MINUTES

Financial Accounting Standards Board

To: Board Members

From: Stell (ext. 211)

Subject: EBC Minutes of the November 19, 2003 Board Meeting **Date:** November 26, 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: Income Taxes, Related Party Transactions, and Other Issues
Basis for Discussion:	Board memorandums dated November 6, 2003; November 7, 2003; and November 19, 2003
Length of Discussion:	10:25 a.m. to 12:00 p.m. and 3:00 p.m. to 4:00 p.m.

Attendance:

Board members present:	Herz, Batavick, Crooch (by phone), 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) Crook – IASB (by phone)

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

The Board discussed issues related to the accounting for income tax effects of equity-based compensation (EBC) arrangements, including the method of allocating those effects to the income statement and equity. The Board also discussed certain convergence issues, related party transactions, and the definition of share-based payment.

The Board decided that temporary differences related to the tax effects of a cash-settled stock appreciation right would be based on the arrangement's fair value and amount of compensation cost recognized in the financial statements.

The Board also made the following decisions that pertain to EBC awards classified as equity:

1. The tax effects of an EBC award classified as equity for which a tax deduction is received for the exercise-date fair value of the award would be calculated using the arrangement's grant-date fair value and the amount of compensation cost recognized in the financial statements.

2. If a deduction reported on a tax return for a stock-based award exceeds the cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction would be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, would be recognized in the income statement.

3. If a temporary difference is due to the measurement of compensation cost for financial reporting purposes occurring prior to the measurement of compensation cost for tax purposes, tax benefits related to the excess deduction would pertain to the equity transaction. If a temporary difference is due to any other circumstance, for instance, different measurement bases, different valuation methodologies, or tax incentives (but in no case due to different measurement dates), the income tax effects from those differences relate to the compensation transaction and would be accounted for in the income statement.

4. A deferred tax asset would be evaluated for future realization and would be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset would not be realized. Differences between (a) the deductible temporary difference computed and (b) the tax deduction inherent in the current fair value of the enterprise's stock would not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under the proposed Statement.

5. The imputed cash flow effects of excess tax benefits would be accounted for in the financing section of the cash flow statement. Consequently, FASB Statement No. 95, *Statement of Cash Flows*, would be amended to allow for such treatment.

In addition to the decisions pertaining to the accounting for income tax effects of EBC arrangements, the Board made decisions relating to (a) convergence issues relating to modifications and (b) certain EBC transactions involving related parties:

1. For situations in which an enterprise modifies a vesting condition of an EBC award classified as equity from a condition that was improbable of being achieved to a condition that is probable of being achieved (a Type III modification), an enterprise would compare the fair value of the old award immediately before the modification multiplied by the probability switch (100 percent or 0 percent) with the fair value of the new award multiplied by the probability switch and would recognize the incremental value. This decision reaffirms a previous Board decision made on September 17, 2003.

2. For an EBC award originally classified as equity that has been modified in such a way that the award meets the definition of a liability, an enterprise would not recognize less than the grant-date fair value of the original award unless the original vesting provisions would not have been met at the date of modification. That means that an enterprise would recognize compensation cost equal to the greater of the cash-settlement value of the liability award or the grant-date fair value of the original award. This decision reaffirms a previous Board decision made on September 17, 2003.

3. The reconveyance of an award from the employee to the employer would be recognized by the issuing enterprise as a credit in the income statement equal to the lesser of (a) the fair value of the award on the reconveyance date or (b) the recognized cumulative compensation cost associated with the award. Such reconveyances are nonreciprocal in nature. If an unvested award is reconveyed, then an enterprise would recognize all unrecognized compensation cost associated with the award on the date of reconveyance.

4. All transactions in which related parties or other economic interest holders of an enterprise grant EBC of that enterprise to employees of that enterprise would be analyzed to determine whether the enterprise benefits from the arrangement. If the enterprise benefits from such transactions, then such transactions would be accounted for as employee compensation cost paid by the enterprise and capital contributions received from related parties or other economic interest holders.

The Board also expressed support for the revised definition of share-based payment transaction, as well as language that would clarify the scope section of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Those revisions incorporate the suggestions of the Board made at its October 8, 2003 meeting.

Matters Discussed and Decisions Reached:

Income Taxes

Accounting for the Tax Effects of a Cash-Settled SAR: Mr. Tovey stated that in tax jurisdictions in which the deduction is based on the cash paid to the employee, the IASB has tentatively concluded that tax effects of a cash-settled SAR would be calculated using the arrangement's intrinsic value. He added that the FASB staff supports this conclusion as well. Board members discussed that accounting treatment and concluded that it did not support the position taken by the IASB. Mr. Trott and Mr. Schieneman proposed that a temporary difference related to the tax effects of a cash-settled SAR be recognized based on the fair value accounting amount recognized in the financial statements for compensation expense. Board members unanimously agreed with that proposal;

however, Mr. Herz expressed concern that the method does not provide for an impairment assessment of the deferred tax asset.

