchase price should be adjusted in the postcombination period related to postcombination forfeitures. Issue 8 relates to the accounting for forfeitures of awards considered to be postcombination consideration.

Issue 6 – Should the portion of the replacement award attributable to past services (the portion recognized as consideration transferred in the business combination) include a forfeiture assumption for awards for which the requisite service has not yet been provided?

38. This issue addresses whether the amount allocated to consideration transferred in the business combination related to unvested shares should be recorded "gross" (without

the consideration of a forfeiture estimate) or "net" (including a discount for future estimated forfeitures). This issue only addresses the amount allocated to consideration transferred in the business combination because the staff does not believe that existing accounting standards (or those proposed in the Exposure Draft) address this issue. Since the consideration of expected forfeitures in amounts recognized as postcombination compensation cost are explicitly addressed in Statement 123(R), the staff did not believe it was necessary to address that portion of replacement SBP awards.

39. *View A*: The fair value of unvested awards included in the purchase price should not include a forfeiture estimate; they should be recorded gross. Proponents of this view believe, consistent with the Board's previous decisions, that the portion of the award attributable to past service represents an equity interest in the acquiree, and that the full fair value of the equity instrument should be included in the consideration for the business combination. Proponents of this view argue that the total amount of compensation cost recognized under Statement 123(R) is based on the number of instruments for which the requisite service has been rendered. They argue that the requisite service has been rendered through the acquisition date and that view coincides with the Board's view that such awards are equity interests in the acquiree. Supporters of View A also believe that forfeiture rates will be unreliable in these circumstances, and that, subject to the Board's conclusions on later issues, there may be no mechanism to adjust the amount in the purchase price in the postcombination period if the future experience is materially different from the estimates used in the initial determination of the consideration transferred in the business combination. (Subsequent adjustments of goodwill relating to postcombination forfeitures are considered in Issue 7 below.) Opponents of View A believe that certain industry-specific situations could result in inappropriate allocations to consideration transferred in a business combination. For example, some retailers may issue SBP awards to their part-time employees. These positions typically have very high turnover, and, as a result, an inappropriately high value may be ascribed to consideration transferred depending on the point in time of the acquisition date. If the Board concludes on View A in Issue 7 below, then the postcombination financial statements would reflect unusual activity in terms of high levels of negative compensation cost from the highly probable future forfeitures.

40. As an example, assume that Target Co. issues 3,000 share options on January 1, 20X7. The options cliff vest at the end of three years. On January 1, 20X8, Buyer, Inc. purchases Target Co. and issues share options to replace those held by the employees of Target Co. On the acquisition date, the fair value of the acquiree awards and the acquirer's replacement awards is $12 per share. Buyer, Inc. would include $12,000 (3,000 options × 1 year served / 3 year total service period × $12) as consideration in the business combination.

41. *View B*: The fair value of unvested awards included in the purchase price should include a forfeiture estimate. That is, they should be recorded net. The forfeiture estimate should be based on the acquirer's estimate of pre-vesting forfeitures. Proponents of this view argue that the total amount of compensation cost recognized under Statement 123(R) is based on the number of instruments for which the requisite service has been rendered. Because the complete requisite service has not yet been rendered for these awards, the amount of consideration in the business combination should also reflect an estimate of the awards for which the remaining requisite service will not be rendered.

42. To illustrate the accounting under View B, assume the same facts as in paragraph 37 above. In addition, assume that Buyer expects a 5 percent forfeiture rate over the remaining two year requisite service period. Accordingly, it expects that only 2,708 ($3{,}000 \times .95^2$) share options will vest. Buyer would include $10,832 (2,708 options × 1 year served / 3 year total service period × $12) as consideration in the business combination).

43. The conclusions resulting from this issue would be applicable to SBP awards classified as either an equity or liability instrument based on the guidance in Statement 123(R).

Discussion Question No. 6: Should the portion of the replacement award attributable to past services (the portion considered to be consideration transferred in the business combination) include a forfeiture assumption for awards for which the requisite service has not yet been provided?

