MINUTES

To: Board Members

From: Miller (ext. 211)

Subject: Minutes of the October 22, 2003 Tripartite AcSB/FASB/IASB Share-Based Payment (EBC) Board Meeting **Date:** November 3, 2003

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

Topic:	Share-Based Payment (EBC) Convergence Issues: (1) Accounting for Income Tax Effects of EBC arrangements and (2) Reload Features
Basis for Discussion:	Joint Board Agenda Papers 9, 9A, and 9B
Length of Discussion:	3:15 p.m. to 5:45 p.m.
Attendance:	
Board members present:	AcSB: Cherry, Bowman, Cetkovski, Craven, Geremia, Lefrancois, Pare, Pahapill, Scott FASB: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott IASB: Tweedie, Barth, Bruns, Cope, Garnett, Gélard, Jones, Leisenring, McGregor, O'Malley, Schmid, J. Smith, Whittington, Yamada
Board members absent:	None
Staff in charge of topic:	Tovey (FASB) and Crook (IASB)
Other staff at Board table:	Cassel, Rohrkemper (FASB), Bugg (IASB)
Outside participants:	None

Summary for ACTION ALERT:

In a tripartite meeting of the AcSB, FASB, and IASB, the Boards discussed certain convergence issues arising from the FASB's and IASB's respective projects on accounting for share-based payments (SBPs) (equity-based compensation). Those issues included accounting for the income tax effects of SBP arrangements and the fair value measurement of an option award with reload features. The FASB and IASB reached the following decisions:

1. After the FASB has completed all phases of its project on equity-based compensation (EBC) and the FASB and IASB have completed their projects related to the classification of liabilities and equity, the IASB and FASB would undertake a convergence project with the objective of eliminating any remaining differences between international and U.S. SBP standards.

2. Tax effects of SBP transactions, depending on the nature of the tax deduction, relate to both an income statement (compensation expense) and an equity transaction; therefore, in those circumstances, the income tax effects of the SBP award should be allocated between the income statement and equity. The FASB and IASB Boards did not reach a decision on (a) the income-tax-effect allocation method and (b) how to account for income tax effects prior to tax realization. The IASB and FASB Boards directed their respective staffs to prepare a joint memorandum on these issues for reconsideration at future FASB and IASB meetings.

3. The fair value of a reload feature would not be incorporated into the estimate of the award's grant-date fair value. As a result, subsequent grants of new awards under the reload feature should be accounted for as new awards on their respective grant dates.

Matters Discussed and Decisions Reached:

Convergence Issues

The AcSB, FASB, and IASB, (the "Boards"), discussed the convergence issues arising from the FASB's and IASB's respective projects on accounting for SBP (EBC). The Boards acknowledged the high degree of convergence that has been achieved on most of the the key issues in the project, including:

a. Mandatory recognition of expense arising from SBP

b. Expense applied based on the grant-date fair value measurement of the SBP transactions

c. Expense recognized over the service period of the award

d. Accounting for cash-settled SBP transactions.

The staff acknowledged that although convergence has been achieved on the bulk of the key issues of the SBP project, some outstanding convergence issues remain relating to liabilities and equity, nonemployee transactions, and other issues arising from the outcome of future independent meetings of the Boards.

The FASB will be issuing its proposed standard to amend FASB Statement 123, *Accounting for Stock-Based Compensation*, in Exposure Draft form. The FASB will consider comments received on the Exposure Draft and redeliberate its decisions before issuing its final standard. Once the FASB and IASB have final standards on EBC and on the classification of liabilities and equity, the staff noted that it would be possible to identify and resolve any convergence issues related to the items in the preceding paragraph.

A FASB Board member stated that the FASB planned to issue its EBC standard, with respect to transactions with employees only, with an effective date of January 1, 2005. This would be the same anticipated effective date for the IASB standard on SBP. The FASB's existing guidance with respect to transactions with nonemployees would continue to apply until completion of the second phase of its project.

