MINUTES

Financial Accounting Standards Board

To: Board Members

From: Stell (ext. 211)

Subject: EBC Minutes of the November 26, 2003 Board Meeting **Date:** December 23, 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: Disclosures (Public and Nonpublic Enterprises), Transition and Effective Date for Nonpublic Enterprises
Basis for Discussion:	Board memorandums dated November 14, 2003, November 18, 2003, and November 25, 2003
Length of Discussion:	10:15 a.m. to 11:35 a.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 and Zeyher
Other staff at Board table:	Cassel and Stell
Outside participants:	Leisenring (IASB) Willis (by phone)

<u>Summary of Decisions Reached</u>:

The Board discussed disclosure requirements relating to equity-based compensation (EBC) arrangements and affirmed its previous decisions that enterprises would be required to disclose information enabling a financial statement user to understand the following:

1. The nature and terms of the financial instruments granted and the rights and obligations embodied in those instruments
2. The fair value of the goods or services received, or the fair value of the equity instruments granted, during the period
3. The effect of expenses arising from EBC arrangements on the enterprise's income statement for the period
4. The cash flows related to EBC arrangements
5. The potential outcomes from EBC arrangements on the transfer of wealth from shareholders to equity award holders.

The Board also expressed support for certain revised specific disclosure requirements that are expected to be included in the proposed Statement. Those disclosures were revised to reflect the suggestions made by the Board in connection with the October 29, 2003 meeting. The Board suggested additional changes to the revised specific disclosure requirements; those suggestions are intended to reduce the volume of required disclosures related to EBC arrangements. The Board will consider the specific disclosure requirements revised for those suggestions at a future Board meeting.

The Board also discussed the effective date and method of transition for nonpublic enterprises and reached the following decisions:

1. The proposed Statement would be effective for all employee awards granted, modified, or settled after the beginning of the first fiscal year for fiscal years beginning after December 15, 2005. Early adoption would be permitted. Enterprises would be required to disclose the effect of the change from FASB Statement No. 123, *Accounting for Stock-Based Compensation,* to the proposed Statement in the year of adoption.

2. The method of transition required for awards that would be classified as equity under the proposed Statement would be described as a "prospective method"—that method would require expense recognition for all employee awards granted, modified, or settled after the beginning of the fiscal year in which the provisions of the proposed Statement are first applied.

3. The method of transition required for awards that would be classified as liabilities under the proposed Statement would be described as similar to a cumulative effect of a change in an accounting principle—under that method, a liability for awards outstanding at the effective date would be recognized at that date in the amount of the fair value or intrinsic value of those awards (as required by the proposed Statement). The cumulative effect adjustment also should reflect the effect of income taxes associated therewith.

Further, the Board discussed certain issues related to transition for both public and nonpublic enterprises and reached the following decisions:

1. In connection with EBC awards that would have been classified as equity under Statement 123 or APB Opinion No. 25, *Accounting for Stock Issued to Employees,* but would be classified as liabilities under the proposed Statement, (a) a cumulative effect of a change in an accounting principle would be recognized by initially measuring the liability at fair value or intrinsic value as required by the proposed Statement, and (b) if any amounts related to those awards have been previously recognized in equity, a liability would be established. This would be done by debiting equity to the extent of those previously recognized amounts and crediting such liability unless the liability's fair value or intrinsic value at the effective date exceeds the amount previously recognized in equity, in which case, a cumulative-effect adjustment would be recognized. If the liability's fair value or intrinsic value is less than the amount previously recognized in equity, no cumulative-effect adjustment would be recognized.

2. In connection with certain awards with graded vesting that are not attributed according to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, (because the enterprise elected to

attribute the compensation cost using the straight-line method) and that are unvested as of the effective date of the proposed Statement, these awards would continue to be attributed using the original provisions of Statement 123.

Matters Discussed and Decisions Reached:

Disclosure Requirements

The Board considered and expressed its views on the specific disclosure requirements that would be included in the proposed Statement. The Board reaffirmed its previous decisions that enterprises would be required to disclose information enabling a financial statement user to understand the following:

1. The nature and terms of the financial instruments granted and the rights and obligations embodied in those instruments
2. The fair value of the goods or services received, or the fair value of the equity instruments granted, during the period
3. The effect of expenses arising from EBC arrangements on the enterprise's income statement for the period
4. The cash flows related to EBC arrangements
5. The potential outcomes from EBC arrangements and the transfer of wealth from shareholders to equity award holders.

The Board also discussed a draft of those disclosure requirements which incorporated the suggestions made by Board members at the October 29, 2003 meeting. The Board expressed support for the proposed disclosure requirements and made several recommendations for revising those disclosures.

The Board expressed support for decreasing the amount of disclosures that an enterprise would be required to prepare because compensation cost would be recognized as a result of the proposed Statement. The Board agreed to limit the requirement for a reconciliation of EBC activity to one year, that is, the current year for which financial statements are presented. The Board also recommended that the staff eliminate the requirement that a range of exercise prices be presented for all awards outstanding and awards exercisable. The Board also recommended that the aggregate intrinsic value of all awards exercised during the period be disclosed.

The Board noted that comparability of information is paramount and agreed that pro-forma disclosures for all periods presented in which Opinion 25 was applied should be retained. The staff agreed to revise the disclosures to include those comments and suggestions made by the Board; the Board will review those revised disclosures at a subsequent Board meeting.