44. *Staff Recommendation:* The staff recommends View B because they believe that a fair-value-based measure under Statement 123(R) must consider estimated forfeitures. Accordingly, the fair value any replacement award considered to be consideration transferred in the business combination for which the requisite service has not yet been rendered should include a forfeiture assumption.

Issue 7 – How should an acquirer account for postcombination forfeitures of awards considered to be consideration transferred in the business combination (or for changes in forfeiture estimates in the postcombination period)?

45. The purpose of this issue is to revisit the Board's previous decision noted above in paragraph 3(e):

> Events that occur after the acquisition date should not change the amounts recognized as consideration for the business combination as of the acquisition date. Therefore, any subsequent changes for example, forfeitures, modifications, ultimate outcome of performance awards, should be accounted for in accordance with Statement 123(R) solely in the postcombination period.

46. A question has arisen regarding the accounting for postcombination forfeitures of awards considered to be consideration transferred in the business combination. (Note that this issue can relate to either forfeitures or adjustments to previous forfeiture estimates. As a result, it is independent of the Board's decision with respect to Issue 6. The discussion of awards being forfeited in the postcombination period can also refer to changes in forfeiture estimates in the postcombination period.)

47. *View A*: If an award considered to be consideration transferred in the business combination is forfeited in the postcombination period, there should not be any adjustment to the purchase price. That is, all postcombination forfeitures (changes in forfeiture estimates) should be accounted for as adjustments to compensation cost in the periods in which the forfeiture (or change in estimate) occurred. View A affirms the Board's previous decision. Supporters of this view believe that the amount determined to be consideration in the business combination should reflect the facts and circumstances at

that time, and that subsequent changes in the postcombination period do not bear on the value transferred as of the acquisition date. Opponents of View A note that this approach could result in postcombination gains (that is, negative compensation cost) for adjustments resulting from postcombination forfeitures or changes in postcombination forfeiture estimates for awards classified as both liabilities and equity.

48. *View B*: If an award considered to be consideration transferred in the business combination is forfeited in the postcombination period, the purchase price should be adjusted. Proponents of this view argue that the total amount of compensation cost recognized under Statement 123(R) is based on the number of instruments for which the requisite service has been rendered. If the remaining requisite service for those awards is not rendered, the fair value of those awards should not be reflected in the purchase price, because to do so is inconsistent with the principles of Statement 123(R). Opponents of this view note that it is not consistent with the other principles in Statement 141(R) with respect to subsequent adjustments to goodwill. In addition, opponents note that these adjustments may occur several years after the business combination. Adjustments to the purchase price so long after the acquisition date would be confusing to users and would not provide decision-useful information.

Discussion Question No. 7: How should an acquirer account for postcombination forfeitures of awards considered to be consideration transferred in the business combination?

49. *Staff Recommendation:* The staff recommends View A because it is better aligned with the other principles of Statement 141(R).

Issue 8 – How should an acquirer account for the postcombination effects of replacement SBP awards classified as liabilities that were issued in a business combination and included in the consideration transferred in the business combination?

50. The purpose of this issue is to also revisit the Board's previous decision noted above in paragraph 3(e) with respect to possible postcombination effects of acquirer replacement awards classified as liabilities:

> Events that occur after the acquisition date should not change the amounts recognized as consideration for the business combination as of the acquisition date. Therefore, any subsequent changes for example, forfeitures, modifications, ultimate outcome of performance awards, should be accounted for in accordance with Statement 123(R) solely in the postcombination period.

51. Under Statement 123(R), the accounting for SBP awards classified as liabilities is significantly different from those classified as equity. Statement 123(R) requires that entities remeasure liabilities at the end of each reporting period until settlement. All changes resulting from the remeasurement are included in current period net income.

