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FASB Redeliberates Guidance on Accounting for Share-Based Payments in Connection with Business Combinations

The Financial Accounting Standard Board (FASB) at its February 13, 2007 meeting continued redeliberations of its ongoing project on business combinations, and tentatively decided the following with respect to accounting for share-based payments.

The proposed guidance would require that when determining the value of replaced share-based payment awards in a business combination, the Statement 123R fair value measurement model should be used. If an acquirer is not contractually obligated to replace outstanding acquiree awards but nevertheless chooses to do so, the fair value of the acquirer's replacement awards is allocated entirely to postcombination compensation cost. If an acquirer is contractually obligated by the purchase agreement to replace outstanding acquiree awards, the fair value of the acquirer's replacement awards (regardless of whether equity or liability awards) is allocated between postcombination compensation cost and purchase price consideration, as described below.

First, any *excess* of the fair value of the acquirer's replacement awards over the replaced acquiree awards is recognized as compensation cost over the postcombination requisite service period, taking into consideration any explicit, implicit, and derived service periods in accordance with Statement 123R. Second, any portion of the remaining fair value of the acquirer's replacement awards attributable to *future* services (with the future service period beginning on the acquisition date) is also recognized as compensation cost over the postcombination requisite service period. Third, any residual fair value of the acquirer's replacement awards attributable to *past* services is recognized as purchase price consideration, net of estimated forfeitures for nonvested awards.

The portion of the replacement awards attributable to past services is equal to the remaining fair value of the acquirer's replacement awards (or settlement) multiplied by the ratio of the past service period to the greater of the total service period or the original service period of the replaced acquiree awards. The portion of the replacement awards attributable to future services is equal to the total remaining fair value of the acquirer's replacement awards less the portion attributable to past services.

For example, assume an acquiree's original award has a 4-year vesting period and a business combination occurs at the end of the second year when the fair value is $40.00 per share, and the acquirer grants a replacement award with the same remaining vesting period and a fair value of $50.00 per share. The $10.00 excess fair value plus 50 percent of the remaining $40.00 fair value (for a total of $30.00) is allocated to future services and recognized as compensation cost over the remaining 2-year postcombination vesting period, and the other 50 percent of the remaining $40.00 fair value ($20.00) is allocated to purchase price consideration (prior to estimated forfeitures).

Events that occur subsequent to the acquisition date, such as forfeitures, modifications, changes in liability award fair value, or the ultimate outcome of performance awards, do not affect the purchase price. Rather, such events are recognized through adjustments to compensation cost and income tax expense in accordance with Statement 123R during the postcombination period.

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General questions about this letter can be addressed to Thomas M. Haines in our Chicago office at 312-332-0190 or by email at tmhaines@fwcook.com. Copies of this summary and other related materials, including our summary of Statement 123R, are available on our website at www.fwcook.com.