MINUTES

Financial Accounting Standards Board

To: Board Members

From: Stell (ext. 211)

Subject: EBC Minutes of the November 11, 2003 Board Meeting **Date:** November 19, 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: Interaction of Statements 123 and 150 and Other Issues
Basis for Discussion:	Board memorandum dated November 3, 2003
Length of Discussion:	1:00 p.m. to 2:15 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:	Willis (by phone)

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

The Board discussed certain issues relating to the measurement basis of EBC arrangements of nonpublic enterprises and the interaction of FASB Statements No. 123, *Accounting for Stock-Based Compensation*, and No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. The Board made the following decisions:

1. Nonpublic enterprises would be permitted the option of measuring EBC arrangements using either a fair value-based method or an intrinsic value based method. Enterprises would be required to make a one-time policy decision that would apply to all EBC arrangements. The measurement date for arrangements measured using the fair value-based method would be the grant date for EBC equity awards; for EBC liability awards, the fair value would be revised at each reporting date until settlement. The measurement date for arrangements measured at intrinsic value would be the grant date for EBC awards of stock and the exercise date for EBC awards of option or similar instruments; for EBC option and liability awards, the intrinsic value would be revised at each reporting date until settlement.

2. The explicit scope exception for EBC arrangements in paragraph 17 of Statement 150 would be retained, and certain provisions in the proposed Statement would make reference to Statement 150. The Board expressed support for a proposal that would classify financial instruments given under an EBC arrangement as liabilities, if those financial instruments would have been subject to Statement 150, absent the explicit scope exception in paragraph 17.

3. Generally, a freestanding EBC financial instrument accounted for under Statement 123 would become subject to Statement 150 when all employee-service conditions have been met or satisfied. For mandatorily redeemable shares (and physically-settled forward contracts and certain arrangements that involve a fixed amount settled in a variable number of shares) given in return for employee services, this means that such shares would become subject to Statement 150 at the date that the service period is completed. For option arrangements and other arrangements settled in a variable number of shares, this means that such instruments would not become subject to

Statement 150 unless the employment relationship ceases or upon exercise, in which case, the underlying financial instruments may become subject to Statement 123 as long as no other employer service conditions persist.

4. Modifications of certain financial instruments that are subject to Statement 150 because all employee-service conditions have been met or satisfied would be accounted for in accordance with the guidance on modifications and settlements set forth in Statement 123, if those modifications or settlements are a result of the holder's employment status. The incremental value transferred to the holder would be presumed compensatory unless that value has been transferred to all holders of that class of equity. However, if that class of equity is designed specifically for employees, then that exception would not apply; that incremental value would be recognized as compensation cost.

Matters Discussed and Decisions Reached:

Measurement Attribute for EBC Arrangements of Nonpublic Enterprises

The Board considered and expressed its views on the following alternatives as to the measurement attribute for EBC liabilities of nonpublic enterprises:

> Alternative 1—Fair Value: All EBC liabilities of nonpublic enterprises would be measured at fair value. This position is consistent with the treatment of such awards issued by public enterprises and with the treatment of EBC equity awards issued by nonpublic enterprises. However, if an enterprise believes it is not possible to reasonably estimate the fair value of the EBC liability award, then that enterprise would use intrinsic value through the exercise date (or settlement date).
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> Alternative 2(a)—Intrinsic Value: All EBC liabilities of nonpublic enterprises would be measured at intrinsic value. This position is not consistent with the position for similar awards issued by public enterprises and the position for equity awards issued by nonpublic enterprises. The key advantage of this measurement basis would be simplicity (especially for put and call options) and reduced costs of implementation.
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> Alternative 2(b)—Intrinsic Value: All EBC liabilities of nonpublic enterprises would be measured at intrinsic value; however, if an enterprise believes it is possible to reasonably estimate the fair value of the EBC liability, then that enterprise would use fair value through the exercise date.

> <u>Alternative 3—Permit Fair Value or Intrinsic Value</u>: All EBC liabilities of nonpublic enterprises would be measured at either fair value or intrinsic value based on a policy decision by the enterprise. Fair value would be the preferable method.