52. The staff notes the following types of effects that a replacement SBP award classified as a liability in a postcombination period:

a. Forfeitures – Consistent with SPB awards classified as equity instruments, the recognition of SBP awards classified as liabilities must also consider forfeitures. In the postcombination period, there could be changes in estimates of forfeitures from those that existed at the acquisition date.

b. Remeasurement – A replacement SBP award classified as a liability that is included in consideration transferred in the business combination must be remeasured at each balance sheet date until settlement. The remeasurements will result from changes in the fair value of the underlying shares, time value of the award, or from multiple factors.

c. Income taxes – Unlike an SBP award classified as an equity instrument, there will typically not be a difference in the cumulative amount of compensation cost and the actual deduction received for awards classified as liability instruments. This is because a liability-classified award is remeasured at each balance sheet, and so are the related deferred taxes. While this issue does not need to consider

the impact of differences at settlement of the award, it does need to consider the impact of changes in deferred taxes due to remeasurement.

53. There are two views for accounting for the postcombination effects of replacement SBP awards classified as liabilities that were issued in a business combination and included in the consideration for the business combination, as follows.

54. *View A* – All postcombination effects of replacement awards classified as liabilities that were issued in a business combination and included in the consideration for the business combination should be recorded as adjustments to compensation cost and income tax expense in the period in which they arise. Proponents of this view believe that these postcombination effects are solely related to changes in circumstances in the postcombination period and not by any facts and circumstances that exist at the date of the business combination.

55. *View B* – All postcombination effects of replacement awards classified as liabilities that were issued in a business combination and included in the consideration for the business combination should be recorded as adjustments to consideration transferred in the business combination. Proponents of this view believe that this approach results in the best ultimate measurement of the consideration transferred. They also believe that it is unfair to burden an entity's postcombination net income with items solely related to a business combination. That is, the SBP awards would not have been issued but for the business combination. Opponents note that these adjustments may occur several years after the business combination. Adjustments to the purchase price so long after the acquisition date would be confusing to users and would not provide decision-useful information.

Discussion Question No. 8: How should an acquirer account for the postcombination effects of replacement SBP awards classified as liabilities that were issued in a business combination and included in the consideration transferred in the business combination?

56. *Staff Recommendation:* The staff recommends View A.

Issues 9–12

57. Issues 9–12 deal with the income tax effects of the subsequent exercise of share options that were issued by an acquirer in a nontaxable business combination. Issue 9 deals with awards that ordinarily would result in a future tax deduction under existing tax law. Issue 10 deals with awards that ordinarily would not result in a future tax deduction under existing tax law. The staff notes that although Statement 123(R) nullified Interpretation 44 and Issue 00-23, constituents have analogized to the guidance in those standards when Statement 123(R) does not include equivalent guidance and when the guidance does not seem to conflict with Statement 123(R). Issues 9–11 are such an area, and constituents have analogized to the guidance in Issues 29(a) and 29(b) of Issue 00-23 since the issuance of Statement 123(R). Issues 29(a) and 29(b) are included in Appendix 1 for reference. Issue 12 relates to the pool of available excess tax benefits that should be considered in accounting for the income tax effects discussed in Issues 9–11.

Issue 9 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would result in a future tax deduction under existing tax law?

58. As noted in Appendix 1, deferred taxes are not recorded in a business combination related to the tax effects of awards issued to employees of the acquiree under Issue 29(a). Future deductions resulting from the exercise of such stock options are recognized as an adjustment to the purchase price of the acquired business.

59. With respect to the Day 1 accounting (that is, whether to record a deferred tax asset), this model is inconsistent with Statement 123(R). Under Statement 123(R), entities should record deferred taxes equal to the cumulative amount of compensation cost recognized. The staff recommends recording deferred taxes in the business combination based on the fair value of equity-classified SBP awards issued in a business combination and included as consideration for the business combination.

60. With respect to the Day 2 accounting, there are two views regarding the accounting for the ultimate deduction received, as follows.

61. *View A* – The difference in the deferred taxes recorded in the business combination and the ultimate deduction received by the acquirer should not result in an adjustment to the purchase price, but instead should follow the accounting in paragraphs 62 and 63 of Statement 123(R).[5] Proponents of this view believe that the Issue 29(a) model is inconsistent with other staff recommendations related to income taxes in a business combination. The difference in the deferred taxes recorded in the business combination and the ultimate deduction will be dictated by future stock prices and not by any facts and circumstances that exist at the date of the business combination. As a result, adjustments to these deferred taxes should be recorded in the postcombination financial statements, consistent with other SBP awards.

