Statutory Issue Paper No. 129

Share-Based Payment, A Replacement of SSAP No. 13—Stock Options and Stock Purchase Plans

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Current Authoritative Guidance for Stock Options and Stock Purchase Plans: SSAP No. 104R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP: SSAP No. 104

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Financial Accounting Standards Board (FASB) issued FAS 123(R): *Share-Based Payments* (FAS 123(R)) in December of 2004. FAS 123(R) is a revision of *FASB Statement No. 123: Accounting for Stock-Based Compensation* (FAS 123) and supersedes *APB Opinion No. 25, Accounting for Stock Issued to Employees* (APB Opinion No. 25), and its related implementation guidance. The scope of FAS 123(R) establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. FAS 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. FAS 123(R) does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and *EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. FAS 123(R) does not address the accounting for employee share ownership plans, which are subject to *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans*. (SOP 93-6 is adopted with modification in *SSAP No. 12—Employee Stock Ownership Plans* and EITF 96-18, and other guidance regardi

4. Under FAS 123(R), a public entity initially measures the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of that award are remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. A nonpublic entity may elect to measure its liability awards at their intrinsic value through the date of settlement.

5. Under FAS 123(R), the grant-date fair value of employee share options and similar instruments are estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost is recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

6. Under FAS 123(R), excess tax benefits are recognized as an addition to paid-in capital. In addition, cash retained as a result of those excess tax benefits are presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost are recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

7. Under FAS 123(R), the notes to financial statements of both public and nonpublic entities disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

8. The purpose of this issue paper is to update statutory accounting principles for the accounting of transactions in which an entity exchanges its equity instruments to employees in share-based payment transactions and proposes the issuance of a new *SSAP No. 104—Stock Options and Stock Purchase Plans* (SSAP No. 104) that adopts, with modification, the guidance from FAS 123(R) and related accounting guidance and interpretations as noted within this issue paper. This issue paper proposes application of the substantively revised SSAP No. 104 for new awards and awards modified, repurchased, or cancelled after the required effective date. This issue paper also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

9. As noted in footnote 1 (paragraph 11), the fair value measurement objective in this issue paper is generally consistent with the fair value measurement objective in *SSAP No. 100—Fair Value Measurements* (SSAP No. 100). However, for certain share-based payment transactions with employees, the measurements at the grant date are fair-value Tc -1.re fair-vabpape-7(m)8(enbjectnt wr)-8(ees ient nodifara100) the

situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

14. The guidance in this issue paper does not apply to share-based transactions for other than employee services.

15. The guidance in this issue paper does not apply to equity instruments held by an employee stock ownership plan. Such equity instruments shall follow the guidance in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12).

16. The guidance in this statement is divided as follows:

a. Compensatory Share-Based Payment Plans: Paragraphs 17-112.

b. Noncompensatory Share-Based Payment Plans: Paragraphs 113-119.

c. Consolidated / Holding Company Share-Based Payment Plans: Paragraphs: 120-121.

Compensatory Share-Based Payment Plans

Recognition

Recognition Principle for Share-Based Payment Transactions

17. Stock purchase and stock option plans that do not meet the criteria of a non-compensatory plan (paragraphs 113-119) and are not otherwise excluded from the scope of this issue paper shall be classified as compensatory and follow the recognition, measurement and disclosure guidance in paragraphs 18-112.

18. An entity shall recognize the services received in a share-based payment transaction with an employee as services are received. Employee services themselves are not recognized before they are received. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 22-35.) As the services are consumed, the entity shall recognize the related cost.

19. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how

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b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices.

Determining Whether to Classify a Financial Instrument as a Liability or As Equity

22. This paragraph, through paragraph 35, provides guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in those paragraphs shall be classified as a liability or as equity, an entity shall apply statutory accounting principles applicable to financial instruments issued in transactions not involving share-based payment.

23. Unless paragraphs 24-35 require otherwise, an entity shall apply the classification criteria in Appendix A, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 73-77 provide criteria for determining when instruments subject to this issue paper subsequently become subject to other applicable statutory accounting principles.

24. In determining the classification of an instrument, an entity shall take into account the classification requirements that are effective for that specific entity at the reporting date as established by Appendix A. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 27 and 28.

25. Appendix A does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurch

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's

32. A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

33. A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

34.

45. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions.

46. Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future.