Five Board members (GMC, EWT, GJB, GSS, and RHH) voted to support Alternative 3, one Board member (KAS) voted to support Alternative 1, and one Board member (LFS) voted to support Alternative 2(b). Ms. Schipper, who voted for Alternative 1, indicated that she would not object to the Board's selection of Alternative 3.

Mr. Herz asked Board members if they would object to supporting Alternative 3 if its provisions were extended to options that are equity awards and not just EBC liabilities. Ms. Schipper objected to extending those provisions to options that are equity awards.

Whether An EBC Arrangement Can Fall Within the Meaning of *Freestanding Financial Instrument*

The Board discussed whether the explicit scope exception for EBC arrangements in paragraph 17 of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, should be retained. Board members unanimously agreed that the scope exception be retained and then discussed how certain provisions in the proposed Statement should make reference to Statement 150. The Board expressed support for a staff proposal that would classify financial instruments given under EBC arrangements as liabilities, if those financial instruments would have been subject to Statement 150, absent of the explicit scope exception in paragraph 17.

Differences in Measurement Attributes for EBC Arrangements under Statement 123 and Non-EBC Arrangements under Statement 150, and When An EBC Arrangement Becomes Subject to Statement 150

The Board discussed the interaction of different measurement attributes under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Statement 150 and considered scenarios in which an EBC arrangement would become subject to Statement 150. The Board agreed upon the following principles:

1. A freestanding EBC financial instrument accounted for under Statement 123 would become subject to Statement 150 if all employee-service conditions have

been met or satisfied, or if the financial instrument ceases to be compensatory in nature (e.g., the financial instrument is fully transferable and the holder ceases to provide services to the issuing enterprise).

2. Modifications and settlements of certain financial instruments that cease to be subject to Statement 123 and become subject to Statement 150 would be accounted for in accordance with the modification and settlement guidance set forth in Statement 123, if those modifications and settlements are a result of the holder's employment status. The incremental value transferred to the holder would be presumed compensatory unless that value has been transferred to all holders of that class of equity. However, if that class of equity is designed specifically for employees, then that exception would not apply; that incremental value would be recognized as compensation cost.

The Board then discussed the interaction of Statements No. 123 and No. 150 in the context of mandatorily redeemable financial instruments.

For mandatorily redeemable shares (and physically settled forwards and certain arrangements that involve a fixed amount settled in a variable number of shares), the Board decided that from grant date to vesting date, the shares would be measured as a Statement 123 EBC liability at a pro rata portion of fair value at each reporting date through the vesting date, recognizing all positive and negative changes in the fair value of the shares as compensation cost in the income statement. From the vesting date on, those shares would be subject to Statement 150 and measured in accordance with papragrapg 22 of Statement 150 through the date of redemption or settlement. The Board reasoned that such shares would no longer be subject to a compensatory arrangement because all employee-service conditions associated with earning the shares would have been satisfied. However, if an enterprise modified the terms of mandatorily redeemable shares and that modification resulted in incremental value being transferred to the holder or if the enterprise settled a share in excess of the share's value, and the modification or settlement does not affect all the holders of that class of equity shares (unless all shareholders of the class are employees), then the mandatorily redeemable shares would be subject to the modification and settlement provisions set forth in Statement 123.

The Board also discussed the interaction of Statements 123 and 150 in the context of certain EBC option arrangements that would be classified as liabilities under Statement 150 and agreed that EBC option arrangements would be subject to Statement 123 from grant date through exercise date. In general, there is a propensity to modify such arrangements prior to exercise and Statement 123 provides guidance on accounting for modifications and settlements of such EBC arrangements. It also was noted that the measurement attribute of such arrangements generally would be the same under Statements 123 and 150. From grant date until exercise date, the option would be measured at its fair value (or a pro rata portion thereof), with any changes in fair value measured and recognized in accordance with Statement 123. However, after exercise date when the option is exercised and shares have been issued, and such shares were subject to Statement 150, then such shares would be accounted for under Statement 150 (unless those shares were subject to further vesting conditions).

Follow-Up Items:

None.

General Announcements:

None.