

*Capital Markets
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Advisory 2005-05*

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**FASB Amends FAS 133 and Revises Three DIG Issues to Reflect the Impact of its
New Standard on Share-Based Payments**

Background

In December 2004, the Financial Accounting Standards Board (FASB or the “Board”) issued Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R)).

The Board has amended FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), and revised the guidance in three DIG issues that were impacted by FAS 123(R).

Paragraph 11

FAS 133 provides certain exceptions for contracts that would otherwise be scoped into the Standard:

11. Notwithstanding the conditions of paragraphs 6–10, the reporting entity shall *not* consider the following contracts to be derivative instruments for purposes of this Statement:
 - a. Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position [C2, C9, G1]
 - b. Contracts issued by the entity in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, *Accounting for Stock-Based Compensation* [C3]

- c. Contracts issued by the entity as contingent consideration from a business combination. The accounting for contingent consideration issued in a business combination is addressed in APB Opinion No. 16, *Business Combinations*. In applying this paragraph, the issuer is considered to be the entity that is accounting for the combination using the purchase method.

In contrast, the above exceptions do not apply to the counterparty in those contracts. In addition, a contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock can be a derivative instrument for the issuer under paragraphs 6–10, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Statement. [C8]

Amendment of paragraph 11(b) in FAS 133 and Revision of DIG Issue C3

Paragraph 11 of FAS 133 specifies certain contracts that are excluded from the scope of FAS 133 even though they may meet FAS 133's definition of a derivative instrument.

Paragraph 11(b) of FAS 133 excludes contracts issued by an entity in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123), that was issued in 1995.

FAS 123(R) amends the scope exception in paragraph 11(b) of FAS 133 as follows:

- Contracts issued by the entity that are subject to FASB Statement No. 123 (revised 2004), *Share-Based Payment*. If any such contract ceases to be subject to Statement 123(R) in accordance with paragraph A231 of that Statement, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Statement (i.e., FAS 133).

Paragraph A231 of FAS 123(R) indicates that a contract ceases to be subject to FAS 123(R) when the rights that the contract conveys to the holder no longer depend on the holder being an employee of the entity or are not dependent on the holder providing services.

SFG Observation: *Generally, the condition in paragraph A231 of FAS 123(R) will be met when a share-based payment to an employee is vested. At that point, the issuer will need to assess whether the contract is subject to other GAAP:*

FAS 133,

FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (FAS 150), or

Emerging Issues Task Force (EITF) Issue 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (EITF 00-19).

For non-employee share-based payments, such as a stock option granted to a supplier of goods or services, the condition will generally be met when the counterparty's (e.g., the supplier's) performance is complete.

When all services have been delivered:

(1) the issuer must determine whether the appropriate other GAAP for the contract is FAS 133, and

(2) if none of the scope exceptions in FAS 133 are available, the contracts will be recognized on the balance sheet at fair value as required by FAS 133.

All contracts that require a liability classification under FAS 123(R), such as FAS 133, FAS 150, or EITF 00-19 should not result in any significant difference in the carrying amount of the liability because all of these pronouncements (including FAS 123(R)) generally require measurement of these liabilities at fair value.

DIG Issue C3, *Scope Exceptions: Exceptions Related to Share-Based Payment Arrangements*, addresses the question of whether equity instruments, including stock options, that are granted to non-employees as compensation for goods and services in share-based payment transactions are subject to FAS 133. Prior to FAS 123(R), the response to the question was that, **for the issuer**, such equity instruments are **not** included in the scope of FAS 133 because of the exception in paragraph 11(b) of FAS 133.

The amendment to paragraph 11(b) of FAS 133 described requires revisions to DIG Issue C3. Issue C3 now states that, for the issuer, such equity instruments are subject to FAS 133 once performance has occurred as discussed by the EITF in Issue 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

SFG Observation: *The scope exception in paragraph 11(b) of FAS 133 will no longer apply once performance has occurred. The issuer might still qualify for the scope exception in paragraph 11(a) of FAS 133 if the instrument is indexed to the issuer's own stock **and** classified in stockholders' equity.*

For the holder, DIG Issue C3 remains the same. The holder is not eligible for the scope exception in paragraph 11(b) of FAS 133).