Accounting for the Tax Effects of an At-The-Money Stock Option: Mr. Tovey informed the Board that for tax jurisdictions in which the deduction is based on the exercise-date intrinsic value, the IASB has tentatively concluded that the tax effects of an at-the-money stock option would be calculated using the arrangement's intrinsic value. He added that the staff supports the IASB's conclusion because the staff believes that it is the theoretically correct accounting treatment under FASB Statement No. 109, *Accounting for Income Taxes*. However, at the October 15, 2003 Board Meeting, the FASB tentatively concluded that the tax effects of an at-the-money stock option would be calculated using the arrangement's fair value. The Board reconsidered its initial tentative conclusion and unanimously reaffirmed its October 15, 2003 decision.

Accounting for Income Tax Deficiencies (EBC Equity Awards): At the October 15, 2003 Board meeting, the Board tentatively concluded that income tax deficiencies[*] would be recognized in equity, whereas the IASB has tentatively concluded that income tax deficiencies would be recognized in the income statement. The staff recommended that the Board support the method of accounting for income tax deficiencies set forth in Statement 123, in which tax deficiencies are recognized in the income statement to the extent that such deficiencies cannot be offset against excess tax benefits recognized in equity from previous awards. The Board then considered and expressed its views on the positions held by both Boards.

Mr. Trott stated that his preference would be to account for income tax deficiencies on an option-by-option basis, as opposed to accounting for deficiencies on a portfolio basis. He added that any deficiencies (shortfalls) would be recognized in the income statement. He concluded his remarks by stating that the method in Statement 123 should be followed, except there should not be a "stopover" in the additional paid-in capital account to determine whether any excess tax benefits from previous awards exist.

[*] That is, the tax deduction realized is less than the tax associated with the cumulative compensation cost recognized in the income statement.

Ms. Seidman noted that she would continue to support the two-transaction view and believes that the differences between the book compensation expense and the tax deduction should be allocated to equity. She added that she is troubled by situations in which there is no tax deduction, so she expressed support for the method in Statement 123. In addition, she noted that the deficiencies should be viewed on a portfolio basis for simplicity, instead of on an individual award basis, and that the amount that is counted in additional paid-in capital should include all awards that are subject to the proposed Statement.

Mr. Schieneman stated that his initial preference would be to treat income tax deficiencies as compensation expense and to recognize the final tax benefit in the income statement and added that his preference would more than likely attack the two-transaction view. However, he stated that he would support the proposal set forth by Mr. Trott, which modifies the approach in Statement 123.

Mr. Crooch stated that he would continue to support the Board's tentative decision that all income tax deficiencies be recognized in equity. Mr. Batavick agreed, but noted that he would not object to the proposal outlined by Mr. Trott. Ms. Schipper expressed support for Mr. Trott's proposal, and Mr. Herz stated that he would support Ms. Seidman's proposal.

Mr. Herz noted that a small majority of Board members supported Mr. Trott's proposal and questioned the Board to determine if anyone would object to that proposal. Ms. Seidman and Mr. Herz both noted that they would object to the proposal set forth by Mr. Trott.

<u>Accounting for Deferred Tax Assets Prior to Realization (EBC Equity Awards)</u>: Mr. Tovey noted that the IASB has tentatively concluded that the deferred tax asset should be based on current share price information at each reporting date; that means that the deferred tax asset would take into account changes in stock price prior to realization and as a consequence, that an equity item would be recognized prior to realization for expected excess tax benefits. He stated that the FASB staff agrees with this position, and

noted that the IASB's approach would introduce an element of income statement volatility. He added that at the October 15, 2003 Board meeting, Board members tentatively concluded to retain Statement 123's method of accounting for deferred tax assets, which would recognize a deferred tax asset based on recognized compensation cost and true that amount up when the tax benefit is realized.

The Board discussed with the staff how the deferred tax asset would take into account changes in stock price prior to realization and the related accounting treatment. Board members ultimately decided to continue to support their tentative conclusion reached at the October 15, 2003 meeting, for accounting for deferred tax assets prior to realization, citing practical concerns (e.g., less complex to apply and less income statement volatility) as a major consideration in their decision making.

Accounting for Income Tax Effects–The Two-Transaction View: The Board considered and expressed its views on the accounting for income tax effects in the context of the two-transaction view. At the October 15, 2003 meeting, the Board tentatively concluded the following:

> If temporary differences are a result of a measurement date for tax purposes that is later than the measurement date for book purposes, then income tax benefits should be allocated to the income statement and equity under the two-transaction view. If temporary differences are a result of any other circumstance, then income tax benefits should be recognized in the income statement only.

