MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Stell (ext. 211)
Subject:	Minutes of the October 8, 2003 EBC Board Meeting
Date:	October 16, 2003
cc:	Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, MacDonald, Pinson, Hurst, McKenna, Thompson, Sutay, Gabriele, Swift, Polley, Allen, Bean, Patton, FASB Intranet

Topic: Equity-Based Compensation: Certain Definitions and Other Issues

Basis for Discussion: Board memorandum dated September 25, 2003

Length of Discussion: 10:45 a.m. to 12:00 p.m. and 1:00 p.m. to 1:15 p.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	Tovey
Other staff at Board table:	Cassel, Zehyer, Stell, and Miller
Outside participants:	Leisenring (IASB) Willis (by phone)

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

The Board discussed definitions of market condition, performance condition, and service condition as they relate to equity-based compensation (EBC) arrangements and related issues. The following decisions were reached:

1. The description of *market condition* in FASB Statement No. 123, *Accounting for Stock-Based Compensation*, would be retained. A definition incorporating that description would be incorporated into the proposed Statement. Under that definition, if an EBC award's exercise price or vesting (or exercisability) is based on the achievement of a specified market target in terms of an index of similar equity securities or a similar equity security of another enterprise, then that condition is a market condition. Furthermore, if the exercise price or exercisability of an EBC award is based on something other than a specified service, performance, or market condition, then the EBC award would be classified as a liability.
2. For EBC arrangements that combine market and non-market vesting or exercisability conditions, an enterprise would be required to use judgment in estimating the service period over which benefits would be received. For EBC arrangements that vest or become exercisable based on either meeting a market condition or a non-market condition, an enterprise would compare the explicit service period and the implied service period associated with the market condition and would use the shorter of the two.
3. The definition of *performance condition* in Statement 123 would be retained but modified to clarify that the term *specified performance* refers to a target that is calculated or measured by reference to the issuer's own operations.
4. A *service condition* would be defined as an award for which vesting depends solely on an employee's rendering service to the employer for a specified period of time (that is, an award that does not specify a performance condition or market condition for vesting or exercisability).
5. Additionally, the total universe of vesting or exercisability conditions would be classified as service, performance, or market conditions, which are mutually exclusive categories.
6. The existing definition of *public entity* in Statement 123 would be retained but modified to include following corresponding elaboration in paragraph 72 of FASB

Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*:

> A subsidiary of a public entity or a public entity with thinly traded stock shall follow the accounting prescribed for a public entity. However, an entity with publicly traded debt but no publicly traded equity securities shall follow the accounting prescribed for a nonpublic entity.

7. The grant date of an EBC arrangement could not occur prior to an enterprise obtaining shareholder approval, regardless of whether that approval is voluntarily sought for or legally required (unless shareholder approval is considered perfunctory).

Matters Discussed and Decisions Reached:

Definition of Market Condition

Mr. Tovey stated that paragraph 26 of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, notes the following:

> No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award**, or because the entity does not achieve a **performance condition**, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. [Footnote references omitted]

Footnote 6 of 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," contains the following definition of *market condition*:

> Market conditions are those conditions that relate to achievement of a specified market target, for example, attaining a specified stock price or specified amount of intrinsic value of a stock option.

The Board also discussed the definition of market condition in Issue 96-18 and considered the following alternatives:

a. Alternative 1: Under this alternative, the Board would retain Statement 123's language on this matter and provide no additional guidance.

b. Alternative 2: Under this alternative, the Board would retain Statement 123's language on this matter and add the definition of market condition that exists in Issue 96-18 but not provide further guidance.

c. Alternative 3: Under this alternative, the Board would retain Statement 123's language on this matter and add the definition of market condition in that exists Issue 96-18, as well as ask the EITF to address this matter.

d. Alternative 4: Under this alternative, the Board would retain Statement 123's language on this matter and add a definition of market condition that might read as follows:

> Market conditions are those conditions that relate to achievement of a specified equity-based market target that is related to the award, for example, attaining a specified stock price for an award of stock or a specified amount of intrinsic value of a stock option. If the exercise price or exercisability of an equity award is based on the achievement of a specified market target in terms of an index of similar equity securities or a similar equity security of another enterprise, then that condition is a market condition. If the exercise price or exercisability of an equity award is based on something other than a market condition described in the two preceding sentences and that condition does not meet the definition of a service or performance condition, then that arrangement shall be accounted for as an equity-based compensation liability award.