62. *View B* – The difference in the deferred taxes recorded in the business combination and the ultimate deduction received by the acquirer should be accounted for as an adjustment to the consideration transferred in the business combination (goodwill). Proponents of this view believe that this approach is consistent with current practice and results in the best ultimate measurement of the purchase price. They also believe it is unfair to burden an entity's APIC pool and/or net income with items solely related to a business combination. That is, the SBP awards would not have been issued but for the business combination.

63. *View C* – The difference in the deferred taxes recorded in the business combination and the ultimate deduction received by the acquirer should be accounted for as an adjustment to additional paid-in capital. Such an adjustment would have no affect on the APIC pool. Supporters of this view note that the portion of the equity classified SBP awards included in the consideration transferred in the business combination is considered to be an equity interest in the acquiree. Accordingly, the tax deduction

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[5] Tax benefits resulting from income tax deductions in excess of recognized compensation cost are recognized in additional paid-in capital. If the tax benefits are less than the cumulative compensation cost, the write-off of the related excess deferred tax asset is recognized in the income statement, except to the extent that credits have previously been recognized in APIC for deductions in excess of compensation cost for past awards.

resulting from the ultimate exercise or vesting of the award is a transaction with an equity holder. EITF Issue No. 94-10, "Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109," requires that the tax effects of such transactions to be included in equity.

Discussion Question No. 9: How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would result in a future tax deduction under existing tax law?

64. *Staff Recommendation:* As noted above, the staff recommends recording deferred taxes in the business combination related to SBP awards issued in a business combination and included as consideration transferred for the business combination with respect to Day 1 accounting. With respect to Day 2 accounting, the staff recommends View C based on the notion that the equity-classified replacement awards issued as consideration transferred in the business combination are equity instruments. As a result, all subsequent transactions (for example, exercise of or vesting in the award) are transactions with the entity's shareholders. The staff notes that this recommendation only applies to adjustments to deferred taxes based on changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

Issue 10 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would NOT result in a future tax deduction under existing tax law?

65. Issue 29(a) of EITF Issue 00-23 does not address the accounting for awards that ordinarily would NOT result in a future tax deduction under existing tax law that were issued in a business combination and included in the consideration for the business combination. Current practice also does not record deferred taxes for those awards because they are not expected to result in a tax deduction for the entity, absent a

disqualifying disposition or other disqualifying transaction. The staff believes that not recording deferred taxes in this situation is appropriate and consistent with Statement 123(R). That is, the tax benefits should only be recognized when they occur.

66. With respect to Day 2 accounting, Views A, B, and C under Issue 9 also apply to this issue. That is, recognizing the income tax effects of these awards based on (a) paragraphs 62 and 63 of Statement 123(R), (b) through an adjustment to the consideration transferred (goodwill), or (c) as an adjustment to equity as a transaction with a shareholder, respectively.

Discussion Question No. 10: How should an acquirer account for the income tax effects from awards classified as equity that were issued in a nontaxable business combination and included in the consideration for the business combination and that ordinarily would NOT result in a future tax deduction under existing tax law?

67. *Staff Recommendation:* For the same reasons described in Issue 9, the staff recommends View C with respect to the Day 2 accounting.

Issue 11 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a business combination and considered postcombination compensation cost?

68. Issue 29(b) of EITF Issue 00-23 addresses the accounting for awards that were unvested on the consummation date of a business combination. It concludes that with respect to the portion of the award attributable to postcombination consideration:

> . . . the accounting for the tax benefit from . . . nonqualified stock options granted in a purchase combination related to the future vesting period (the compensatory portion) should be the same as for nonqualified stock options granted to employees absent a business combination.

69. The staff recommends a similar approach under Statement 141(R). That is, the income tax effects from awards classified as equity that are considered to be postcombination compensation cost should be accounted for in a manner consistent with Statement 123(R) as if they were granted absent a business combination. This

recommendation applies equally to awards that ordinarily would and would NOT result in a future tax deduction under existing tax law.