Revision of DIG Issue G1

DIG Issue G1, *Cash Flow Hedges: Hedging an SAR Obligation*, addresses the question of whether, in a cash flow hedge of the exposure to variability in expected future cash flows associated with unrecognized, non-vested, cash-settled stock appreciation rights (SARs), a public company can designate as a hedging instrument a cash-settled, purchased call option that is:

(1) indexed to the issuer's own stock, and

(2) classified as an asset.

FAS 123(R) requires that a cash-settled SAR be classified as a liability and reported at fair value each reporting period. A stock-settled SAR is generally classified as equity and reported at its grant date fair value and is not adjusted in subsequent reporting periods under FAS 123(R). This Advisory refers to a SAR as a cash-settled SAR.

Before FAS 123(R), a public company could have designated a hedging relationship to the extent that vesting of the SARs is probable. DIG Issue G1 also required that depending on the method that was documented and used to assess hedge effectiveness, changes in either the **fair value** of the purchased call option or the **intrinsic value** of the purchased call option would be recorded in OCI.

The revised DIG Issue G1 continues to state that a public company may designate the purchased call option as the hedging instrument if vesting of the SARs is probable. The revision of DIG Issue G1 reflects a change necessitated by FAS 123(R) in that SARs must be reported at fair value rather than at intrinsic value under prior GAAP.

The change in the measurement basis of the SAR liability from intrinsic value under FAS 123 to fair value under FAS 123(R) requires revisions to DIG Issue G1 to eliminate:

1. the alternative of assessing hedge effectiveness based on the hedging instrument's (the purchased call option's) and the hedged item's (the unrecognized, non-vested SAR's) intrinsic value, and
2. recording only intrinsic-value changes of the hedging instrument in OCI.

The revised DIG Issue G1 states that companies should record the changes in the purchased call option's **fair value** (not just the **intrinsic value**) in OCI. The changes in the hedging instrument's **time value** will no longer be recognized in current earnings.

SFG Observation: *The measurement basis of the SAR liability has changed. Companies that previously based their assessment of hedge effectiveness on the hedging instrument's -- the purchased call option's -- intrinsic value will have to de-designate their prior hedging relationships and re-designate new hedging relationships.*

The newly re-designated hedging relationships must include documentation that the assessment of hedge effectiveness will be based on the changes in the purchased call option's fair value (rather than its intrinsic value).

Companies that previously based their assessment of hedge effectiveness on changes in the purchased call option's fair value as permitted by DIG Issue G20, Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge, are not impacted by the revised guidance in DIG Issue G1. These companies can continue their prior hedging relationships without any need for de-designation and re-designation.

Effective Date

The changes described above are required by the issuance of FAS 123(R), and the revisions to both DIG Issues C3 and G1 require that the effective date for the revised guidance is the first day of the fiscal quarter in which the reporting entity initially adopts FAS 123(R).

For public companies, FAS 123(R) is effective for interim and annual periods beginning after June 15, 2005. FAS 123(R) applies to all outstanding and unvested share-based payment awards at the adoption date.

Early adoption of FAS 123(R) is encouraged, provided that the financial statements or interim reports for the periods prior to the required effective date have not been issued.

SFG Observation: *Companies should incorporate in their FAS 123(R) implementation plans an assessment of the impact that the changes in FAS 133 and these DIG issues will have on both their current and future share-based-payment awards.*

A comprehensive assessment should help companies avoid surprises in the wake of adopting FAS 123(R) as the effective date for both FAS 123(R) and the revised guidance in FAS 133 is identical.

Minor Revisions in DIG Issue E19

DIG Issue E19, *Hedging – General: Methods of Assessing Hedge Effectiveness When Options Are Designated as the Hedging Instruments*, has undergone no substantive changes.

The background discussion specific to question 2 in DIG Issue E19 noted the definition of **intrinsic value** that appears in FAS 123. The revisions to DIG Issue E19 replace the reference to FAS 123 with a reference to FAS 123(R) and make some minor changes to the definition of intrinsic value.

For example, the phrase “**market price** of the underlying stock” is replaced by the phrase “**fair value** of the underlying stock.”

Questions

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