Mr. Tovey stated that the staff recommends Alternative 4, but added that some revisions may have to be made to the proposed definition of market condition. He noted that the fair value of certain equity-based compensation (EBC) arrangements may not be indexed solely to its stock price, but also may be indexed to something else, such as commodity prices, interest rates, or foreign currencies. Mr. Tovey added that the staff believes that such arrangements should be treated as liabilities. He noted that under IASB Exposure Draft 2, *Share-based Payment*, those arrangements would be classified as equity.

Board members discussed (1) whether they support including a definition of market condition in the proposed Statement and (2) whether they support the concepts outlined the proposed wording set forth in Alternative 4.

Ms. Seidman expressed support for including a definition of market condition in the proposed Statement, but indicated her concern with the narrow scope of that definition. She added that the proposed definition of market condition is too broad, and that certain distinctions made between derivatives (liabilities) and equity in other existing authoritative literature, such as in FASB Statement No. 150, *Accounting for Certain*

Financial Instruments with Characteristics of both Liabilities and Equity, and EITF Issue No. 01-6, “The Meaning of ‘Indexed to a Company's Own Stock,’”are narrower. She further noted that under such guidance, the arrangement must be indexed to a company’s own stock or factors that are unique to that particular company. She stated that market conditions that are linked to the Standard & Poor’s 500 Index do not represent the company’s own stock. She concluded her comments by emphasizing the importance of internal consistency in the proposed Statement. She noted that if the Board supports the proposed definition, some instruments customarily considered to be derivative instruments in other authoritative literature would now be accounted for as equity instruments under the proposed Statement. She suggested that the staff narrow the definition of market condition.

Ms. Schipper stated that paragraph 26 of Statement 123 should be rewritten in its entirety because it introduces a distinction between a fixed award and a performance condition. She noted that the proposed definition of market condition introduces three separate categories of conditions: market conditions, performance conditions, and service conditions. She added that the categories of conditions set forth in the proposed definition are intended to be exhaustive and mutually exclusive, whereas paragragh 26 or paragraph 395 of Statement 123 do not clarify that point. She agreed with the concepts outlined in the proposed definition and suggested that the staff rewrite paragraphs 26 and 395 of Statement 123 to incorporate those concepts.

Mr. Batavick stated that he agreed with those comments made by Ms. Seidman and Ms. Schipper. He indicated that he would support Alternative 4, but clarified his comments by suggesting that the definition be more narrow. Mr. Schieneman indicated that he agreed with Ms. Seidman’s comments and would support a narrower definition of market condition.

Mr. Trott presented a scenario in which an enterprise issues options on its own stock (with an exercise price that is a fixed amount of cash) that vest or are exercisable only if the enterprise’s stock outperforms the Standard & Poor’s 500 Index. He stated that under the proposed definition, this arrangement would be classified as an equity instrument with a market condition.

Mr. Tovey then introduced the concept of dual-indexing and modified that scenario so that the exercise price would be a fixed quantity of gold. Mr. Tovey noted that if that arrangement was freestanding and evaluated under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, then that arrangement would be classified as a derivative.

Mr. Crooch questioned the staff to determine whether any circumstance in which the exercise price is fixed and the option holder received stock in exchange should be classified as an equity arrangement. Mr. Cassel responded to his question by stating that an arrangement could have exercisability with a fixed price contingent on an index or an arrangement could contain provisions that would allow the exercise price to be indexed to similar item.

Mr. Tovey noted that exercisability may not directly influence the payoff structure, but it may indirectly influence the payoff structure because it represents an on-off switch, meaning that the arrangement has to be exercisable for the holder to benefit from the payoff. He concluded that exercise price and exercisability are interrelated and both impact the payoff structure in some regard.

Ms. Schipper stated that the Board must determine whether it will allow treatment alternatives across the three categories (market, performance, service) and noted that Statement 123 currently has a treatment alternative. She noted that it would be difficult to apply a distinction between derivatives and equity in a manner consistent with the way constituents have thought about derivatives in the past.

Mr. Herz asked all Board members to express their views again with respect to this issue. Five Board members (Herz, Schipper, Trott, Schieneman, Crooch) all supported the staff's recommendation and two Board members (Batavick, Seidman) who supported a narrower definition of market condition noted that they would not object to the staff's recommendation.

Mr. Tovey and Mr. Leisenring both noted that convergence may not be reached with the IASB on this issue. Mr. Tovey noted that this issue would likely not be addressed for convergence purposes until both Boards have completed their Liabilities and Equity projects.