The IASB and FASB unanimously agreed to consider certain convergence issues, such as those relating to liabilities and equity, nonemployee transactions, and other issues arising from the outcome of future independent meetings of the Boards, in a convergence project on SBP and EBC in the future, after the issuance of final standards on SBP and EBC and the classification of liabilities and equity by both Boards.

Income Taxes

The Boards then addressed the treatment of tax effects arising from SBP transactions.

At the IASB's September Board meeting, the IASB agreed to retain the proposed approach in Exposure Draft 2, *Share-based Payment*, that all tax effects of SBP transactions be recognized in the income statement. This decision was based on the premise that all tax effects relate solely to an income statement item, compensation expense, and, therefore, all of the tax effects should be recognized in the income statement.

The FASB recently agreed to retain the accounting treatment specified in Statement 123 that, based on U.S. tax law, tax effects are related to both an income statement item (compensation expense) and an equity transaction from the enterprise's perspective. Statement 123 requires that realized tax benefits in excess of the expected tax benefits associated with the total amount of compensation expense recognized in the income statement be credited directly to equity as additional paid-in capital (APIC). However, if the tax benefit realized is less than the expected tax benefits associated with the total amount of compensation expense recognized in the income statement, Statement 123 requires that the write-off of the related deferred tax asset be recognized in the income statement, except to the extent that excess tax benefits from prior EBC transactions exist in APIC to offset the write-off: the FASB agreed to change Statement 123's method, requiring the write-off of the related deferred tax asset to be recognized directly in equity.

In reaching those decisions, both Boards considered their respective tax standards, FASB Statement No. 109, *Accounting for Income Taxes,* and IAS 12, *Income Taxes*. The staff explained that both tax standards apply most of the same basic principles regarding the recognition of deferred tax assets and liabilities and the recognition of temporary differences. Both tax standards also require the entity to account for the tax effects of transactions or events in the same way as the entity accounts for those transactions and events themselves.

Nature of the Transaction

The first issue considered with respect to the treatment of tax effects was the nature of the transaction, specifically contemplating circumstances in which the measurement date used for tax purposes occurs later than the measurement date used for book purposes.

When a temporary difference is generated because the measurement date for tax purposes is later than the measurement date for book purposes, the FASB's view is that excess or deficit[1] tax benefits pertain to the equity transaction. The IASB's view is that excess or deficit tax benefits pertain to an income statement item. If temporary differences are generated because of different measurement bases, different valuation methodologies, or tax incentives (but in no case due to a different measurement date), the view of both the FASB and the IASB is that the tax effects from such differences relate to the compensation transaction and should be accounted for in the income statement.

Some Board members said that given the present tax standards of the FASB and the IASB, Statement 109 and IAS 12, respectively, and the grant-date measurement approach, they believe it most appropriate to recognize in equity tax benefits arising from fluctuations in the share price subsequent to the grant-date measurement of fair value.

One Board member stated that every conceivable tax regime could not be considered when applying an approach: and that, as such, the Boards should enunciate a principle. He suggested a principle that tax effects resulted because of an equity transaction between an employer and an employee acting as a shareholder; hence, tax effects relate to both an income statement item (compensation expense) and an equity item (payment in shares), and that, therefore, all tax effects should be allocated between the income statement and equity.

Other Board members viewed the tax effects as arising from the one transaction of renumeration transaction for employee services and that not recognizing the tax effects of SBP in the income statement would understate income and assets, and, thereby, net

[1] This term is used as shorthand to describe a situation in which the tax benefits realized from an EBC arrangement based on the cumulative compensation cost recognized in the income statement are less than those expected to be realized.

assets, resulting in financial statements that were not representationally faithful of the economics of the enterprise.

Concern was expressed by other Board members with the potential under the two-event approach of tax affecting an expense for accounting purposes where no tax effect had resulted for income tax purposes.

Other Board members expressed the view that the employer-employee relationship gives rise to compensation expense, and that upon the exchange of the employee's services for an equity instrument (option), the employee becomes an equity participant. They agreed that all changes in the value of the equity instrument subsequent to its grant accrue to the employee as an equity participant, and have no effect on the compensation expense previously recognized. Therefore, they believe that the tax effects of those changes in value relate to an equity item and should not be recognized in the income statement.

