IASB/FASB Meeting December 2009

IASB agenda reference 5B

FASB memo reference 74

Project	**Financial instruments with characteristics of equity**
Topic	**Share-based payments—U.S. GAAP**

Introduction

1. This paper provides information to FASB members on which to base a preliminary decision about whether to retain Topic 718, Stock Compensation (originally issued as FASB Statement No. 123 (revised 2004), *Share-Based Payment* for instruments within its scope or to give further consideration to eliminating Topic 718 in a future meeting. This paper may not provide enough information to make a final decision to eliminate Topic 718. If the Board is inclined to consider that further, we are prepared to provide a more detailed analysis of the consequences of that decision at a future meeting.

2. This paper analyzes the following two alternatives:

    (a) **Alternative 1**—Apply Approach 4.1 to instruments within the scope of Topic 718.

    (b) **Alternative 2**—Provide a scope exception for instruments in the scope of Topic 718

Scope of Share-Based Payment Requirements

3. Topic 718 provides classification and measurement requirements for all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee that meet either of the following conditions:

    (a) The amounts are based, at least in part, on the price of the entity's shares or other equity instruments.

(b) The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

4. Some common examples of instruments in the scope of Topic 718 include:

   (a) Stock options

   (b) Restricted shares and restricted share units

   (c) Share-settled and cash-settled stock appreciation rights (SARs)

   (d) Employee stock purchase plans

   (e) Long-term incentive plans in which the amount earned by the employee is based on the issuer's own equity instruments.

5. Topic 718 applies to public and non-public entities. However, non-public entities are provided with alternatives in measurement.

Alternative 1—Apply Approach 4.1 to Instruments in the Scope of Topic 718 (no scope exception)

6. Applying Approach 4.1 to instruments within the scope of Topic 718 would drastically change classification requirements for share-based payments. For example, under Approach 4.1 only very simple (plain vanilla) physically settled written call options would be classified as equity. Current share-based payment literature allows some net-share settled instrument and some cash-settled instrument to be classified as equity. All net-share settled and cash-settled instruments would be classified as liabilities under Approach 4.1.

7. Appendix A provides a list of instruments and their classification under Topic 718 and Approach 4.1. The appendix is intended to highlight the major differences between the classification under Topic 718 and Approach 4.1. This appendix does not consider the many nuances in Topic 718. Therefore, it should not be used for any other purpose other than discussion at this Board meeting.

Analysis of Alternative 1

8. Alternative 1 would eliminate what some may perceive as inconsistent accounting for similar financial instruments. Those who support Alternative 1 would argue that a share or an option on a share issued as a share-based payment

award should be accounted for the same as a share or an option issued to an investor.

9. Topic 718 and IFRS 2 are not currently different. If both Boards decide to include share-based payments in the scope of the financial instruments with characteristics of equity project, the Boards will have the same classification results for *vested* share-based payment awards. (The IFRS and US GAAP requirements may not be the same for reasons described below.)

Definition of a Financial Instrument

10. Alternative 1 raises an interesting issue related to the definition of a *financial instrument* in U.S. GAAP. On the grant date, grants of shares or options on shares to employees are promises to deliver those shares or options in the future if the employee provides future services. That is, they are exchanges of shares or options for services. Although the shares or options to be delivered will be financial instruments, the promises at the grant date are not financial instruments as the FASB has defined financial instruments.

11. Financial liabilities that arise are either (a) promises to deliver cash or other financial instruments in the future for no future consideration or (b) promises to deliver cash or other financial instruments in the future in exchange for cash or other financial instruments. Share-based payment arrangements involve exchanges of financial instruments for services before vesting. Consequently, they are not financial instruments. Because the scope of the planned liability-equity standard would include only financial instruments, that standard would not apply to the share–based payment arrangement at the grant date.

12. The situation changes at the vesting date, which occurs when the required services are performed. At that date the employee may receive shares, which are financial instruments and which, once issued, are reported by the issuer in the same manner as other outstanding shares. That is, the original amount at which they are recognized is not adjusted. If the employee receives options instead of shares, those options are financial instruments. There is no longer any requirement to provide services; the employee has the right to purchase shares for a specified (fixed or determinable) price. That instrument is a financial

instrument as defined by the FASB. Consequently, the planned liability equity standard would apply to those instruments at the vesting date and thereafter. We are not sure if this issue arises would also arise in IFRS.

13. If the FASB chooses Alternative 1, the Board will probably have to maintain the existing requirements or develop new requirements on how to account for the instruments before they become financial instruments. In either case, the accounting would change at the vesting date.

Measurement Requirements

14. Based on the decisions the Boards have made so far in Approach 4.1, employee share options classified as liabilities would be treated as any other equity derivative instrument, which means they would be measured at fair value with changes reported in net income. The measurement attribute used in Topic 718 is a fair-value-based measurement, not fair value.

15. Additionally, under Topic 718 particular non-public entities are provided with measurement options for practical reasons. For example, a non-public entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity measures its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value).

Alternative 2—Provide a Scope Exception for Share Based Payment Awards

16. The second alternative is to provide a scope exception for instruments accounted for under Topic 718. This alternative would maintain the classification and measurement requirements for instruments within the scope of Topic 718.

Analysis of Alternative 2

17. Those who support this alternative may believe that share-based payment awards are fundamentally different from other instruments and should be accounted for differently. There are different motivations for issuing options to employees than options to investors. The primary reason an entity issues a stock option or other

share-based payment award is to compensate or reward employees. Other written call options are issued to investors primarily to raise capital.

