



**Board Meeting Handout
Equity-Based Compensation
Employee Share Purchase Plans II
September 8, 2004**

At today's meeting, the Board will re-confirm the Board's tentative conclusion on the accounting for employee share purchase plans (ESPPs). There are six views with respect to ESPPs:

View A: Retain the ED Guidance

Paragraph 23 of the FASB Exposure Draft, *Share-Based Payment*, states:

If the terms of an employee share purchase plan are no more favorable than those available to all holders of the same class of shares and substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis, the plan is not compensatory. Illustration 19 (paragraphs B177–B179) of Appendix B provides guidance on how to determine whether the terms of an employee share purchase plan are no more favorable than those available to all holders of the same class of shares and gives examples of limited employment qualifications. [Footnote reference omitted.]

View B: Retain the Guidance of FASB Statement No. 123, *Accounting for Stock-Based Compensation*

Paragraphs 23 and 24 of Statement 123 state:

23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

a. The plan incorporates no option features other than the following, which may be incorporated:

(1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

(2) The purchase price is based solely on the stock's market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

b. The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.

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c. Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock's market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the stock's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

View B': Modify the Statement 123 Guidance

This view would retain the Statement 123 guidance in View B, above, but remove the 5 percent safe harbor and replace it with the notion of the proceeds being no less than what the company would otherwise receive in an offering to third parties. If the Board were to select this view, the staff would ask the Board if there is any other guidance from Statement 123 that they would want to revise as well. The Statement 123 guidance would be modified as follows (additions are underscored and deletions are marked):

23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

a. The plan incorporates no option features other than the following, which may be incorporated:

(1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

(2) The purchase price is based solely on the stock's market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

b. The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. ~~A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.~~ Any discount for the purchase of shares provided under the plan results in proceeds to the employer that are not less than the proceeds it would receive in an offering of shares if the shares had been issued to third parties by other means, for example, through an underwriter.

c. Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock's market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan

in which the purchase price is based on the stock's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

View D: Modify the Guidance in the ED

This was the tentative conclusion at the August 25, 2004 Board meeting.

The September 2, 2004 FASB Action Alert states:

An ESPP is not compensatory and does not give rise to recognizable compensation cost if all of the following conditions are met:

1. The ESPP satisfies one of the following criteria:
 - a. The terms of the ESPP are no more favorable than those available to all holders of the same class of shares.
 - b. Any discount for the purchase of shares provided under the plan results in proceeds to the employer that are not less than the proceeds it would receive in an offering of shares if the shares had been issued to third parties by other means, for example, through an underwriter.
2. Substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis.
3. The ESPP does not incorporate option features. For example, a plan in which the purchase price is based on the share price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan. The Board will consider related implementation issues at a future Board meeting.

View D': Modify View D

View D' would continue the two-principle approach in View D but add a 5 percent safe harbor and a prohibition on share repurchases. That guidance would look like the following (additions from View D are underscored):

An ESPP is not compensatory and does not give rise to recognizable compensation cost if all of the following conditions are met:

1. The ESPP satisfies one of the following criteria:
 - a. The terms of the ESPP are no more favorable than those available to all holders of the same class of shares.
 - b. Any discount for the purchase of shares provided under the plan results in proceeds to the employer that are not less than the proceeds it would receive in an offering of shares if the shares had been issued to third parties by other means, for

example, through an underwriter. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.

2. Substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis.
3. The ESPP does not incorporate option features. For example, a plan in which the purchase price is based on the share price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan. The Board will consider related implementation issues at a future Board meeting.
4. The company does not repurchases shares from others while offering employees the opportunity to purchase shares through an ESPP.