Board members discussed how the tax effects arising from the SBP transaction would be reflected in the operating section of the statement of cash flows under US GAAP, although certain FASB Board members acknowledged that this classification would likely be reconsidered pending the final outcome of accounting for income taxes.

A few Board members asserted that if changes in value are due to equity, then all tax effects should go to equity and no allocation should be performed. It was stated that an allocation may be inappropriate if there is not a practical method of discerning the mechanism driving the tax deduction.

The FASB staff reminded the Boards that convergence on this issue was paramount to achieving convergence on EBC accounting as a whole. It was asserted that the result of not reaching convergence on the issue of tax effects would overwhelm existing convergence achievements.

All of the FASB Board members reaffirmed and a majority of IASB Board members agreed that income tax effects of SBP transactions relate to both an income statement item (compensation expense) and an equity transaction, and, therefore, the tax effects of the SBP award should be allocated between the income statement and equity. Many members stated that this decision was made in the interest of convergence rather than by a belief of the conceptual superiority of one method over another. Others agreed to this decision provided that a logical and workable approach for allocating tax effects to the income statement and equity could be defined and agreed upon.

Allocation of Tax Effects

The IASB staff summarized four alternative tax allocation methods based on the current allocation method in Statement 123, a revised Statement 123 allocation method reflecting recent FASB decisions, an IASB staff proposed allocation method, and an FASB staff proposed allocation method. Board members were asked to focus on the differences between the allocation methods, which were summarized by the IASB staff as follows:

1. The interpretation of tax legislation that bases the tax deduction on the difference between the share price and the exercise price at exercise date; that is, whether this difference represents an intrinsic value or fair value measurement basis, given that intrinsic value and fair value are the same upon exercise. This interpretation would affect the amount of the deduction that would be credited to equity.

2. The treatment of deficit tax benefits. Statement 123 generally recognizes the tax effects of a deficit in the income statement (but sometimes in equity). The IASB staff proposed method always recognizes the tax effects of the shortfall in the income statement. The revised Statement123 method and the FASB staff proposed method always recognize the tax effects of the shortfall in equity.

3. The recognition of the deferred tax asset between the date when the expense is recognized and the date when the tax deduction is received. The Statement 123 method and the revised Statement 123 method do not take into account the current share price when measuring the deferred tax asset (for either recognition or impairment related to share price purposes) and, hence, do not consider whether the tax asset is expected to be realized as a result of share price fluctuation. Both the IASB and the FASB staffs' proposed methods base the deferred tax asset on the expected future tax benefits, based on the current share price. The IASB staff's proposed method recognizes a deferred tax asset for the expected future tax benefit relating to compensation expense only, not the equity item, whereas the FASB staff's proposed method recognizes a deferred tax asset for the expected future tax benefits relating to both compensation expense and the equity item.

Some Board members expressed concern with the recognition of a tax benefit in the income statement that was higher than the actual tax benefit received. Other members questioned why the tax benefits recognised for any recognized expense that is not ultimately tax deductible should not be reversed in the income statement.

One FASB staff member commented that under the two-event approach, any unrealized tax benefits ultimately represent a reduction in the issuance proceeds of the equity transaction. Conversely, any excess tax benefits realized represented additional issuance proceeds of the equity transaction.

Some Board members asserted that the U.S. Tax Code does not allow a deduction for the time value of an EBC award. One Board member noted that at the exercise date, the time value of an option does not have any relevance because it has been eliminated. That Board member added that some might consider that as a different measurement basis, but she does not. She emphasized that as the measurement date goes further and further into the future, the measurement date approaches the exercise date. Upon exercise, an employee would sacrifice the remaining time value, if any, to obtain the intrinsic value. She concluded that such an event does not constitute a different measurement basis but is a different (later) measurement date; hence, fair value and intrinsic value are the same measurement basis upon exercise (at the exercise date). She stated that income tax benefits should be recognized for at-the-money options based on their grant-date fair values. In addition, she noted that excess or deficit tax benefits for an at-the-money option that is subsequently exercised to obtain a positive intrinsic value should be recognized through equity. Furthermore, there would be an initial recognition of a deferred tax asset that would be a function of the fair value of the at-the-money option even though it has no intrinsic value.