18. Others may support this alternative for practical reasons. The classification of share-based payment awards is a controversial and difficult topic. Including share-based payment awards in the scope of the financial instruments with characteristics of equity project may prevent the project from ever being completed.

Classification Criteria in Topic 480 (originally issued as Statement 150)

19. The classification requirements for some awards in Topic 718 rely on the classification of instruments within the scope of Topic 480, Distinguishing Liabilities from Equity (originally issued as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Chacteristics of both Liabilities and Equity)*. The classification approach developed in the financial instruments with characteristics of equity project would replace the classification requirements in Topic 480. Therefore, the FASB has two options:

    (a) Alternative 1—Maintain the classification for instruments issued as compensation that are within the scope of Topic 480 This alternative would require the FASB to import the classification requirement currently described in Topic 480 into Topic 718. (The requirements in Topic 480 are currently deferred for particular mandatory redeemable instruments issued by certain non-public entities.)

    (b) Alternative 2—Amend Topic 718 such that the classification of the following instruments would be consistent with Approach 4.1:

        (i) Mandatorily redeemable instruments

        (ii) Obligations to repurchase an entity’s equity shares

        (iii) Particular obligations to issue a variable number of shares.

20. Under Topic 718, options or similar instruments are classified as liabilities if the underlying share is classified as a liability. Some of the instrument described in paragraph 19(b)(i)–(iii) may be classified as a liability, equity, or separated into liability and equity components depending on the instrument’s redemption terms.

If the classification of the underlying instrument is changed, the classification of the option will change, too.

Staff Recommendation

21. For practical purposes, we recommend that the FASB exclude share-based payment awards from the scope of the financial instruments with characteristics of equity project. The issues surrounding share-based payment awards are complex and controversial. We are concerned that including share-based payments in the scope of the financial instruments with characteristics of equity project may prevent the Boards from ever issuing a final standard on financial instruments with characteristics of equity.

22. We recognize that Alternative 1 would result in converged accounting for share-based payment awards. Currently, U.S. GAAP and IFRS are very different in this area. However, we believe that the development of a comprehensive joint standard should be conducted in a separate joint project.

Questions for the FASB

Questions
Q1. Should Topic 718 be retained or should it be considered for elimination? Q2. If Topic 718 is to be considered for elimination, what additional information would you need (other than a detailed consideration of consequences)?

Appendix A

Note: This appendix is intended to highlight the major differences between the classification under Topic 718 and Approach 4.1. This appendix does not consider the many nuances in Topic 718. Therefore, it should not be used for any other purpose other than discussion at this Board meeting.

	Description of Instrument	**Classification under Topic 718 (Originally issued as Statement 123(R))**	**Classification Under Approach 4.1**
1	Awards exercised through a broker-assisted cashless exercise	Equity	Liability
2	A share-based payment award that permits shares that are issued upon exercise to be withheld as a means of meeting tax withholding requirements	Equity	Liability
3	A callable share issued as compensation in which the call can prevent the employee from bearing the risks and rewards of ownership and it is probable it will happen	Liability	Equity

	Description of Instrument	Classification under Topic 718 (Originally issued as Statement 123(R))	Classification Under Approach 4.1
3(a)	An option on instrument 3	Liability	Equity
4	A share redeemable at the option of the holder issued as compensation in which the put can prevent the employee from bearing the risks and rewards of ownership and it is probable it will happen	Liability (temporary equity for public entities)[1]	Equity or Liability and Equity components depending on redemption triggers
4(a)	An option on instrument 4	Liability	Equity or (??) (The Boards have not discussed how to classify an option on an instrument that is separated into components)
5	Written put options and forward purchase contracts issued as compensation	Liability (forward purchase contract presented gross)	Liability
6	Share that is required to be redeemed if an uncertain event occurs	Equity	Liability and Equity

[1] In the past, the SEC staff has indicated to the FASB staff that it will eliminate the temporary equity category upon completion of the financial instruments with characteristics of equity project. However, this issue has not been discussed recently.

	Description of Instrument	Classification under Topic 718 (Originally issued as Statement 123(R))	Classification Under Approach 4.1
6(a)	An option on instrument 6	Equity	?? (The Boards have not discussed how to classify an option on an instrument that is separated into components)
7	An arrangement under which the entity will settle a bonus that is a fixed dollar amount by issuing a variable number of shares based on the stock price at the time of settlement	Liability	Liability
8	An option that includes a cash bonus feature designed to reimburse the employee for a portion of the personal income tax liability related to the exercise of the option	Liability (the cash bonus feature) and Equity (the option feature)	Liability
9	A tandem award in which an employee receives a stock option or a cash settled SAR	Liability if the holder has the choice of settlement Equity if the issuer has the choice of settlement[2]	Liability

[2] If the issuer has a past practice of settling options in cash, the instrument is a substantive liability.

	Description of Instrument	Classification under Topic 718 (Originally issued as Statement 123(R))	Classification Under Approach 4.1
10	An option that has an exercise price denominated in either the (a) functional currency of the entity's foreign operation or (b) the currency in which the employee is paid	Equity[3]	Equity (if the number of shares issued is fixed, otherwise liability)
11	An option that contains a market, service, or performance condition that adjusts the exercise price per share	Equity	Liability
12	An option with a cash settlement feature that is contingent on an event that is (a) not probable and (b) outside the control of the issuer.	Equity (temporary equity for public entities)[1]	Liability

[3] The EITF recently decided that an award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trade may be classified as equity.