MINUTES

Financial Accounting Standards Board

To: Board Members

From: Miller (ext. 276), Stell

Subject: Minutes of the October 1, 2003 Board Meeting **Date:** October 1, 2003

cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Sutay, Gabriele, Swift, Polley, Allen, Bean, Patton, FASB Intranet, McKenna, Pinson, MacDonald, Hurst

Topic:	Equity-Based Compensation (EBC): Attribution and Other Issues, and Post-Vesting Restrictions
Basis for Discussion:	Board memoranda dated September 22, 2003 and September 19, 2003
Length of Discussion:	11:15 a.m. to 12:00 p.m. and 1:00 p.m. to 1:30 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott (by phone)
Board members absent:	None
Staff in charge of topic:	Tovey and Metcalfe
Other staff at Board table:	Cassel, Miller, Zeyher, and Stell
Outside participants:	Willis (by phone)

<u>Summary for ACTION ALERT</u>:

The Board discussed certain issues related to the attribution of equity-based compensation (EBC) and reached the following decisions:

1. The example in paragraph A17 of FASB Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS*, *Share-based Payment*, contains multiple grant dates.

2. Valuation *and* attribution treatment alternatives described in paragraph 30 of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as they relate to option awards with graded vesting, would be eliminated. This means that enterprises issuing awards with graded vesting would have to use tranche-specific expected lives for valuation purposes and the method of attribution set forth in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.
3. The method of attribution in Interpretation 28 would not be reconsidered.
4. The guidance in paragraph 27 of Statement 123 related to awards that have performance conditions that affect either the exercise price or the date of exercisability of an award would be extended to awards with market conditions. In addition, an illustration of how that guidance would be applied would be included in the appendix of the proposed Statement.
5. The method of accounting for modifications of fully vested EBC awards would be consistent with the method set forth in IASB Exposure Draft 2, *Share-based Payment*. In other words, incremental compensation cost would be calculated by comparing the fair value of the modified award to the fair value of the original award immediately prior to the modification.
6. For arrangements in which an EBC award classified as equity is modified to an EBC award classified as a liability that has a similar risk profile to that of the original award, the liability created at the date of modification would be recognized for the portion of the award that would be recognized under Interpretation 28.
7. The guidance in Statement 123 that requires that recognized compensation cost related to vested, unexercised awards that expire not be reversed would be retained.

The Board also addressed the valuation of employee equity-based compensation (EBC) arrangements that contain post-vesting restrictions. The Board reached the following decisions:

1. The term *restriction*, as it pertains to equity-based compensation, would be defined as:

   > A limitation that is contractually or governmentally imposed that prohibits the transfer of fully vested and outstanding shares.

   The Board clarified that if the holder of such shares can synthetically transfer the risks and rewards from holding the shares by the use of derivatives or otherwise, such shares would not be considered restricted.

2. The proposed Statement would provide additional discussion in the basis of conclusions regarding why restrictions that will be lifted as of the vesting date are not considered in the grant-date estimate of fair value.

3. The proposed Statement would require an entity to document its methodology for valuing restricted shares, and clarify that arbitrary restriction discounts are not acceptable.

<u>Matters Discussed and Decisions Reached:</u>
Attribution

Attribution and Grant-Date–ITC Example from EBC Memo No. 12 and Attribution Before Vesting

This issue was not addressed by the Board in its earlier deliberations on issues related to grant date. Board members considered and expressed their views regarding whether the following example contains a single or multiple grant dates:

> Enterprise B hires a CEO. As part of the employment contract, Enterprise B agrees to give 100,000 fully vested stock options at the end of each of the next 5 annual periods (500,000 stock options in total); however, the exercise price of the stock options will be the average market price for the 12 months preceding each separate delivery of options. . . . [B]oth Statement 123 and the Proposed IFRS define grant date as the date when both the employer and employee have "a mutual understanding of the terms" of the award. The employer and the employee understand the

> formula that will establish the exercise price at the date of each individual grant; however, the exercise price is a key term of the options granted over the five-year period and is not known. Consequently, the day the agreement is signed is not the grant date for the award under both Statement 123 and the Proposed IFRS. [Paragraph A17; footnote reference omitted.]

The staff noted that most respondents to the Invitation to Comment believed that the arrangement above contains a single grant date, whereas both the FASB and IASB staffs view the arrangement as having multiple grant dates (five separate grant dates) which would be valued at the end of each period.

Ms. Schipper agreed with the staff's view and noted that the example represents a specific instance of applying general guidance for determing grant date. She added that the grant date would generally occur when the terms of the arrangement are mutually understood; however, in the example, the terms are not understood but the formula that would determine the terms is understood. The Board members unanimously agreed with her comments.