View E: Modify View D'

View E would continue the two-principle approach in View D but add a 5 percent safe harbor. (View E would not have the prohibition on share repurchases that View D' has.) That guidance would look like the following (additions from View D are underscored):

An ESPP is not compensatory and does not give rise to recognizable compensation cost if all of the following conditions are met:

1. The ESPP satisfies one of the following criteria:
 - a) The terms of the ESPP are no more favorable than those available to all holders of the same class of shares.
 - b) Any discount for the purchase of shares provided under the plan results in proceeds to the employer that are not less than the proceeds it would receive in an offering of shares if the shares had been issued to third parties by other means, for example, through an underwriter. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.
2. Substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis.
3. The ESPP does not incorporate option features. For example, a plan in which the purchase price is based on the share price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan. The Board will consider related implementation issues at a future Board meeting.

Discussion Question No. 1: Does the majority of the Board continue to believe the View D approach, as described above, is the best alternative for accounting for ESPPs?

Discussion Question No. 2: Does the Board want to specifically address the implementation issues raised by the staff?

Implementation Issues

Issue 1: How frequently would a company need to determine whether or not the proceeds it received were no less than it would have otherwise received in an offering? If a company determined its issuance costs would be 3 percent on January 1 and employees could purchase shares through an ESPP throughout the year (or over the next two years), would the company need to constantly reassess the discount?

Staff Recommendation: The staff believes that the reassessment should take place at least annually, and no later than the first purchase that needs to be recognized in that year.

Issue 2: If a company were to estimate its issuance costs at 7 percent and offered a 15 percent discount to employees, would only 8 percent be deemed compensatory? Or would the entire 15 percent be deemed compensatory?

Staff Recommendation: The staff believes that offering a 15 percent discount is not a capital raising transaction in this case, and therefore, the entire 15 percent would be compensatory. This is consistent with the liability classification related to awards with nondiscretionary minimum tax withholdings and the current requirements of Statement 123.

Issue 3: If a company repurchases shares from others while offering employees the opportunity to purchase shares through an ESPP, should the ESPP plan continue to be considered a capital raising transaction?

Staff Recommendation: The staff believes this issue raises several additional implementation issues as far as whether a company has an intent to repurchase shares from others, the timing of the repurchase of shares, whether the company has a history of share repurchases, etc. The staff is not sure if the Board would want to address all of the related implementation issues this question raises. However, the staff believes that if a single statement is made that to the extent that the employer has repurchased shares during the same fiscal year, then the ESPP is compensatory might suffice.

Issue 4: What would be the attribution period for any expense recognized under an ESPP plan?

Staff Recommendation: The staff believes that under the Statement 123 proforma disclosure requirements, companies have been including discounts of 15 percent (which are considered noncompensatory under APB Opinion No. 25, *Accounting for Stock Issued to Employees*) as compensatory and have been recognizing this expense over the service period. The staff believes that generally the service period would be over the purchase period (that is, the cash accumulation period or the purchase date if there is no required accumulation).

Issue 5: If a company could sell shares in two different markets, either in the U.S. or in another market such as Frankfurt (because its shares are already listed in those two markets) and the offering costs were different, which discount would they be allowed to take?

Staff Recommendation: The staff believes that raising capital has to be a function of the economic environment of the parent entity. If a German employee is able to buy shares of the parent company that are registered in Germany, then the discount should relate to those shares registered in Germany. If a U.S. employee is able to buy shares of the parent company that are registered in the U.S., then the discount should relate to those shares registered in the U.S.



**Board Meeting Handout
Equity-Based Compensation
Disclosures
September 8, 2004**

At today's meeting, the Board will discuss issues related to the disclosure objectives and the minimum required disclosures of the proposed Statement.

Disclosure Objectives

Discussion Question No. 1: Does the Board wish to retain the disclosure objectives from the FASB Exposure Draft (ED), *Share-Based Payment*?

Paragraph 46 of the ED states:

An entity with one or more share-based payment arrangements with employees shall disclose information that enables users of the financial statements to understand:

- a. The nature and general terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders (for example, the transfer of value from existing shareholders to option holders upon exercise)
- b. The effect of compensation cost arising from share-based employee payment arrangements on the income statement
- c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period
- d. The cash flow effects resulting from share-based payment arrangements.