Discussion Question No. 11: Does the Board agree with the staff recommendation with respect to an acquirer's accounting for the income tax effects from awards classified as equity that were issued in a business combination and considered postcombination compensation cost?

Issue 12 – How should the pool of excess tax benefits be determined for replacement SBP awards?

70. This issue relates to the determination of the pool of excess tax benefits for the awards considered in Issues 9–11 of this memo. (Note that in View C of Issues 9 and 10, the staff notes that the resulting adjustments to additional paid-in capital would not affect an entity's pool of excess tax benefits. Accordingly, if the Board foll) What, if any, special considerations are there related to the pool of excess tax benefits related to business combinations?

71. *View A* – The income tax effects of awards issued in a business combination should be evaluated against a pool of excess tax benefits that includes the pool of excess benefits from awards granted by any entities that are consolidated within the reporting entity's consolidated financial statements at the time the income tax effect must be evaluated in comparison to the pool, for example, exercise, vesting, or settlement of the award. For example, Company A acquires Companies X, Y, and Z in business combinations. The income tax effects of acquirer replacement awards issued to employees of Company Z may be offset by the pool of excess tax benefits generated by the awards granted to and subsequently exercised by employees of Companies A, X, Y, and Z. Supporters of View A note that this approach focuses on the total reporting entity and is the simplest approach to implement. Supporters of View A do not believe that it is necessary or meaningful to draw a distinction between SBP awards issued to employees in the "normal course of business" and replacement SBP awards issued in a business combination.

72. *View B* – The income tax effects of awards issued in a business combination should be evaluated against a pool of excess tax benefits that is limited to other awards that were issued in business combinations, although not necessarily the same business combination. For example, Company A acquires Companies X, Y, and Z in business combinations. The income tax effects of acquirer replacement awards issued to employees of Company Z may be offset by the pool of excess tax benefits generated by the awards granted to its employees and those of Companies X and Y, but not to awards issued to Company A employees. Supporters of this view believe that awards issued in a business combination represent a special class of awards and that only replacement SBP awards should be used to evaluate the tax effects of other replacement SBP awards issued in business combinations.

73. *View C* – The income tax effects of awards issued in a business combination should be evaluated against a pool of excess tax benefits that is limited to awards issued in that specific business combination. For example, Company A acquires Companies X, Y, and Z in business combinations. The income tax effects of acquirer replacement SBP awards issued to employees of Company Z may ONLY be offset by the pool of excess tax benefits generated by the awards granted to its employees, but not to awards issued to Company A employees or to employees of Companies X and Y as replacement SBP awards in those business combinations. Supporters of this view believe that each individual business combination is a unique transaction, and that the pool of excess tax benefits should be separately maintained for each set of acquirer replacement awards issued in a business combination. They believe that a business combination is a unique transaction and that unique and separate pools of excess tax benefits should be maintained for each pool.

Discussion Question No. 12: How should the pool of excess tax benefits be determined for replacement SBP awards?

74. *Staff Recommendation:* The staff notes that it has recommended View C in Issues 9 and 10. That view contained the notion that the resulting adjustments to additional paid-in capital would not affect an entity's pool of excess tax benefits. Accordingly, if the Board agrees with the staff recommendation for Issues 9 and 10, then this issue would only relate to the portion of replacement SBP awards recognized as compensation cost. In that

case, the staff would support View A, because it believes that View A's approach would be consistent with the objectives of Statement 123(R) with respect to accounting for the tax effects of share-based payment awards.

Appendix 1

EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44"

Issues 29(a) and 29(b)

Tax Benefits of Nonqualified Options Issued in a Purchase Business Combination

129. Issue 29 addresses the accounting for tax benefits from an employee's exercise of nonqualified employee stock options that were issued or granted in a purchase business combination for a company that accounts for stock compensation in accordance with Opinion 25. Issue 29 does not apply to qualified options because the exercise of a qualified option does not result in tax benefits to the company.