The staff noted that the IASB has tentatively concluded the following:

> Income tax benefits of EBC equity awards resulting from temporary differences, regardless of form, shall be recognized in the income statement unless the tax deduction for tax purposes exceeds the tax deduction for book purposes. If the tax deduction for tax purposes exceeds the tax deduction for book purposes based on the recognized compensation cost, the excess tax benefit should be recognized in equity.

The staff indicated that it supports the FASB's decision on this matter because it provides the theoretical support for the two-transaction view. The Board discussed the relative merits of both approaches for accounting for income tax effects in the context of the two-transaction view, and agreed to continue to support its tentative conclusion made on October 15, 2003.

Accounting for Income Tax Effects in the Cash Flow Statement: Mr. Tovey informed the Board that the IASB has tentatively concluded to account for the imputed cash flow effects of excess tax benefits in the financing section of the cash flow statement. He added that the FASB staff supports that position but believes that Statement 95 be amended to allow for such treatment. The Board unanimously agreed with the IASB's tentative conclusion, as well as the staff's recommendation that Statement 95 would have to be amended to allow for such treatment.

Convergence with IASB on Accounting for Income Tax Effects: Board members discussed whether they would support convergence with the IASB based on the IASB's current position. Mr. Trott emphasized that convergence is a priority, and therefore, he would not object to convergence on all issues. Ms. Schipper and Mr. Crooch also indicated that they would not object to convergence. Ms. Seidman agreed that convergence is important; however, she noted significant differences between the IASB and FASB on several issues, leading her to support the FASB's position. Mr. Schieneman and Mr. Batavick both agreed with Ms. Seidman to support the FASB's position. Mr. Herz stated that he supports the FASB's position and specifically noted that he does not think that the IASB's method of interim accounting for deferred tax assets is correct.

Certain Convergence Issues: Type III (Improbable-to-Probable) Modifications, Equity-to-Liability Modifications, and Reconveyances

The Board discussed certain convergence issues including Type III (Improbable-to-Probable) modifications, Equity-to-Liability modifications, and reconveyances. Those issues were discussed at earlier Board meetings held on August 27, 2003, and September 17, 2003. The following paragraphs summarize the discussion by topic.

<u>Type III Modifications:</u> The Board discussed scenarios in which an enterprise modifies a vesting condition of an EBC award from a condition that was improbable of being achieved to a condition that is probable of being achieved. Under the FASB position (the FASB approach), an enterprise would compare the fair value of the old award immediately before vesting multiplied by the on-off probability switch percentage (100 percent or 0 percent) to the fair value of the new award multiplied by the on-off probability switch percentage and would recognize the incremental value. Mr. Tovey noted that the IASB believes that a modification should be viewed as changing the number of options expected to vest and such change should be dealt with through the truing up mechanism, rather than the calculation of incremental value. Mr. Tovey stated that the staff supports the Board's original decision and, therefore, does not recommend converging with the IASB because the staff believes that the principle put into place by the FASB is a stronger principle.

Mr. Trott expressed his support of the FASB's original position, noting that it would be a preferable approach to accounting for such modifications. Ms. Schipper stated that the FASB approach has the conceptual advantage of maintaining the fair value to fair value comparison associated with other types of modifications. She added that she understands the importance of convergence, but the Board should be as consistent as possible across all types of EBC arrangements. She concluded her remarks by stating that she agrees with Mr. Trott that the FASB approach is conceptually superior. Board members unanimously agreed to support the Board's original decision with respect to Type III modifications.

<u>Equity-to-Liability Modifications</u>: For an EBC award originally classified as equity that has been modified in such a way that it meets the definition of a liability, the Board tentatively concluded that an enterprise should never recognize less than the grant-date fair value of an award originally classified as equity unless the original vesting provisions would not have been met at the date of modification. This would mean that an enterprise would always recognize compensation cost equal to the greater of the cash-settlement value of the modified award or the grant-date fair value of the original award.

Mr. Tovey stated that the IASB has expressed concern with the tentative conclusion reached by the Board because under the position taken by the FASB, changes in a liability would potentially be recognized directly in equity. He added that the IASB would argue that changes in liabilities should be recognized in the income statement, which is consistent with other cash-settled liabilities.

Ms. Schipper indicated that even though neither the IASB nor FASB solutions to this issue are perfect, she would continue to support the Board's tentative conclusion for the accounting for equity-to-liability modifications because it is more internally consistent. The other Board members agreed with her comments, with the exception of Mr. Herz. He noted that he was sympathetic to the approach applied by the IASB because he was somewhat troubled by the FASB's approach.

<u>Reconveyances:</u> A reconveyance of an EBC award would occur when an employee who holds an EBC award voluntarily gives that award back to the issuing enterprise without receiving any other benefit from the issuing enterprise. Such transfers are nonreciprocal in nature.

