MINUTES

Financial Accounting Standards Board

To: Board Members

From: Stell (ext. 211)

Subject: Minutes of the August 13, 2003 Board Meeting **Date:** August 18, 2003

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

Topic:	Stock-Based Compensation: Definition of Grant Date, Cash-Settled SBC Arrangements, and Statement 150 Issues
Basis for Discussion:	Board memorandums dated July 18, 2003 and July 28, 2003
Length of Discussion:	9:00 a.m. to 10:25 a.m.
Attendance:	
Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Tovey
Other staff at Board table:	Cassel, Stell, and Miller
Outside participants:	Leisenring (IASB)

Summary for ACTION ALERT:

The Board discussed several issues relating to the definition of grant date and the accounting for and attribution of stock-based compensation (SBC) arrangements classified as liabilities. The Board reached the following decisions with respect to those issues:

- The definition of grant date in FASB Statement No. 123, *Accounting for Stock-Based Compensation* will be retained.
- The guidance in paragraph 39 of Statement 123 will be retained and subsequently revised, if necessary, based on the outcome of the Board's deliberations in Phase II of the Liabilities and Equity project.
- The guidance in FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, with respect to SBC awards with tax net-settlement features will be retained.
- The guidance on cashless exercises found in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44," will be retained.
- SBC arrangements with characteristics similar to financial instruments classified as liabilities under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, will be classified as liabilities.
- For public entities, SBC liabilities will be accounted for using fair value as the measurement attribute. The Board will consider this issue as it relates to nonpublic entities at a subsequent meeting.
- SBC liabilities will be attributed according to the method established in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, with the initial grant-date fair value of SBC liabilities and subsequent fluctuations in value characterized as compensation cost.
- The guidance in paragraph 39 as well as illustrations 7 and 8 of Statement 123 with respect to measurement and attribution of SBC arrangements with multiple settlement features will be retained and subsequently revised, if

necessary, based on the outcome of the Board's deliberations in Phase II of the Liabilities and Equity project.

Matters Discussed and Decisions Reached:

The Board discussed several issues relating to the definition of grant date and the accounting for and attribution of stock-based compensation (SBC) arrangements classified as liabilities.

Issue 1: Definition of Grant Date. The Board unanimously agreed with the staff's recommendation with respect to the definition of grant date, which encompasses the following:

- The definition of grant date from FASB Statement No. 123, *Accounting for Stock-Based Compensation*, will be retained (with some minor modifications). That definition requires that key terms and conditions exist and be understood by the employer and the employee.
- Active service should be a concurrent condition of establishing a grant date.
- In certain SBC arrangements, grant date may not be established until after service inception by the employee. Mr. Tovey noted that the final measurement of the SBC award's fair value would be delayed until grant date under such circumstances and attribution would occur, beginning on the service inception date, if the fair value of the award is reasonably estimable. He added that such SBC arrangements would be accounted for like variable awards under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, until grant date is established.

Issue 2: Meaning of Cash Settled. The staff recommended that the Board retain the guidance in paragraph 39 of Statement 123 and asserted that equity-settled SBC arrangements that require the issuing enterprise to purchase shares in the marketplace to satisfy those arrangements create substantive liabilities.

The Board discussed whether certain enterprise policies relating to SBC arrangements create substantive liabilities. Several Board members disagreed with the staff's recommendation, noting that the purchase of shares in the open market to satisfy SBC arrangements *may or may not* create a liability and do not change the nature of an equity-settled award. Ms. Schipper stated that the intent of an entity's management or past practices with respect to such arrangements also does not create a substantive liability. She added that the determination of whether to record a liability or an equity instrument should be made based on the contractual requirements (written terms) of the employee option plan and not on the notion of past practices, which is a concept contained in paragraph 39 of Statement 123.

Mr. Cassel cautioned Board members that such an approach as recommended by Ms. Schipper would create a form-over-substance issue. Mr. Schieneman stated that he was concerned about placing form-over-substance in these transactions, but believed that the issue would not be ultimately settled until the completion of Phase II of the Liabilities and Equity project. He suggested that the Board require stronger footnote disclosure to more adequately reflect the substance of such transactions.