Transition Provisions for Nonpublic Enterprises (EBC Equity Awards)

The Board considered the three following alternative transition methods for nonpublic enterprises related to EBC awards classified as equity:

<u>Alternative 1: Prospective Method</u>

> Apply the recognition provisions to all employee awards granted, modified, or settled after the beginning of the fiscal year in which the recognition provisions are first applied. This alternative would provide prospective expense recognition for all new awards as of the effective date.

<u>Alternative 2: Modified Prospective Method</u>

> Recognize share-based employee compensation cost from the beginning of the fiscal year in which the recognition provisions are first applied as if the fair value-based accounting method in the proposed Statement had been used to account for all employee awards granted, modified, or settled in fiscal years beginning after December 15, 1994. This alternative would provide prospective expense recognition for all new awards and also include expense recognition for the unvested portion of prior awards as of the effective date. No cumulative effect of a change in accounting principle would be recognized and prior periods would not be adjusted.

<u>Alternative 2′: Modified Prospective Method Prime</u>

> Recognize share-based employee compensation cost from the beginning of the fiscal year in which the recognition provisions are first applied as if the provisions of the proposed Statement had been used to account for all employee awards granted, modified, or settled in fiscal years beginning after December 15, 1994. This alternative would provide prospective expense recognition for all new awards as of the effective date. No cumulative effect of a change in accounting principle would be recognized and prior periods would not be adjusted. As of the effective date, compensation cost related to the nonvested portion of awards outstanding as of that date would be based on the grant-date value of those awards as calculated under the original provisions of Statement 123.

The staff recommended that the Board select Alternative 2′ and the Board discussed that recommendation. Mr. Trott expressed support for Alternative 1 and noted that mixing minimum value and fair value attributes together would be cumbersome for nonpublic enterprises to apply, so Alternative 1 would be a preferable method of transition. Board members unanimously agreed with Mr. Trott's comments and voted to support Alternative 1 as the transition method for nonpublic enterprises related to EBC awards classified as equity.

Transition Provisions for Nonpublic Enterprises (EBC Liability Awards)

For those EBC awards that would be classified as liabilities, the staff recommended that a cumulative effect of a change in an accounting principle be recognized by initially measuring the liability at fair value or intrinsic value as required by the proposed Statement. However, if any amounts had been previously recognized in equity for that instrument, the liability would be established by debiting equity and crediting the liability. To the extent that the liability's fair value or intrinsic value exceeds the amount taken from equity, a cumulative effect adjustment (a debit to the income statement) would be recognized. If the liability's fair value or intrinsic value is less than the amount taken from equity, no cumulative effect adjustment would be recognized (that is, the only entry would be to debit equity and credit the liability for the fair value or intrinsic value).

The staff also recommended that for EBC awards that would be classified as liabilities under Statement 123's original provisions, and if the nonpublic enterprise elects fair value treatment, a cumulative effect of a change in an accounting principle be recognized by initially measuring the liability at fair value as required by the proposed Statement as of the effective date. The Board discussed and unanimously agreed with both staff recommendations.

Effective Date of the Proposed Statement for Nonpublic Enterprises

The staff recommended that the proposed Statement be effective for nonpublic enterprises for all new awards after the beginning of the fiscal year that begins after December 15, 2005, noting that the proposed date would be one year after the effective date for public enterprises. Early adoption would be permitted. Enterprises would be required to disclose the effect of the change from Statement 123 to the proposed

Statement in the year of adoption. The Board unanimously agreed with that staff recommendation.

Transition for Awards That Were Classified as Equity under the Original Provisions of Statement 123, but Are Classified as Liabilities under the Proposed Statement

Ms. Zeyher noted that this issue is effectively the same issue that was addressed in Issue 3, except it would be applied to public enterprises as well. Again, the staff recommended that (a) a cumulative effect of a change in an accounting principle would be recognized by initially measuring the liability at fair value or intrinsic value as required by the proposed Statement, and (b) if any amounts related to those awards have been previously recognized in equity, a liability would be established. This would be done by debiting equity to the extent of those previously recognized amounts and crediting such liability unless the liability's fair value or intrinsic value at the effective date exceeds the amount previously recognized in equity, in which case, a cumulative effect adjustment would be recognized. If the liability's fair value or intrinsic value is less than the amount previously recognized in equity, no cumulative effect adjustment would be recognized (that is, the only entry will be to debit equity and credit the liability for the fair value). The Board unanimously agreed with that staff recommendation.

Transition for Awards with Graded Vesting

Ms. Zeyher noted that under Statement 123, the expense of an EBC award with graded vesting could be recognized using the straight-line method (if the valuation was performed using the weighted-average expected life of the entire award). Under the proposed Statement, the valuation would have to be based on the tranche-specific expected terms; hence, the expense would be recognized using the model set forth in Interpretation 28. She added that that provision would result in more expense recognized earlier in the award's life than under the straight-line method allowed by Statement 123's original provisions. Ms. Zeyher recommended that Statement 123's original attribution also should be respected for those awards. The Board unanimously agreed with the staff's recommendation on this issue.

Follow-Up Items:

None.

General Announcements:

None.