The FASB tentatively concluded that a credit should be recognized by the issuer and limited to the lesser of the fair value of the award on the reconveyance date or recognized compensation cost attributable to the award.

Mr. Tovey stated that the IASB was concerned that any type of special accounting treatment for a reconveyance would be misapplied and added that the IASB does not accept that such a nonreciprocal transfer can exist. Therefore, the IASB would treat a reconveyance as a settlement of an award.

Several Board members questioned the staff about reconveyances of unvested awards, and specifically, the accounting treatment for such awards. Mr. Cassel stated that if the reconveyance is made while there is still unrecognized compensation cost outstanding, then that compensation cost should be recognized on the reconveyance. He emphasized that an enterprise would not be able to not recognize the unrecognized compensation cost. Mr. Cassel also stated that the guidance could be clarified to state that if the reconveyance is an award that is not fully vested, then the enterprise would have to recognize the unrecognized compensation cost, which would then make it the equivalent of a fully vested award (that is, only a fully vested award can be reconveyed). He concluded his remarks by stating that the enterprise would then recognize as a contribution, the lesser of the aggregate cost or the fair value of the instrument.

Ms. Schipper stated that she would continue to support the Board's tentative conclusion, revised for Mr. Cassel's clarifying comments. Mr. Trott, Mr. Batavick, and Ms. Seidman all agreed with Ms. Schipper's comments. Mr. Herz and Mr. Schieneman voted to converge with the IASB with respect to this issue, which would treat modifications as settlements.

Certain Related Party Transactions

The Board considered and expressed its views on the differing guidance associated with certain transactions described in the context of EBC arrangements found in Statement 123 and IASB Exposure Draft 2, *Share-based Payment*. The staff recommended that all transactions in which related parties or other economic interest holders of an enterprise grant EBC (based on financial instruments of the employer) to employees of the enterprise should be analyzed to determine whether the enterprise benefits from the arrangement. If the enterprise benefits from such transactions, then such transactions should be accounted for as employee compensation paid by the enterprise, and capital contributions received from related parties or other economic interest holders.

The Board agreed with the staff recommendations. However, Ms. Seidman and Mr. Cassel suggested that the guidance expand the number of grantors addressed in Statement 123. They both noted that the scope of the guidance be limited to the financial instruments that otherwise would be covered by the proposed Statement. In general, the Board agreed with that approach.

Definition of Share-based Payment and Applicability to Certain Transactions Involving Financial Instruments

This topic was first presented at the October 8, 2003 Board meeting, at which an issue was raised about whether Statement 123 would apply to transactions related to financial instruments. Mr. Tovey noted that Statement 123 is ambiguous in terms of whether it was ever meant to relate to situations in which an enterprise acquired financial instruments with its own financial instruments. He added that financial instruments are generally mentioned in Statement 123 as something other than goods or services, and Statement 123 does not reference financial instruments in its scope section.

As a result, the staff recommended the following definition of *share-based payment transaction*:

> **A transaction in which (a) the enterprise (i) exchanges its shares or other equity instruments, or incurs liabilities that are based on, at least in part,[1] the price of its shares or other equity instruments for (ii) goods or services* or (b) related parties or other economic interest holders of the enterprise enter into similar transactions that benefit the enterprise.**
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> ***The Board will address whether part (a)(ii) of the definition should include a reference to financial instruments in the second phase of the project on share-based compensation.**

The staff also recommended that the following wording be added to the paragraph 6 of Statement 123:

> This Statement applies to all **share-based payment transactions**. **This Statement also applies to all transactions in which an entity acquires goods or services that must or may be settled by issuing equity shares or other equity instruments.** Therefore, it applies to all transactions in which an entity grants shares of its common stock, stock options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan. [Footnote references omitted]

Ms. Schipper questioned whether the proposed definition was intended to apply only to exchanges with employees. She further questioned whether that definition would be applied broadly throughout all phases of the project. She also noted that it is important that the Board not inadvertently include issues related to nonemployees in the scope of the current phase of the project or incorporate confusing or ambiguous concepts from FASB Statement No. 57, *Related Party Disclosures*, into the proposed Statement.

Mr. Herz stated that he did not understand footnote 1 of the definition of *share-based payment transaction* and noted that it could be revised to provide more clarity. The staff agreed to clarify that guidance. The Board unanimously voted to support the staff's

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[1] This phrase refers to EBC arrangements that are indexed to (a) shares of the enterprise and (b) something other than (i) shares of the enterprise or (ii) a market, performance, or service condition.

proposed definition of *share-based payment transaction* as well as the revised language in the scope section of Statement 123.

Follow-Up Items:

None.

General Announcements:

None.