Board members considered and expressed their views regarding the following example. Specifically, the Board considered how to account for awards that combine different types of vesting and exercisability conditions.

> Company A has an EBC plan. Company A plans to issue at-the-money options to eight highly paid executives. Company A would like to base the "vesting" provisions on a market condition: if Company A's stock price exceeds the average appreciation of an index of comparable companies by 3 percent over a 3-year period, the options would become immediately vested and exercisable at the end of that period. Company A is informed by Compensation Consultant B that the grant-date fair value of the arrangement could not be reversed under Statement 123 if the market condition was not achieved because Statement 123 treats such arrangements different from those based on performance conditions. After further consideration, Company A determines to add a 10-year service-based cliff-vesting provision in addition to the market condition to the arrangement; therefore, vesting would occur at the end of 10 years unless the market condition was triggered before then. Company A estimates that none of the executives would satisfy the service-based vesting provisions; Company A believes that if the market condition is met, then some expense would be necessary. Company A concludes that compensation expense should only be recognized if and when the market condition is met or if it appears probable that the executives will meet the service condition. Compensation Consultant B uses a path-dependent option-pricing model to determine the fair value of the at-the-money options ($40 million total for all of the awards); the consultant determines that the average expected life is 5 years (i.e., because the market condition triggers vesting). The consultant also states that the mode of the distribution is four years.
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> In year 6, the Board of Directors asked for the CEO's resignation because of poor company performance during the preceding 2 years. By the end of year 7, the rest of the remaining 8 highly paid executives left for other employment opportunities.

Mr. Tovey noted that the staff believes that the mode of four years is reasonable (assuming exercise occurs at some period after the options become exercisable). He stated that a 10-year service period is reasonable in these circumstances.

Board members agreed with the staff's assessment of the above example. However, several Board members questioned the staff to ascertain why the mode of the distribution was used in the example rather than a measure of central tendency, such as the mean. Mr. Tovey noted that the staff created an arrangement in which exercisability is based on meeting a market condition. He explained that the compensation consultant in the example values the arrangement and determines the average expected life of the arrangement. He further explained that the compensation consultant calculates the value based on a distribution of expected lives using Monte Carlo simulation. He noted that in this scenario, the distribution (bell curve) is skewed to the right and the highest point in the distribution is the mode. He added that the mode provides the highest frequency of observations in which exercisability would occur. In other words, the mode represents the most likely outcome for exercisability, and that is why the staff believes use of the mode is reasonable.

Ms. Schipper noted that the mode does not incorporate dispersion, whereas the mean does. She expressed her preference for using the mean rather than the mode to determine the service period, but noted that she would not object to the staff's view with respect to this example.

The Board also considered and expressed its views as it relates to market conditions in the following example, which involved an enterprise that issues nonvested stock awards to its employees:

> Company B has an EBC plan and issues nonvested stock unit awards to its employees. Company B's stock price on the date of grant is $50 per share. The nonvested stock unit awards are convertible to common stock at the end of year 3 as follows: if Company B's common stock price is at least $100 or above, the conversion ratio is 4 times (i.e., 1 stock unit equals 4 shares of common stock); if Company B's common stock price is at least $75 but less than $100, the conversion ratio is 3 times; if Company B's common stock price is at least $50 but less than $75, the conversion ratio is 2 times; if Company B's common stock price is at least $25 but less than $50, the conversion ratio is 1 times; and if Company B's common stock price is less than $25, the conversion ratio is zero times. Company B's shareholders are very supportive of the new arrangement as they believe it aligns the employees' interests with those of the shareholders. If an employee leaves before the end of year 3, the employee forfeits the nonvested stock units. Company B estimates that the fair value of each nonvested stock unit is $35, and the total of all the awards is $350,000,000.
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> At the end of year 3, Company B's industry has been hit hard by a national economic recession, and its stock price is trading at $24 per share upon the designated conversion-ratio-determination date. Company B applies the conversion ratio and no common stock is issued. Because no common stock is issued, Company B's management argues that no expense should be recognized.

The staff noted that the arrangement in the example above is similar to a vested option that has expired out-of-the-money. Board members unanimously agreed with the staff's assessment of this example and raised no further comments on this issue.

Definition of Performance Condition

Board members discussed whether the guidance in Statement 123 related to the definition of a *performance condition* should be retained. Mr. Tovey noted that paragraph 395 of Statement 123 provides the following definition of *performance condition* or *performance award*:

> An award of stock-based employee compensation for which vesting depends on both (a) an employee's rendering service to the employer for a specified period of time and (b) the achievement of a specified performance target, for example, attaining a specified growth rate in return on assets or a specified percentage increase in market share for a specified product. A performance condition might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division.