Mr. Tovey stated that some valuation experts would characterize the example as an Asian option, which accounts for the average value of the stock over a period of time. Mr. Tovey added that those experts believe that the five awards could be valued at the beginning of each period, instead of at the end of the period.

Attribution–Entire-Award Average Expected Life vs. Tranche-Specific Expected Life

The Board discussed whether to retain the treatment alternative applicable to option awards with graded vesting. The guidance in FASB Statement No. 123, *Accounting for Stock-Based Compensation*, allows an enterprise a valuation treatment alternative: (a) to use different expected lives for the options that vest each year (referred to as tranche-specific expected lives) or (b) to use a weighted-average expected life for all options comprising the entire award.

The staff noted that the valuation treatment alternative gives rise to another treatment alternative applicable to attribution and added that in Issue 7 of EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under

APB Opinion No. 25 and FASB Interpretation No. 44," the Task Force concluded that an enterprise's choice (if service-based graded-vesting awards are granted) of FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, or straight-line attribution was a policy decision.

The staff recommended that the valuation treatment alternative be eliminated and that preparers be required to value each tranche using tranche-specific expected lives. With respect to attribution, the staff recommended that the treatment alternative be eliminated and noted that preparers should be required to use the Interpretation 28 method of attribution for awards with graded vesting.

The Board discussed whether to retain both the valuation and attribution treatment alternatives applicable to option awards with graded vesting. Ms. Schipper emphasized the importance of eliminating the treatment alternative of using the weighted-average expected life because it would not fit with computational models. The Board unanimously agreed with the staff's recommendations.

Attribution–Interpretation 28 Attribution Method

That staff stated that Interpretation 28's attribution method is distinct as compared to the accounting for other employee compensation arrangements. Under those other arrangements, graded vesting arrangements would generally be recognized using a straight-line approach for each marginal tranche which is viewed as an incremental benefit for each successive service period rather than for service from inception of the entire arrangement.

The Board discussed whether this method should be reconsidered during the current phase of the project, during a subsequent phase of the project, or not at all. Mr. Herz stated that constituents are comfortable with and understand the attribution method in Interpretation 28, and the method should be retained. However, the Board members unanimously agreed that should a reconsideration of the attribution method in Interpretation 28 be undertaken, that reconsideration should take place in a subsequent phase of the project.

Attribution–Determining the Service Period for Certain Awards with Market-Based Conditions

The staff discussed the following example with the Board to illustrate possible issues that an entity may encounter if it grants awards with market-based conditions, especially if those awards are valued using path-dependent option-pricing models.

> Company V has an EBC plan. Under that plan, Company V grants options with a market-based condition: if the stock price of Company V exceeds $30 at the close of 10 consecutive trading days, the options become exercisable. The exercise price is $15 per option. Company V has analyzed its employee early exercise behavior and has determined that on average, it would expect exercisable options to be exercised if the share price is 2.5 times the exercise price. Company V uses a lattice approach with Monte Carlo simulation (using 10,000 simulations) to determine the value of the award; based on that valuation approach, Company V estimates the average expected life of the options granted to be 6 years. Because the market-based condition is 2 times the exercise price, Company V knows that the options would become exercisable before the exercise date on all paths that result in an exercise and would have a longer expected life along paths with prices ultimately less than $30. However, Company V understands from its third party valuation expert that, along some of the paths in the simulation, option exercises occur as early as three years after grant. Company V's third party valuation expert estimates, based on the distribution of the paths, that options would first become exercisable at year 5. Company V is unsure whether compensation cost should be allocated over three years or five years, but ultimately decides that five years is more reasonable because it is based on the mean of the paths rather than paths that are several standard deviations out from the mean.

The staff noted that paragraph 27 of Statement 123 provides guidance for determing the service period when awards have performance conditions that affect either the exercise price or the date of exercisability. The staff recommended that such guidance be extended to awards with market conditions as well.

Ms. Schipper questioned the staff about the requisite service period that employees would have to fulfill in the example. She noted that for arrangements that do not stipulate in the contract a requisite service period, there is only a market condition. She added that even though there is no stipulated service period, a preparer would still have to calculate one, and that the Board should provide guidance that bases the calculation on the assumptions used in the calculation of fair value. She stated that the guidance in paragraph 27 is not detailed enough and should be improved.

The staff asked if such guidance could be incorporated into the implementation guidance, and the Board indicated no preferences. However, Board members stated that examples should be provided to enhance preparers' understanding of paragraph 27 of Statement 123.