Such disclosure objectives are similar to those in IFRS 2.

Respondents to the ED were asked in Issue 12 of the Notice for Recipients to comment on whether they believe that the disclosure objectives set forth in the proposed Statement are appropriate and complete. Respondents also were asked whether they believe that the minimum required disclosures are sufficient to meet those disclosure objectives. The overwhelming majority of respondents believe that the disclosure objectives set forth in the proposed Statement are appropriate and complete. The majority of respondents who disagree with the appropriateness and completeness of the disclosure objectives question the need to understand the cash flow effects resulting from share-based payment arrangements. The staff recommends retaining the disclosure objectives in the proposed Statement.

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Minimum Required Disclosures

Discussion Question No. 2: Does the Board wish to retain, as a minimum, the current disclosures as prescribed in the ED?

Appendix B of the ED indicates the minimum information needed to achieve the disclosure objectives of paragraph 46 of the ED and illustrates how the disclosure requirements might be satisfied.

The overwhelming majority of respondents disagree with the minimum required disclosures set forth in the ED. Half of those respondents believe that additional disclosures should be required, while the other half believes that minimum required disclosures should be reduced or eliminated.

Most respondents who believe that additional disclosures should be required provided a number of suggestions that can generally be categorized into the following groups: (a) valuation, (b) volatility, (c) expected term, (d) presentation, and (e) other. The overwhelming majority of respondents who believe that minimum required disclosures should be reduced or eliminated questioned the need for certain disclosures as proposed in the ED. The staff recommends that the Board, at a minimum, retain the current disclosures as prescribed in the ED.

Discussion Question No. 3: Does the Board wish to add any additional disclosures to the minimum required disclosures of the ED?

The Board has received suggestions of additional disclosures from comment letters, participants in roundtable discussions, and from other constituents. See the Appendix at the end of this handout to view those suggestions.

Discussion Question No. 4: Does the Board wish to require the disclosure of sensitivity analysis in the proposed Statement?

Many constituents suggested that sensitivity analysis of volatility and expected term be required. Paragraph B193 in the ED prescribes that an entity may provide such analysis in the form of a supplemental disclosure if the entity believes that the analysis would be useful to investors and creditors. In addition, most estimates do not require such disclosure. The staff recommends that sensitivity analysis should not be a required minimum disclosure, but rather be retained in paragraph B193 in the ED.

Discussion Question No. 5: Does the Board intend to require the disclosure requirements of paragraphs B191(d) and B191(h) in the ED as quarterly disclosure requirements?

The staff observed that paragraph B191(d) in the ED uses the phrase “date of the latest statement of financial position.” That phrase may be interpreted as a quarterly reporting requirement. The staff believes that the Board did not intend the required disclosures of paragraph B191(d) to be quarterly disclosure requirements.

Discussion Question No. 6: Does the Board wish to amend paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*, to add EBC to the list of required interim disclosures?

Should the Board decide that the disclosure requirements be required quarterly, some members of the staff believe that the recognition of EBC represents a significant income statement item. Therefore, the staff believes that paragraph 30 of Opinion 28 should be amended to add EBC to the list of required interim disclosures. Those staff proposes the following wording be added to paragraph 30 of Opinion 28:

- k. Compensation cost from awards of share-based payments (as qualified by footnote 64 of the proposed Statement).

Appendix

Valuation		Staff Recommendation
1.	Forfeiture assumption	No
2.	Comparison of grant-date fair value to exercise-date intrinsic value for options exercised during the year	No
Volatility		
1.	Sensitivity analysis	No
2.	Changes in assumptions	No
3.	Comparison of historical volatility to expected volatility	No
4.	At-the-money implied volatility for listed options	No
Expected Term		
1.	Sensitivity analysis	No
2.	How management defines employee groups	No
3.	Comparison of expected term, on the grant date, to historical behavior and termination behavior experienced subsequent to the grant date	No
Presentation		
1.	Distinguish the amount of equity-based compensation that comprises aggregated expense line items in the income statement	No
2.	Intrinsic value of exercisable options as a percentage of market capitalization	No
Other		
1.	Timing and expected number of grants in the following year	No
2.	Key assumptions and any related changes, affecting the determination of estimated requisite service period that is subject to performance or market conditions	No
3.	Economic hedging obligation for outstanding equity stock option plans	No
4.	Quarterly	Yes