130. The following example is used for illustrative purposes in this Issue:

> On January 1, 20X0, Company A acquires Company B in a nontaxable purchase business combination in exchange for 5,000,000 shares of Company A. The value of those shares, determined in accordance with Issue No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination," is $100,000,000 (that is, $20 per share). In addition, Company A grants options to employees of Company B in exchange for their options to acquire Company B stock. Company A issues to Company B employees 100,000 fully vested options to acquire Company A common stock for $10 per share any time within 2 years of the grant date. At the date the combination is consummated, the vested options have an intrinsic value of $10 per option, and, at the Issue 99-12 measurement date, a fair value of $12 per option. Company A also grants to Company B employees 200,000 options to acquire Company A common stock for $12 per share any time within 3 years of the grant date. The options cliff vest two years from the date of the combination (that is, all options vest at the end of the second year) and replace awards that cliff vested three years from their original grant date and had one year of expired vesting at the consummation date of the business combination. The partially vested options have an intrinsic value of $8 per share, and a fair value of $10 per share. The fair value of Company B's net identifiable assets is $80,000,000 on the date the business combination was consummated. Those net assets have a net tax basis of $40,000,000. Subsequent to the consummation of the business combination, all of the options are exercised on January 1, 20X2, when the market price of Company A's common stock is $40. Goodwill is amortized over 10 years. At the consummation date, the business combination is recorded as follows (before any recognition of the expected tax benefits from the option awards issued or granted in the combination):

Net identifiable assets	80,000,000	
Goodwill	38,133,333	
Stockholders' equity—		
unearned compensation	1,066,667 (a)	
Common stock		5,000,000
APIC—common stock		95,000,000
APIC—options		3,200,000 (b)
Net deferred tax liability		16,000,000 (c)

(a) Computed as two-thirds of the intrinsic value ($1,600,000) of the partially vested options.
(b) Represents the fair value of the employee stock options granted in the business combination, calculated as follows: [(100,000 × $12) + (200,000 × $10)].
(c) Computed as the difference between the $80,000,000 book value of the net identifiable assets less the assumed net tax basis in those assets of $40,000,000 multiplied by an assumed 40 percent tax rate. Deferred taxes are presented net for purposes of simplicity. Goodwill is not deductible for tax purposes in a nontaxable business combination and, accordingly, no deferred tax liability has been recorded with respect to goodwill.

Issue 29(a) — How to account for the income tax benefits from the exercise of nonqualified employee stock options that were issued in a nontaxable purchase business combination and that were fully vested at the date the combination was consummated.

131. The Task Force reached a consensus that the expected tax benefit from vested option awards that are issued as consideration to employees of an acquiree in a purchase business combination does not result in a deferred tax asset on the date the business combination is consummated. Any future deduction resulting from the exercise of the stock options should be recognized as an adjustment to the purchase price of the acquired business when realized to the extent that the deduction reported for tax purposes does not exceed the fair value of awards recognized as part of the purchase price. The tax benefit of any remaining excess deduction reported should be recognized in additional paid-in capital. [Note: This consensus has been nullified by Statement 123(R). See STATUS section.]

132. Under the consensus, the following additional entries would be made for the example described previously for the stock options that were fully vested on the date of the business combination:

On the date the options are exercised:

Taxes refundable/payable	1,200,000 (a)	
Goodwill		480,000 (b)
APIC—options		720,000 (c)

(a) Calculated as (1) the intrinsic value of the vested awards at the exercise date of $3,000,000 [100,000 options × ($40 market value of underlying stock on exercise date less $10 exercise price)] multiplied by (2) Company A's effective tax rate of 40 percent.

(b) Represents the portion of the benefit recognized as a reduction to the purchase price (goodwill in this case). Calculated as the portion of the tax deduction equal to the $1,200,000 fair value of the options included in the purchase price (100,000 awards at $12) multiplied by Company A's effective tax rate of 40 percent.

(c) Represents the $1,800,000 excess of the ultimate $3,000,000 tax deduction over the $1,200,000 fair value of the options included in the purchase price multiplied by Company A's 40 percent effective tax rate.

Issue 29(b)— How to account for the income tax benefits from the exercise of nonqualified employee stock options that were granted in a purchase business combination and that were unvested on the consummation date for the combination.