47. As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not.

Factors or Restrictions that Impact the Determination of Fair Value at Grant Date

Vesting Versus Nontransferability

48. To satisfy the measurement objective in paragraph0 Td( )Tjc0h50 Tcat Grant -32.2traT 1 Tfwnlsf344 -1goil

Market, Performance, and Service Conditions That Affect Conditions Other than Vesting or Exercisability

53. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

Nonvested or Restricted Shares

Requisite Service Period

62. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

63. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions

b. All explicit, implicit, and derived service periods

change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

75. Other modifications of that instrument that take place when the holder is no longer an employee shall be subject to the modification guidance in paragraph 77. Following modification, recognition and measurement of the instrument should be determined through reference to other applicable statutory accounting principles

76. Once the classification of an instrument is determined, the recognition and measurement provisions of this issue paper shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 74. Other applicable statutory accounting principles apply to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this issue paper.

77. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to other applicable statutory accounting principles. Such a modification or settlement shall be accounted for under the provisions of this issue paper unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee's beneficiary). Following the modification, the instrument continues to be accounted for under other applicable statutory accounting principles. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this issue paper. See paragraph 74 for a discussion of changes to awards made solely to reflect an equity restructuring.

Change in Classification Due to Change in Probable Settlement Outcome

78. An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.

Subsequent Measurement For Awards Classified as Equity

Fair Value Not Reasonably Estimable

79. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Contingent Features

80. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from th

Subsequent Measurement For Awards Classified as Liabilities

Measurement

paragraphs 23-35. Incremental guidance is also provided for issues related to employee stock ownership plans.

Tax Effects for Instruments Classified as Equity

96. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of *SSAP No. 101—Income Taxes* (SSAP No. 101). The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation costs that are capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

97. Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Tax Effects for Instruments Classified as Liability

98. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation costs recognized for financial reporting purposes.

Accounting for Tax Effects – Initial Measurement

99. SSAP No. 101 requires a deferred tax asset to be evaluated for future realization and to be reduced by a statutory valuation allowance to the amount that is more likely than not to be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 96 and 97 and the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

Accounting for Tax Effects – Subsequent Measurement

100. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

101. The amount deductible for an award of equity instruments on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the rel2 -1iningif an sisset relat

102. An excess tax benefit determined pursuant to paragraph 100 shall be recognized as gross paid-in and contributed surplus, except that an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than 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.

103. Paragraph 101 contains measurement guidance on how much, if any, of the write-off of a deferred tax asset from a tax deficiency shall be offset against additional paid-in capital. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement.

Tax Benefits of Dividends on Share-Based Payment Awards to Employees

104. A realized income tax benefit from dividends or dividend equivalents that are charged to unassigned-funds (surplus) and are paid to employees for any of the following equity classified awards shall be recognized as an increase to gross paid-in and contributed surplus:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

105. The amount recognized in gross paid-in and contributed surplus for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards.

106. Dividends or dividend equivalents paid to employees for the awards identified in paragraph 104 may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. The income tax benefit of those dividends shall not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

107. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests be charged to unassigned-funds (surplus). If the related award is not expected to vest, dividends or dividend equivalents shall be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between unassigned-funds (surplus) and compensation costs in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

108. Adjustments to gross paid-in and contributed surplus for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from gross paid-in and contributed surplus to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) shall be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

Accounting for Rabbi Trusts

109. Rabbi trusts are grantor trusts generally set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for income tax purposes, the terms of

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period

d. The cash flow effects resulting from share-based payment arrangements.

The disclosures in paragraph 112 are for annual audited statutory financial reports only. Appendix B provides the information needed to achieve the objectives in this paragraph.

Noncompensatory Employee Share Purchase Plans

Overview and Background

113. This section provides guidance to all entities that use employee share purchase plans. The entity must first determine whether the plan is compensatory or noncompensatory. This is determined by the terms of the plan (see paragraphs 114 and 115). A plan with an option feature, for example a look-back feature, is considered compensatory.

Recognition

114. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation costs (that is, the plan is noncompensatory):

a. The plan satisfies either of the following conditions:

   i. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

   ii. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of five percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than five percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of five percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:

   i. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

   ii. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

115. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase, commonly called a look-back plan, is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory.

116. The requisite service period for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Initial Measurement

117. The objective in paragraph 44 also applies to the fair value measurements associated with grants under a compensatory employee share purchase plan. The objective in this paragraph states that the fair value measurement method is to estimate the fair value of the equity instruments, based on the share price and other measurement assumptions at the grant date, that are issued in exchange for employee services.

