FASB STAFF POSITION

No. FAS 123(R)-3

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

Date Posted: November 10, 2005

Introduction

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

Background

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

3. Because discussions with constituents have revealed that some entities do not have, and may not be able to re-create, information about the net excess tax benefits that would have qualified as such had those entities adopted Statement 123 for recognition purposes, this FSP provides an elective alternative transition method. That method comprises (a) a computational component that establishes a beginning balance of the APIC pool related to

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

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

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

> The sum of all net increases of additional paid-in capital recognized in an entity's annual financial statements related to tax benefits from stock-based employee compensation during fiscal periods subsequent to the adoption of Statement 123 but prior to the adoption of Statement 123(R).
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> Less:
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> The cumulative incremental pretax employee compensation costs that would have been recognized if Statement 123 had been used to account for stock-based employee compensation costs, multiplied by the entity's blended statutory tax rate upon adoption of Statement 123(R), inclusive of federal, state, local, and foreign taxes. Cumulative incremental compensation costs are the total stock-based employee compensation costs included in pro forma net income as if the fair-value-based method had been applied to all awards pursuant to the provisions of Statement 123,[1,2] less the stock-based compensation costs included in the entity's determination of net income as reported.

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[1]In calculating cumulative incremental compensation costs, entities shall exclude compensation costs associated with an award that ordinarily does not result in tax deductions under existing tax law (as described in paragraph 59 of Statement 123(R)) unless the award has resulted in a tax deduction prior to the adoption of Statement 123(R) or the entity is unable to obtain the information necessary to determine the amount of such cost.

[2]In calculating cumulative incremental compensation costs, entities shall exclude compensation costs associated with awards that are partially vested upon the adoption of Statement 123(R).

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

7. The impact on the APIC pool of an employee award that is partially vested upon or granted after the adoption of Statement 123(R) should be determined in accordance with the guidance in Statement 123(R). That is, the compensation deduction for tax purposes for a partially vested award should be compared with the sum of compensation cost recognized or disclosed for that award under Statement 123 and Statement 123(R). The tax effect of any resulting excess deduction for tax purposes should increase the APIC pool; the tax effect of any resulting deficient deduction for tax purposes should be deducted from the APIC pool.

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

Effective Date and Transition

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

time election. Until and unless an entity elects the transition method described in this FSP, the entity should follow the transition method described in paragraph 81 of Statement 123(R) and the guidance related to reporting cash flows described in paragraph 68 of Statement 123(R). If an entity elects the transition method described in this FSP and the entity has previously reported cash flows or results of operations under paragraphs 68 and 81 of Statement 123(R), the effect of applying the transition method described in this FSP shall be reported as a change in accounting principle in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. An entity that elects the transition method described in this FSP is not required to justify the preferability of its election.

Appendix A

Illustrative Example

Background

A1. Entity A, a calendar-year company, adopted Statement 123 for disclosure purposes on January 1, 1996, and elected to continue to apply the recognition provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* for purposes of determining its net income. In accordance with the transition provisions of Statement 123, Entity A's pro forma disclosures included the effects of all awards granted since January 1, 1995. The awards granted by Entity A are ordinarily expected to result in a tax deduction under existing tax law. From January 1, 1995, through December 31, 2005, Entity A recognized the following net increases in additional paid-in capital (that is, the amounts that have been included in its statement of changes in stockholders' equity for each of the respective years) in connection with its stock-based employee compensation plans.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Tax benefits from stock-based compensation plans	—	—	$100	$120	—	$180	$480	—	$180	$150	—	$1,210

A2. During the same period, the following incremental pretax compensation costs would have been recognized if Statement 123 had been used to account for stock-based employee compensation costs. Assume $400 of the cumulative compensation cost disclosed relates to awards that are partially vested. The company's current blended statutory tax rate is 40 percent. This illustration assumes that the tax benefits realized upon exercise of the awards are also 40 percent of the related tax deduction. However, the tax benefit realized upon the exercise of an award should be determined based on the tax rates in effect (for the applicable taxing jurisdictions) at the date of the related tax reduction.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Incremental stock-based compensation costs	—	\$100	\$100	\$200	\$200	\$200	\$300	\$300	\$300	\$200	\$200	\$2,100

Beginning Balance

A3. On January 1, 2006, Entity A adopts Statement 123(R) and elects the alternative transition provisions described in this FSP. Entity A would compute the beginning balance of its APIC pool as the cumulative credits recognized in additional paid-in capital from January 1, 1995, until the adoption of Statement 123(R) (\$1,210) less the tax effect of incremental stock-based compensation costs that would have been recognized if Statement 123 had been used to account for stock-based compensation costs, excluding the cost associated with partially vested awards ((\$2,100 – \$400) × 40%).

Beginning balance of APIC pool = [\$1,210 – ((\$2,100 – \$400) × 40%)] = \$530

Fully Vested Awards

A4. Assuming all the same facts as above, on January 1, 1998, Entity A grants 100 employee share options each with a grant-date fair value of \$6 and a 10-year contractual term. The awards vest at the end of 3 years of service and have an exercise price of \$20 (the entity's closing share price on the date of grant). The awards are exercised in 2006 when the share price is \$30, resulting in an aggregate tax deduction of \$1,000 ((\$30 – \$20) × 100). Because the award qualifies as a fixed award under Opinion 25, no compensation cost or associated deferred tax asset was recognized in the financial statements prior to the adoption of Statement 123(R). As a result, the tax benefit of the deduction (\$400 = \$1,000 × 40%) is recognized in APIC in 2006. Under the alternative transition method the exercise would increase the APIC pool by the same amount (\$400).

Partially Vested Awards

A5. Assuming all the same facts as above, on January 1, 2004, Entity A grants 100 employee share options each with a grant-date fair value of $6. The awards vest at the end of 3 years of service and have an exercise price of $25 (the entity's closing share price on the date of grant). The awards are exercised in 2009 when the share price is $32, resulting in an aggregate tax deduction of $700 (($32 – $25) × 100). Because Entity A adopted Statement 123(R) on January 1, 2006, 33.3 percent (1 of 3 years) of the award will be recorded as compensation cost in the financial statements with a corresponding deferred tax asset. Pursuant to the provisions of Statement 123(R), upon exercise of the award Entity A would adjust its APIC pool for an excess tax benefit or tax deficiency as if it had always followed the fair value measurement principles for recognition purposes. That is, the aggregate tax deduction ($700) less the cumulative compensation cost recognized or disclosed for the award under Statements 123 and 123(R) ($600 = $400 + $200) is $100. The tax benefit of the excess deduction ($40 = $100 × 40%) increases the entity's APIC pool. The total tax benefit of the award ($280 = $700 × 40%) in excess of the deferred tax asset related to compensation cost recognized in earnings ($80 = $200 × 40%), or $200, is recognized in APIC.