Modifications–Post-Vesting Modifications

At the September 17, 2003 Board meeting, the Board directed the staff to consider different modification alternatives for fully vested awards, specifically those awards in which time value is exchanged for intrinsic value. Some believed that this type of transaction is the same as a cash settlement. During that meeting, the staff proposed the three following methods of calculating incremental compensation cost related to such awards:

> <u>IASB Method (Method 2)</u>: Incremental compensation cost is calculated by comparing the fair value of the modified award to the fair value of the original award immediately prior to the modification. The Board has tentatively agreed on this method.
>
> <u>New Award Method (Method 4)</u>: The fair value of the modified award represents a new award (i.e., no incremental compensation cost calculation is necessary).
>
> <u>Statement 123 Method (Method 1)</u>: This method is the same as Method 2 except for stock options; in that case, incremental compensation cost is calculated by comparing the fair value of the modified award to the calculated value of the original award using the shorter of the expected life of the modified award or the original remaining expected life of the original award.

At the October 1, 2003 meeting, the Board discussed the methods above for accounting for post-vesting modifications and also considered if the definition of cash settlement should be expanded to encompass transactions in which time value is exchanged for intrinsic value (referred to as synthetic cash settlement).

The staff noted that Board in earlier deliberations contemplated on what to do with arrangements that appear to be cash-settled. An example provided by the staff included an enterprise that has a policy which precludes it from issuing new shares to satisfy option exercises, but requires the enterprise to buy shares in the marketplace. The staff added that the Board tentatively concluded that cash settlement occurs only when an enterprise "issues a check" out of its own cash funds to an employee and that the notion of synthetic cash settlement may not be consistent with this characterization.

Mr. Herz expressed support for Method 2 and indicated that he did not support the notion of synthetic cash settlement. He noted that the concepts in Method 2 are consistent with the grant date model.

Mr. Batavick also supported Method 2 and based his decision on the need to maintain internal consistency within FASB literature as well as convergence with the IASB. Ms. Seidman agreed with those comments.

Mr. Crooch expressed his concern with the example and noted that by exchanging time value for extrinsic value, the fair value may be the same, but both the issuing enterprise and the employee would be in very different positions because an employee could now obtain an immediate benefit by simply exercising the option. He added that he would support Method 1.

Ms. Schipper noted that if the Board wishes to be internally consistent, then it must think through the following series of questions: (1) Does it matter whether the employee has to continue being employed (exchanging time value for intrinsic value)? (2) Does it matter where the cash comes from? (3) Does it matter if one payoff is replaced with another one that has a completely different structure? (4)

Does it matter if options are legally cancelled? She also added that she would support the approach in Method 2.

Mr. Herz took a final vote and six Board members (RHH, EWT, KAS, GJB, LFS, GSS) supported Method 2, while one Board member (GMC) supported Method 1.

Modifications–Scenario 9 of Appendix 1 of EBC Memo No. 19

At the September 17, 2003 Board meeting, the Board discussed a scenario in which an EBC award classified as equity is modified to an EBC award classified as a liability that has a similar risk profile to that of the original award. The Board deferred that issue, and discussed at the October 1, 2003 meeting, whether the liability created at the date of modification should be recognized for the portion of the award that would be recognized under Interpretation 28 or for the entire award, regardless of vesting status.

Ms. Schipper stated that she analyzed the issue by determing whether the classification from equity to liability is a settlement followed by a new award, or a modification. She noted that she answered the same questions (see above) and stated that the cash comes from the employer's funds, but the payoff structure has not changed. She added that she accorded primacy to the payoff structure, which in fact, led her to conclude that the scenario included a modification. She stated that she would support the method for accounting for the liability recognized at the date of the modification in accordance with Interpretation 28. The other Board members unanimously agreed with her comments and voted to support that method.

Attribution–Accounting for Vested Awards That Expire Unexercised

The staff stated that both Statement 123 and IASB Exposure Draft 2, *Share-based Payment*, require that recognized compensation cost related to vested, unexercised awards that expire not be reversed. The rationale is that the company has received the benefits of the arrangement and has paid for the arrangement via the transfer of an EBC award (i.e., the exchange is complete). Because the exchange is complete under the modified grant-date approach, compensation cost is not unwound because the option expires out-of-the-money. The Board discussed this issue and unanimously agreed to retain that guidance.