Financial Accounting Standards Board

Board Meeting Handout

Proposed FSP on 142

September 8, 2004

The Board will consider the comments received on proposed FSP FAS 142-c, “Application of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to Exchange Memberships” and whether to direct the staff to post that FSP to the FASB website as final.

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Board Meeting Handout
Proposed FSP on Issue 03-1
September 8, 2004
(Revised 9/8, 9:00 a.m.)

The FASB staff will ask the Board to consider the following implementation issues associated with interest rate impaired debt securities evaluated for impairment under paragraph 16 of EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (Issue 03-1):

1. At what unit of accounting should an investor assert its ability and intent to hold to a forecasted recovery?
2. Although Issue 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, paragraph 16 does not refer to the severity of the impairment. Is there a level of impairment that effectively can be considered temporary that would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery?
3. If an interest rate impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery:
 - a. When is the impairment considered other-than-temporary?
 - b. Are there circumstances for such a change in intent that do not call into question the investor’s intent to hold other securities to recovery?

Issue 1: At what unit of accounting should an investor assert its ability and intent to hold to a forecasted recovery?

The FASB staff will recommend that an investor assert its ability and intent to hold to a forecasted recovery at the individual security level, as stated in paragraph 16 of FAS 115.

Issue 2: Although Issue 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, paragraph 16 does not refer to the “severity” of the impairment. Is there a level of impairment that can effectively be considered temporary that would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery?

The FASB staff will recommend three alternatives. Under the first alternative, an entity focus on impairments that have a level of severity in which more than a normal change in interest rates over a relatively short period of time would not eliminate the impairment.

The level of normal interest rate fluctuation can be established by evaluating interest rate volatility, for a six-month period, for debt securities with the same term and credit rating.

Under the second alternative, interest rate impairments of five percent or less of the cost of a debt security would be treated as temporary.

Under the third alternative, an investor considers the severity of the impairment. If the severity of the impairment is minimal, the impairment can effectively be considered temporary.

An investor does not need to assert its ability and intent to hold an investment that is impaired temporarily.

Issue 3(a): If an interest rate impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, when is the impairment considered other-than-temporary?

The FASB staff will recommend that the impairment is considered other than temporary when the investor's assertion to hold an investment to a forecasted recovery is changed.

Issue 3(b): If an interest rate impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, are there circumstances for such a change in intent that do not call into question the investor's intent to hold other securities to recovery?

The FASB staff will recommend that changes in circumstances, such as discussed in paragraphs 8 and 11 of FAS 115, should not call into question the investor's intent to hold other securities to recovery. The FASB staff will also recommend that the following circumstances not call into question the investor's intent to hold other securities to recovery:

1. Unexpected and significant changes in liquidity needs,
2. Unexpected and significant increases in interest rates that significantly extend the period that a security would need to be held by the investor, and
3. A de minimus volume of sales of securities.

Transition

The FASB staff acknowledges that the effective date for applying paragraph 16 must be delayed prior to September 30, 2004. Therefore, the FASB staff will recommend that the Board issue two separate Board-Directed FSPs:

1. The first FSP, which would be subject to a 45-day comment period, would provide the implementation guidance. The guidance in this proposed FSP would be effective for other-than-temporary impairment evaluations of interest rate impaired debt securities analyzed under paragraph 16 of Issue 03-1 on the last reporting date for reporting periods ending after the final FSP is posted on the FASB website.
2. The second FSP, which would be subject to a 15-day comment period, would delay the effective date for the application guidance contained in paragraph 16 of Issue 03-1.