Mr. Trott and Ms. Schipper expressed support for retaining that definition and also suggested that the staff clarify or elaborate on the term *specified performance target* in the proposed Statement. Mr. Tovey proposed that specified performance target should be defined as one that is calculated or measured solely by reference to the issuer's own operations. All other Board members agreed with those comments and voted to retain the general guidance in Statement 123, with modifications, as necessary.

Definition of Service Condition

The Board considered and discussed the following proposed definition for *service condition* or *service award*:

> An award of equity-based compensation for which vesting depends solely on an employee's rendering service to the employer for a specified period of time (that is, an award that does not specify a performance condition or market condition for vesting or exercisability).

Board members voted to support the definition for *service condition* or *service award* and unanimously agreed that the total universe of vesting or exercisability conditions should be classified as service, performance, or market conditions.

Definition of Equity-Based Compensation

The Board discussed the following proposed definition of *share-based payment transaction*:

> A transaction in which the entity (a) exchanges its shares or other equity instruments, or incurs liabilities that are based on the price of its shares or other equity instruments for (b) goods, services, or financial instruments.

Ms. Schipper questioned the staff regarding the scope of the definition of share-based payment transaction, and provided examples of transactions that would be within the scope of that definition. She questioned the staff on whether a written put option would be considered equity under the proposed definition, noting that the scope of the definition of share-based payment transaction should not overlap with other literature. She added that there are several examples of commercial arrangements that might test the boundaries of that definition, and further discussion on that topic is warranted. She did indicate that she supported the spirit and direction of the proposed definition, but noted that she was concerned with the specific wording of the definition.

Ms. Willis then commented on the scope of the terms *goods* and *services* in Statement 123. She noted that the general definition of goods would exclude financial instruments. She added that the then-staff considered issues related to items that did not have a clearly determinable or valuable amount of cash or other financial instrument in which a fair value could be determined. She noted that there is nothing in Statement 123 that would be inappropriate for ordinary issuances of equity instruments for cash, but that those arrangements were intended to be scoped out of Statement 123.

Board members deferred decision making on this item until a subsequent meeting.

Mr. Tovey noted that EITF Issue No. 87-23, "Book Value Stock Purchase Plans," provides the following description of such plans:

> A privately held company has a stock purchase plan for employees who reach a certain level in the company (either by promotion or through direct entry) to acquire shares in the company. Participation in the plan may be either mandatory or optional for employees. The purchase price is a formula price based on book value or earnings. The arrangement requires that the employee sell the shares back to the company at retirement or upon leaving the company; the selling price is determined in the same manner as the purchase price.

Issue 87-23 also states that a company may provide options on book value shares as well. Mr. Tovey noted that the underlying shares or those arrangements would be treated as liabilities under Statement 150.

Mr. Tovey noted that since the Board has tentatively concluded that options on liabilities are liabilities themselves, then the staff believes that options on book value shares (with redemption features) should be treated as liabilities as well.

The Board discussed whether compensation arrangements involving book value stock and book value stock options are liabilities subject to the provisions in Statement 123 and if supplemental guidance should be provided to account for such compensation arrangements. The Board agreed with the staff's position.

Definition of Public Enterprise

The Board discussed how to define the term *public enterprise* in the proposed Statement. Paragraph 395 of Statement 123 defines the term *public entity* as follows:

> Any entity (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b).

Paragraph 72 of FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, expands on this definition for purposes of applying certain provisions of Interpretation 44 by adding the following language:

> A subsidiary of a public entity or a public entity with thinly traded stock shall follow the accounting prescribed for a public entity. However, an entity with publicly traded debt but no publicly traded equity securities shall follow the accounting prescribed for a nonpublic entity.

The Board unanimously agreed that the definition of *public entity* in Statement 123 should be retained and the corresponding elaboration in Interpretation 44 should be incorporated into the proposed Statement.

Grant Date: Voluntary Shareholder Approval

Interpretation 44 addresses whether grant date can occur prior to the enterprise obtaining shareholder approval, even if that shareholder approval is a voluntary corporate requirement (i.e., not legally required). The Board discussed whether the grant date could not occur prior to all approvals being obtained and unanimously agreed that it could not unless shareholder approval is considered perfunctory.

Follow-up Items:

None.

General Announcements:

None.