

## Discussion Document C

### **Topic: Treatment in Pre-Adoption Pro Forma Income Statement of Options Given to Employees of a Target in a Business Combination after the Acquirer has Adopted Statement 123(R) (Discussion Document H from June 20, 2006 Meeting)**

**Background:** Registrants other than small business issuers must implement FASB Statement 123(R) at the beginning of fiscal years beginning after June 15, 2005, and small business issuers must implement Statement 123(R) at the beginning of fiscal years beginning after December 15, 2005. Registrants may implement Statement 123(R) using either a modified retrospective or a modified prospective transition method.

**Question:** If a registrant acquires a business after it implements Statement 123(R) and grants options to the target's employees as part of the acquisition (e.g., exchange such employee's previous options related to target securities to options related to registrant securities), and the unvested portion of those options are to be accounted for as compensation, how should the compensation related to those options be treated in the pro forma income statement covering the year before Statement 123(R) was adopted? Does the answer depend on which transition method the registrant uses?

For example, Company X is a calendar year-end SEC registrant with publicly traded equity. Company X has an employee stock option plan which it has historically accounted for under APB 25 (with pro forma disclosures under Statement 123 included in the notes to the financial statements). Company X adopted the provisions of Statement 123(R) effective January 1, 2006 and filed its March 31, 2006 Form 10-Q on May 1, 2006. Company X acquired a significant business in June 2006; accordingly, Company X's Form 8-K must include pro forma income statements for the year ended December 31, 2005 and for the three months ended March 31, 2006.

If the registrant uses the **modified retrospective transition method** to adopt Statement 123(R)–

View A: The pro forma income statement in the example above should not include an adjustment to reflect the projected compensation expense related to the options granted on the acquisition date.

Although the issuance of the options is factually supportable, any pro forma adjustment would be calculated in accordance with Statement 123(R) (i.e., it would be measured and recognized following the principles in Statement 123(R)) because that is the accounting standard that applies at the date of acquisition. However, these amounts are calculated differently than the amounts computed in accordance with the retrospective adoption of Statement 123(R). Under the modified retrospective approach, Statement 123 applies to the 2005 financial statements. Because of these differences, no adjustment should be made.

View B: The pro forma income statements in the example above should include an adjustment to reflect the projected compensation expense related to the options granted on the acquisition date computed in accordance with Statement 123(R), the accounting standard applicable to the options issued in the acquisition. In order to avoid “double counting,” a pro forma adjustment should be made to eliminate the compensation expense, if any, reflected in the target’s historical financial statements related to options exchanged in the business combination.

The additional options granted in connection with the acquisition are essentially a change in the pay level for the target’s employees which were made in connection with the acquisition. The amount is factually supportable and directly attributable to the transaction, so an adjustment is required.

The fact that the adjustment is not computed in the same manner as the adjustments retrospectively reflected in the registrant’s financial statements is not relevant. What is relevant is that these adjustments will affect the registrant’s financial statements after the acquisition date. This was the rationale for the approach used in making pro forma adjustments when registrants transitioned to Statements 141 and 142. Acquisitions made after the effective date of those standards were reflected in pro forma income statements covering prior years using the accounting prescribed by those standards (i.e., purchase accounting was applied and goodwill was not amortized).

If the registrant uses the **modified prospective transition method** to adopt Statement 123(R) –

View A: The pro forma income statement should not include an adjustment to reflect the projected compensation expense related to the options granted on the acquisition date. Any adjustment should be calculated in accordance with Statement 123(R) (i.e., it should be based on the value calculated on the acquisition date in accordance with Statement 123(R) and reflected as a pro forma expense using the recognition method in Statement 123(R)) because those are the amounts that are factually supportable. However, these amounts are calculated differently than the amounts computed in accordance with APB 25 that the registrant recorded in its historical financial statements. In addition, it would be inconsistent and therefore not meaningful to reflect compensation expense computed under Statement 123(R) for options granted to the target’s employees but not the registrants’ employees in the pro forma income statement. Therefore, no adjustment should be made.

View B: The pro forma income statement should include an adjustment to reflect the projected compensation expense related to the options granted on the acquisition date. In order to avoid “double counting,” a pro forma adjustment should be made to eliminate the compensation expense, if any, reflected in the target’s historical financial statements related to options exchanged in the business combination.

The additional options granted in connection with the acquisition are essentially a change in the pay level for the target’s employees which were made in connection with the

acquisition. The amount is factually supportable and directly attributable to the transaction, so an adjustment is required.

The fact that the registrant did not record stock option expense retrospectively in its financial statements is not relevant. What is relevant is that these adjustments will affect the registrant's financial statements after the acquisition date. This was the rationale for the approach used in making pro forma adjustments when registrants transitioned to Statements 141 and 142. Acquisitions made after the effective date of those standards were reflected in pro forma income statements covering prior years using the accounting prescribed by those standards (i.e., purchase accounting was applied and goodwill was not amortized).

**Committee Recommendation:**

If the registrant uses the modified retrospective transition method – View B

If the registrant uses the modified prospective transition method – View B

**SEC Staff Position: With respect to the Modified Retrospective Transition Method, the SEC staff agrees with View B. With respect to the Modified Prospective Transition Method, the SEC staff agrees with View A unless incremental value (i.e., a change in value resulting from a change in option terms) is transferred, in which case, the staff agrees that View B would be appropriate (*with respect to such incremental value*). If View A applies, there is no adjustment, but there should be disclosure as if Statement 123(R) had been adopted.**