Post Vesting Restrictions

The Board discussed several issues relating to the valuation of equity-based compensation (EBC) arrangements that contain post-vesting restrictions. The Board reached the following decisions with respect to those issues:

Issue 1: Definition of Restriction—The Board discussed the definition of the term *restriction* with respect to the valuation of EBC arrangements. The staff had suggested two alternative definitions of *restriction*, relating to a share's transferability. Under one alternative, a share may be legally or contractually transferable but still considered to be restricted because the market in which the share can be transferred is limited in terms of potential transferees. Under the other alternative, a share that is transferable would not be considered restricted. The Board decided to define the term *restriction* as follows:

> **Restriction: A limitation that is contractually or governmentally imposed that prohibits the transfer of fully vested and outstanding shares.**

Mr. Trott was supportive of a narrow definition of *restriction***,** inclusive of all forms of prohibition on the transfer of fully vested and outstanding shares. He noted the need to address the increasingly common phenomena of prohibitions incorporated into EBC arrangements. He stated that prohibitions on the transfer of fully vested and outstanding shares should be identified, and their impact on the award's fair value evaluated, at the grant date.

Ms. Schipper also supported a narrow definition of *restriction*. She clarified that this definition was not intended to value a lack of marketability arising from shares with a small float limitation. In that instance, the shares can be sold or transferred, just not sold or transferred widely.

Mr. Schieneman agreed with Mr. Trott and Ms. Schipper. He expressed concern that a broader definition of the term *restriction* may have an unintended valuation effect on the lack of marketability of the shares of nonpublic companies. Mr. Tovey noted that a discount for the lack of marketability is inherent in the valuation of shares of a nonpublic company.

Mr. Crooch suggested that the Board not define what constitutes a restriction, and instead consider all the terms specific to a particular award, including restrictions that continue after the vesting period. He stated that this suggestion was not aimed at defining what inputs should be considered in a valuation model. Mr. Crooch did not object to the more restrictive definition of *restriction* if the scope of the definition was limited to EBC arrangements.

Mr. Batavick supported a more expansive definition of restriction. He agreed with Mr. Crooch's fact and circumstance approach to the valuation of an award with post-vesting restrictions.

Ms. Seidman also supported a more expansive definition of restriction, which would not specify the contractual or governmental limitation on a share of fully vested and outstanding shares as a prohibition of transfer. Ms. Seidman questioned the establishment of a different measurement approach for valuing a post-vesting restriction from valuing a lack of marketability due to other limitations such as blue-sky laws and 144A requirements.

No Board member objected to defining the term *restriction* as a contractual or governmental limitation imposed to prohibit the transfer of fully vested and outstanding shares. The staff clarified that the word "prohibit" was intended broadly, i.e. if the holder of such shares can synthetically transfer the risks and rewards from holding the shares by the use of derivatives or otherwise, such shares would not be considered restricted. The

Board agreed with this clarification.

<u>Issue 2: Potential Valuation Guidance Related to Restrictions</u>—At the September 10, 2003 Board meeting, the Board directed the staff to consider what guidance, if any, might be added to the proposed Statement with respect to restrictions. The staff offered several alternatives for guidance on estimating a discount for a restriction, as defined in Issue 1, on an EBC arrangement for the Board's consideration. One of the alternatives included language describing additional factors for consideration in estimating the fair value of restricted shares.

The Board decided to provide additional guidance regarding the valuation of restricted shares. The proposed Statement would provide additional discussion in the basis of conclusions regarding why restrictions that will be lifted as of the vesting date are not considered in the grant-date estimate of fair value. The proposed Statement also would require an entity to document its methodology for valuing restricted shares and clarify that arbitrary restriction discounts are not acceptable.

Ms. Schipper supported additional guidance which contained additional factors for consideration in estimating the fair value of restricted shares. She did not feel the additional factors were controversial, based on her analysis of relevent academic studies which suggested the importance of such factors (nature and term of the restriction, nature of the enterprise, nature of the market [or expected market] for the share, volatility of the share, and the risk-free interest rate).

Mr. Trott also supported providing more expansive guidance, which would include the listing of additional factors for consideration in valuing a restriction. He said that the advantage of listing the factors would be to emphasize that arbitrary restriction discounts are not acceptable.

Ms. Seidman did not support providing additional factors as she felt this would become a point of significant contention among constituents. She did not feel that such additional guidance would justify the months of debate that she forsaw as a result of including such a listing. She felt that defining factors for consideration in estimating the fair value of restricted shares was an issue more appropriate for consideration in the Fair Value Measurement project. Instead she supported the staff's recommendation that the proposed Statement provide additional discussion in the basis of conclusions regarding why restrictions that will be lifted as of the vesting date are not considered in the grant-date estimate of fair value. She also agreed with the staff's recommendation to require an entity to document its methodology for valuing restricted shares and that the proposed statement clarify that arbitrary restriction discounts are not acceptable. Mr. Herz noted that the Board would consider disclosures related to restricted stock valuation in a future meeting.

Mr. Trott was the only Board member to object to not incorporating the listing of additional factors for the reasons previously stated.

Follow-up Items:

None.

General Announcements:

None.