All Board members agreed that the contractual terms of an arrangement should determine the type of accounting treatment (liability versus equity); however, Ms. Seidman and Mr. Herz noted that past practices also should be considered, as set forth in paragraph 39 of Statement 123. Mr. Trott raised the issue that if an employee has the option to require the issuing entity to repurchase shares on the open market to satisfy an option exercise, then the SBC award should be bifurcated, separating the award into an equity instrument and a put option (liability). Mr. Tovey pointed out that such bifurcation would not result in additional compensation expense because the fair value of an option to purchase an asset at the asset's fair market value upon exercise is zero.

Mr. Herz asked Board members to vote on the following three approaches for determining whether certain enterprise policies in relation to SBC arrangements create substantive liabilities: (1) consider only contractual requirements, (2) consider the components of the SBC arrangements separately (i.e., bifurcation into equity and liability components), and (3) retain paragraph 39 of Statement

123. Two Board members (KAS & GSS) voted for approach 1, two Board members (EWT & GMC) voted for approach 2, and three Board members (GJB, RHH, & LFS) selected approach 3. Mr. Herz then asked how many Board members would object to approach 3. Three Board members objected to approach 3 (GSS, KAS, & EWT).

Mr. Cassel noted that the Board could revise the guidance in paragraph 39 of Statement 123 if necessary based on the outcome of the Board's deliberations on Phase II of the Liabilities and Equity project.

Issue 3: Tax Net-Settlement. The Board discussed whether SBC awards with tax net-settlement features cause the SBC award (or a portion thereof) to be a substantive liability. The staff recommended that such awards be bifurcated into their cash- and equity-settled portions, but noted that as a result of the decisions reached on Issue 2, the guidance in FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, should be retained. Board members unanimously agreed to retain the guidance in Interpretation 44 with respect to SBC awards with tax net-settlement features.

Issue 4: Cashless Exercise. The Board then discussed whether SBC awards with cashless exercise features represent substantive liabilities. Mr. Tovey noted that EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44," establishes a definition for cashless exercises and provides guidance on the accounting treatment in which such transactions should receive. The staff recommended that the Board retain the guidance on cashless exercises found in Issue 00-23, and the Board members unanimously agreed.

Issue 5: Statement 150 – Put Options and SBC Arrangements Settled with a Variable Number of Shares. The Board discussed whether SBC arrangements with characteristics similar to financial instruments subject to FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, also should be classified as liabilities. The staff recommended that put options given to employees as part of SBC arrangements should be classified and accounted for as liabilities. The staff further recommended that SBC arrangements whose fair value is based solely or predominantly on something other than fluctuations in the fair value of the issuer's equity shares and that will be settled in a variable number of the issuer's equity shares should be classified and accounted for as liabilities. Board members did not object to either of the staff's recommendations.

Issue 6: Measurement Attribute of SBC Liabilities. The Board discussed the appropriate measurement attribute to use for SBC liabilities and unanimously agreed to account for such liabilities using fair value.

Issue 7: Attribution of SBC Liabilities. The Board agreed with the staff's recommendation that SBC liabilities be attributed according to the method established in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. The staff also recommended that the initial grant-date fair value of a SBC liability and subsequent fluctuations in value be characterized as compensation cost. Board members unanimously agreed with that recommendation as well.

Issue 8: Measurement and Attribution of SBC Arrangements with Multiple Settlement Features. The Board discussed this issue simultaneously with Issue 2. Mr. Tovey informed Board members that certain SBC arrangements give either the employer or the employee the choice of physical settlement, net-share settlement, or cash settlement. He added that if these features result in the issuing enterprise incurring an obligation to settle the award in cash or other assets, then the award should be classified as a liability. Similar to the decisions reached by the Board for Issue 2, Board members unanimously agreed to retain the guidance in paragraph 39 as well as illustrations 7 and 8 of Statement 123 with respect to such arrangements.

Follow-up Items:

None.

General Announcements:

None.