Subsequent Measurement

118. Changes in total employee withholdings during a purchase period that occur solely as a result of salary increases, commissions, or bonus payments are not plan modifications if they do not represent changes to the terms of the award that was offered by the employer and initially agreed to by the employee at the grant (or measurement) date. Under those circumstances, the only incremental compensation cost is that which results from the additional shares that may be purchased with the additional amounts withheld (using the fair value calculated at the grant date). For example, an employee may elect to participate in the plan on the grant date by requesting that five percent of the employee's annual salary be withheld for future purchases of stock. If the employee receives an increase in salary during the term of the award, the base salary on which the five percent withholding amount is applied will increase, thus increasing the total amount withheld for future share purchases. That increase in withholdings as a result of the salary increase is not considered a plan modification and thus only increases the total compensation cost associated with the award by the grant date fair value associated with the incremental number of shares that may be purchased with the additional withholdings during the period. The incremental number of shares that may be purchased is calculated by dividing the incremental amount withheld by the exercise price as of the grant date (for example, 85 percent of the grant date stock price).

119. Any decreases in the withholding amounts (or percentages) shall be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost shall be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the re

b. Compensation costs associated with share-based payments provided by a related party or holder of an economic interest in the reporting entity, equal to the required contribution to the plan for the period, are included in allocated expenses to the reporting entity. A liability shall be established for any such contributions due and unpaid.

121. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liability for the share-based payment plan, then the other provisions of this issue paper apply.

Relevant Literature

122. This issue paper adopts, with modification, GAAP guidance regarding stock options and stock purchase plans reflected in *Topic 718: Compensation – Stock Compensation*, as amended by *ASU 2010-13, Compensation – Stock Compensation (Topic 18): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades*, with the exception of *FASB Codification Subtopic 718-40: Employee Stock Ownership Plans*. Statutory guidance on employee stock ownership plans is provided in *SSAP No. 12—Employee Stock Ownership Plans*. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718, not reflected within this issue paper.

123. The adoption, with modification, of FASB Codification Topic 718 identified in paragraph 122 also reflects adoption, with modification, of the following pre-codification GAAP standards:

a. *FAS 123R, Share-Based Payment* (FAS 123R), establishes accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses liabilities in exchange for goods or services that are based on the fair value if the entity's equity instruments or that may be settled by the issuance of those equity instruments. The guidance from FAS 123R has been incorporated within the FASB Codification in *Topic 718, Compensation – Stock Compensation* and is the underlying base of guidance included within this issue paper. (FASB Codification Topic *718-40, Employee Stock Ownership Plans* is excluded from this issue paper as it generally reflects guidance from *AICPA SOP 93-6; Employer's Accounting for Employee Stock Ownership Plans*, and is adopted, with modification in SSAP No. 12.)

b. *FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) establishes GAAP standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The guidance in FAS 150 was previously under consideration by the Statutory Accounting Principles Working Group, and in November 2007, the Valuation of Securities Task Force advised that it is not prevalent for insurers to issue securities or financial instruments within the scope of FAS 150. As a result of that information, in March 2008, FAS 150 was rejected by the Statutory Accounting Principles Working Group as not applicable to statutory accounting. Although originally rejected as not applicable, the guidance in FAS 150 (included within *Topic 480: Distinguishing Liabilities from Equity* (Topic 480) of the FASB Codification) referenced in FAS 123R for classifying instruments as equity or liability is adopted for application in this issue paper. The adopted guidance is reflected in Appendix A of this issue paper.

c. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1). Under FSP FAS 123R-1, certain freestanding instruments shall continue to be subject to the recognition and measurement provisions of

FAS 123(R) throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. The guidance from FSP FAS 123R-1 has been incorporated within the FASB Codification in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraphs 718-10-35-9 through 718-10-35-11.

d. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2). This FSP provided a practical solution for when a mutual understanding of key concepts of a share-based payment award exist. The guidance from FSP FAS 123R-2 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-25-5.

e. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4). The guidance in this FSP revised FAS 123R to clarify that an option or instrument classified as equity with a cash settlement feature shall not be reclassified to a liability until it becomes probable that the event will occur. The guidance from FSP FAS 123R-4 has been incorporated within the

2005, has not been incorporated in the FASB Codification. FSP FAS 123R-3 is rejected for statutory accounting, with transition guidance established within this issue paper.

b. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in* accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. FAS 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. FAS 123(R) does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and *EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. FAS 123(R) does not address the accounting for employee share ownership plans, which are subject to *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans*.

129. FASB's reasons for issuing FAS 123(R) are as follows:

a. Addressing concerns of users and others by requiring an entity to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of the transactions in the financial statements.

b. Improves comparability of reporting financial information by eliminating alternative accounting methods.

c. Simplifies U.S. GAAP.

d. Convergence with international accounting standards.