Other Board members expressed concern regarding how to account for a financial instrument which contains eroding time value, such as a cash share appreciation right (SAR). Some members said that this was a bigger picture question, with implications that the members did not feel they clearly understood.

The Board members did not reach a decision on the income-tax-effect allocation method. The IASB and FASB Boards directed their respective staffs to prepare a joint memorandum on these issues for reconsideration at future FASB and IASB meetings.

Tax Effects Prior to Realization

The members discussed the interim accounting of income tax effects prior to realization. Specifically, the members considered and expressed their views on the two following alternative methods of reporting income tax effects prior to their realization.

a. The first method would subject the deferred tax asset to a type of impairment test if the tax deduction inherent in the stock price at the reporting date is less than the stock price at grant date.

b. The second method would recognize expected excess tax benefits or tax benefit deficiencies through equity for temporary differences that change as a result of stock price changes after the grant date and prior to the realization of the tax effects. That method also would implicitly subject the deferred tax asset to the same type of impairment test as in Method A above.

Some members expressed concern that recognizing the expected excess tax benefits or tax benefit deficiencies through equity (Method B) would introduce unwanted volatility into equity.

Other members expressed a preference for Method A, which would establish a deferred tax asset that is a function of the compensation expense recognized and the effective tax rate of a particular jurisdiction. Some members noted that this method would not permit an enterprise to make subsequent adjustments based on the changes in the underlying stock price. Those members also questioned the appropriateness of applying an impairment test to a deferred tax asset based solely on stock price fluctuations, which in and of themselves may not provide sufficient evidence that a deferred tax asset has been impaired.

Board members noted the treatment of tax effects prior to realization is related to the decision regarding allocation of the tax effects arising from equity-based compensation arrangements. Board members also did not reach a decision on the treatment of tax effects prior to realization. Members directed their respective staffs to discuss both the treatment of tax effects prior to realization and income-tax-effect allocation methods in a joint memorandum. The members agreed to reconsider both issues at future FASB and IASB meetings.

The IASB staff commented that postponing decisions on accounting for income tax effects would affect the appendix of the proposed Statement and would not likely cause any delay in drafting or the timing of the completion of the project.

Awards with a Reload Feature

The Boards then discussed how to account for options with reload features.

The FASB Board discussed reload features at the September 10, 2003 Board meeting and decided to retain the guidance in Statement 123 that all reload grants should be treated as new awards.

The IASB Board discussed reload features at its July meeting and tentatively agreed to retain the proposal in ED 2 that the fair value impact of a reload feature at grant date would be incorporated into the estimate of the award's fair value unless it is not deemed practicable.

The FASB and IASB staffs presented members of the Boards with a third alternative that would prescribe the accounting treatment of reload grants dependent on nonmarket-based vesting conditions as new grants and incorporate the fair value impact of a reload feature dependent on market-based vesting conditions into the award's grant-date fair value.

One Board member said that based on academic studies she had read, valuation of a reload award with a performance-based vesting condition would be impracticable as such a valuation would require (1) knowledge of an employee's wealth portfolio (it would affect their preference for a reload award where the employee would be exchanging mature vested shares for new share options) and (2) an assumption of the value and quantity of mature shares at the time of the achievement of the performance condition that gave rise to the reload award. That Board member believes that, in most cases, it would be impracticable to measure the grant-date fair value of an option with a reload feature.

Members generally agreed that the advantage of treating a reload option as a new award was simplicity. The FASB and IASB Boards noted that they could not anticipate the treatment for every compensation plan variable that might develop and the Statement 123 treatment of reload awards would reduce complexity in application.

The majority of the IASB and FASB Board members agreed that the fair value impact of a reload feature should not be incorporated into the estimate of the award's grant-date fair value, rather, subsequent grants of new awards under the reload feature would be accounted for as new awards on their respective grant dates.

Follow-up Items:

None

General Announcements:

None