133. The Task Force reached a consensus that the proportion of unvested employee stock option awards granted as consideration in a purchase business combination equal to the proportion of the vesting period that has expired as of the consummation date should be accounted for in accordance with the consensus on Issue 29(a). The Task Force observed that the approach is consistent with the guidance in paragraph 85 of Interpretation 44 on the accounting for unvested awards in a purchase business combination and with the prior conclusions in Issue 00-23 on accounting for subsequent repurchases or modifications of those awards. [Note: This consensus has been nullified by Statement 123(R). See STATUS section.]

134. The Task Force reached a consensus that the accounting for the tax benefit from the proportion of unvested nonqualified stock options granted in a purchase combination related to the future vesting period (the compensatory portion) should be the same as for nonqualified stock options granted to employees absent a business combination. That is, assuming that the options are fixed awards, the intrinsic value of the options is recognized as compensation cost over the vesting period. Paragraph 89 of Interpretation 44 provides guidance on the accounting for deferred taxes resulting from outstanding stock options and states that "deferred tax assets shall be determined by the compensation expense recognized for financial reporting rather than by reference to the expected future tax deduction (which would be estimated using the current intrinsic value of the award)." Accordingly, the Task Force believes that a deferred tax asset should be recognized when

the unearned compensation measured at the consummation date of the business combination is recognized as compensation cost. [Note: This consensus has been nullified by Statement 123(R). See STATUS section.] For the example described in paragraph 130, above, the following additional entries would be made to recognize compensation cost and the related tax benefits of the nonqualified stock options that are not fully vested:

At the end of each of the two years following the business combination:

Compensation expense	533,333 (a)	
Deferred tax asset	213,333 (b)	
APIC—unearned compensation		533,333
Income tax expense		213,333

(a) Calculated as 200,000 options multiplied by 2/3 (to determine the compensation portion of the unvested options) multiplied by $8 (intrinsic value on the date of the business combination) divided by 2 years (the remaining vesting period at the consummation date).

(b) Calculated as 533,333 (compensation expense) multiplied by Company A's 40 percent effective tax rate.

On the date the options are exercised for the compensatory portion of the award:

Taxes refundable/payable	1,066,667	
APIC—options		1,066,667

Calculated as (1) the intrinsic value at the exercise date of the compensation portion of the awards of $3,733,333 [200,000 awards × 2/3 × ($40 market value of underlying stock on exercise date less $12 exercise price)] multiplied by (2) Company A's effective tax rate of 40 percent, less (3) the $426,666 in expected tax benefits previously recognized.

On the date the options are exercised for the portion of the unvested awards at the business combination date equal to the expired portion of the vesting period:

Taxes refundable/payable	746,667 (a)	
Goodwill	266,667 (b)	
APIC—options		480,000 (c)

(a) Calculated as (1) the intrinsic value of the "vested" portion of the awards at the exercise date of $1,866,667 [200,000 options × 1/3 × ($40 market value of underlying stock on exercise date less $12 exercise price)] multiplied by (2) Company A's effective tax rate of 40 percent.

(b) Represents the portion of the benefit recognized as a reduction to the purchase price (goodwill in this case). Calculated as the portion of the tax deduction equal to the $666,667 fair value of the "vested" portion of the options included in the purchase price (200,000 options × 1/3 × $10 fair value) multiplied by Company A's effective tax rate of 40 percent.

(c) Represents the $1,200,000 excess of the ultimate $1,866,667 tax deduction over the $666,667 fair value of the options included in the purchase price multiplied by Company A's 40 percent effective tax rate.

135. The Task Force observed that if the intrinsic value declines below the amount necessary to recover the deferred tax asset recognized for the compensatory portion of the unvested options at the date of the business combination, that excess deferred tax asset should be written-off at exercise to (a) equity, to the extent that there is remaining additional paid-in capital from previous stock-based employee compensation awards, or (b) earnings.

136. The Task Force reached a consensus that the guidance in Issue 29(a)-(b) should be applied prospectively to exchanges of awards in business combinations that occur after January 18, 2001.