130. Typically, stock option plans issue options that are "at the money", where the exercise price equals that of the market value for the underlying security and requires a vesting period to earn the stock option. These stock options are issued as an incentive for employees to work to increase the market value of the company's stock and thus shareholder value. As the intrinsic value method (required in SSAP No. 13) measures compensation expense as the fair value (market value) of the underlying stock less the amount by the employee is required to pay, this results in zero compensation expense for stock options issued to employees issued at the money. FAS 123(R) requires that the stock option be measured at fair value on the date of grant using option-pricing models adjusted for the unique characteristics of the instruments issued. This accounting treatment captures the costs of employee services relative to the awards granted, which is now more conservative than current SAP guidance.

131. NAIC staff notes that SSAP No. 13 rejected FAS 123. Although the rationale for rejection is based on the impact on statutory assets and liabilities. The Working Group considers the optionality of FAS 123 to be an additional reason why FAS 123 was rejected. FAS 123(R) now eliminates the optional accounting treatment by requiring recognition of compensation expense for all employee services received in share-based payment transactions using a fair-value-based method. As a result, this statement recognizes transactions that affect the issuer's reported financial condition and results of operations that previous guidance, and guidance adopted in SSAP No. 13, fails to capture.

132. This issue paper proposes adoption, with modifications, of FAS 123(R), as reflected in the FASB Codification *Topic 718, Compensation – Stock Compensation*. Consideration of FAS 123(R), as it is reflected in the FASB Codification, also resulted with consideration of the following guidance:

a. *ASU 2010-13 – Compensation – Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades – a consensus of the FASB Emerging Issues Task Force*, issued in April 2010. The accounting guidance in ASU 2010-13 clarifies that an that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The guidance in ASU 2010-13 has been incorporated within the FASB Codification in *Topic 718-10, Compensation – Stock Compensation*, *Overall*. This issue paper proposes to adopt, with modification, ASU 2010-13.

b. *FAS 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150), issued May 2003, establishes GAAP standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The guidance in FAS 150 was previously under consideration by the Statutory Accounting Principles Working Group, and in November 2007, the Valuation of Securities Task Force advised that it is not prevalent for insurers to issue securities or financial instruments within the scope of FAS 150. As a result of that information, in March 2008, FAS 150 was rejected by the Statutory Accounting Principles Working Group as not applicable to statutory accounting. Although originally rejected as not applicable, the guidance in FAS 150 (included within *Topic 480: Distinguishing Liabilities from Equity* (Topic 480) of the FASB Codification) as it is referenced in FAS 123R for classifying instruments as equity or liability is proposed to be adopted within Appendix A of this issue paper. This reversal of position on FAS 150 is considered necessary to prevent a GAAP to SAP difference regarding the classification of share-based payments. (If desired by the Working Group, subsequent consideration of Topic 480 could occur to provide criteria for liability or equity classification for instruments outside the scope of this issue paper.)

c. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01), issued in December 1997. The accounting guidance in TB 97-1 addresses the accounting for certain stock purchase plans with a look-back option. An example of a look-back option is a provision that establishes the purchase price as an amount based on the lessor of the stock market's price at the grant date or its market price at the exercise (or purchase) date. The guidance in TB 97-1 originally revised *FAS 123, Share-Based Payment* (FAS 123), but was amended after the issuance of FAS 123(R). The guidance in TB 97-1 has been incorporated within the FASB Codification in *Topic 718-50, Compensation – Stock Compensation, Employee Share Purchase Plans*. This issue paper proposes to adopt, with modification, TB 97-01. (Guidance from TP 97-01 included within the implementation guidance of the FASB Codification guidance is also considered adopted for statutory, but is not explicitly included within this issue paper.)

d. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1), issued in August 2005. This Statement defers the guidance in FAS 123R that requires a freestanding financial instrument issued to an employee in exchange for past or future employee p -es uubsjeFiudance in TBt reutu0.03TJ0.0003 T e fo, but

e. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2), issued in October 2005. This FSP provides a practical solution for when a mutual understanding of key concepts of a share-based payment award exist. Under this guidance, a mutual understanding of key terms and concepts of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements if the following two conditions are met: (1) the award is a unilateral grant, therefore the recipient does not have the ability to negotiate key terms and conditions with the employer; and (2) The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short-period form the date of approval. The guidance from FSP FAS 123R-2 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-25-5. This guidance is proposed to be adopted, with modification, for statutory accounting.

f. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3), issued in November 2005. This FSP provided a practical transition election related to accounting for the tax effects of share-based payment awards to employees. This guidance, as it relates to transition of FAS 123R in 2005, has not been incorporated the FASB Codification. As the guidance from FSP FAS 123R-3 results in two transition options, for consistency purposes it is presumed that a single transition method will be desired for statutory. As such, it is proposed that the guidance from FSP FAS 123R-3 be rejected for statutory accounting, with transition guidance established within this issue paper.

g. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4), issued in February 2006. This FSP addresses the classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this FSP revised FAS 123R to clarify that an option or instrument classified as equity with a cash settlement feature shall not be reclassified to a liability until it becomes probable that the event will occur. The guidance from FSP FAS 123R-4 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-14. This guidance is proposed to be adopted, with modification, for statutory accounting.

h. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5), issued in October 2006. This FSP addresses a question on whether an entity that executes a restructuring must, in all cases, reassess whether the recognition and measurement of an instrument whose holder is no longer an employee becomes subject to other applicable GAAP. Under the guidance in the FSP, instruments that were originally issued as employee compensation and then modified, and that modification is made to the terms of the instrument solely to reflect an equity restructuring that occurs when the holders are no longer employees, no change in the recognition and measurement (due to a change in classification) of those instruments will result if both of the following conditions are met: (a) there is no increase in the fair value of the award, or the anti-dilution provision is not added to the terms of the award in contemplation of an equity restructuring; and (b) all holders of the same class of equity instruments are treated in the same manner. The guidance from FSP FAS 123R-5 has been incorporated within the FASB Codification (included through the reference of FSP FAS 123R-1) in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-10. This guidance is proposed to be adopted, with modification, for statutory accounting. (This

previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

t. *EITF 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout* (EITF 84-13): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

u. *EITF 84-18, Stock Option Pyramiding* (EITF 84-18): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

v. *EITF 84-34, Permanent Discount Restricted Stock Purchase* (EITF 84-34): This guidance was nullified by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

w. *EITF 85-45, Business Combinations: Settlement of Stock Options and Awards* (EITF 85-45): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

x. *EITF 87-6, Adjustments Relating to Stock Compensation* (EITF 87-6): This guidance was

- *APB Opinion No. 25, Accounting for Stock Issued to Employees* (Adopted with modifications in SSAP No. 13)

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*, Chapter 13, *Compensation, Section B—Compensation Involved in Stock Option and Stock Purchase Plans* (Adopted with modifications in SSAP No. 13)

- *FASB Technical Bulletin 97-1, Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (Pending)

- *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (Pending)

- *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (Pending)

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- *FASB Emerging Issues Task Force No. 88-6, Book Value Plans in an Initial Public Offering* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 90-7, Accounting for a Reload Stock Option* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 94-6, Accounting for the Buyout of Compensatory Stock Options* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 97-12, Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25 This guidance was*

APPENDIX A: Classification Criteria: Liability or Equity

Classification Criteria

1. As detailed in paragraph 22 of the issue paper, an entity shall apply the classification criteria detailed in paragraphs 22 through 35 in the issue paper, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction.

2. The guidance in this Section shall be applied to a freestanding financial instrument in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

<u>Mandatorily Redeemable Financial Instruments</u>

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this issue paper. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

<u>Obligations to Repurchase Issuer's Equity Shares by Transferring</u> Assets

7. An stances)
other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.

b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this issue paper, *indexed to* is used interchangeably with *based on variations in the fair value of*. The phrase *requires or may require* encompasses instruments that either conditionally or

unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of Appendix A include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

11. Certain financial instruments that embody obligations that are liabilities within the scope of this issue paper also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts

b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

12. An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 7-12 of Appendix A, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this issue paper.

Certain Obligations to Issue a Variable Number of Shares

13. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

Prohibition on Combining Freestanding Financial Instruments

14. A freestanding financial instrument that is within the scope of this issue paper shall not be combined with another freestanding financial instrument in applying paragraphs 3-13 of Appendix A. For example, a freestanding written put option that is classified as a liability under this issue paper shall not be combined with an outstanding equity share.

Distinguishing Liability from Equity – Scope and Scope Exclusions

15. The guidance in paragraphs 22-35 of this issue paper applies to any freestanding financial instrument, including one that has any of the following attributes:

a. Comprises more than one option or forward contract

b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled). Accordingly, this issue paper does not address an instrument that has only characteristics of an asset.

16. For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument. That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the

(c) Those that during the year were:

(1) Granted

(2) Vested

(3) Forfeited.

d. For each year for which an income statement is provided, both of the following:

i. The weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 58-59) of equity options or other equity instruments granted during the year .

ii. The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.

e. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position, both of the following:

i. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding.

ii. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).

f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 58-59 is not required to disclose the following information for awards accounted for under that method):

i. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements

ii. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):

(a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and postvesting employment termination behavior into the fair value (or calculated value) of the instrument.

(b) Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. An entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.

(c) Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

(d) Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(e) Discount for post-vesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraph (a) through (f) separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

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