FASB Emerging Issues Task Force

Issue No. 04-12

Title: Determining Whether Equity-Based Compensation Awards Are Participating Securities

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Previously distributed EITF materials: None

References:

FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123)

FASB Statement No. 128, *Earnings per Share* (FAS 128)

Proposed FASB Statement, *Share-Based Payment*, March 2004

APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25)

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*" (Issue 03-6)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Background

1. FAS 128 provides guidance on the calculation and disclosure of earnings per share (EPS). FAS 128 defines EPS as "the amount of earnings attributable to each share of common stock," and indicates that the objective of EPS is to measure the performance of an entity over the reporting period. In its deliberations of FAS 128, the Board decided to require the use of the two-class method of computing EPS for those enterprises with participating securities or multiple classes of common stock.

2. Paragraph 60(a) of FAS 128 provides the following description of participating securities:

> Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

Paragraph 61 of FAS 128 adds the following:

> The if-converted method shall be used for those securities that are convertible into common stock if the effect is dilutive. For those securities that are not convertible into a class of common stock, the "two class" method of computing earnings per share shall be used. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that method:
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> a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends).[25]
> b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.
> c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.
> d. Basic and diluted EPS data shall be presented for each class of common stock.

> For the diluted EPS computation, outstanding common shares shall include all potential common shares assumed issued. Illustration 6 in Appendix C provides an example of that provision.
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> [25]Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

3. In Issue 03-6, the Task Force addressed a number of issues related to the application of paragraphs 60 and 61 of FAS 128, including:

> Issue 2—How a participating security that requires application of paragraph 61 of Statement 128 should be defined.
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> Issue 2(a)—Whether all potential common shares, that is, securities or other contracts that may entitle their holders to obtain common stock (such as options, warrants, forwards or other contracts to issue common stock), may be participating securities.
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> Issue 2(b)(i)—Whether dividends or dividend equivalents paid to the holder of a convertible security that are applied to either reduce the conversion price or increase the conversion ratio of the security represent participation rights.
>
> Issue 3—How undistributed earnings should be allocated to a participating security.

4. In Issue 03-6, the Task Force reached a consensus that a participating security is a security that may participate in undistributed earnings with common stock in its current form, whether that participation is conditioned upon the occurrence of a specified event or not. The Task Force also observed that the form of participation does not have to be a dividend for a security to qualify as participating—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend. The Task Force also reached consensus in Issue 03-6 that dividends or dividend equivalents transferred to the holder of a convertible security or other contract (security) to issue an entity's common stock in the form of a reduction to the conversion price or an increase in the conversion ratio, are not participation rights.

5. The Task Force reached the following consensus on Issue 2(a) of Issue 03-6:

> The Task Force decided to discontinue discussion of Issue 2(a) noting that potential common shares, that is, securities or other contracts that may entitle their holders to obtain common stock (such as options, warrants, forwards, or other contracts to issue common stock), may be participating securities if they meet the definition of a participating security in their current form (that is, prior to exercise or settlement) as set forth in Issue 2. However, the Task Force reached a consensus that stock-based compensation subject to the provisions of Opinion 25 and Statement 123, including options and non-vested stock, that contain a right to receive dividends declared on the common stock of the issuer, are not subject to the guidance in this Issue until such time as those options or shares are fully vested.

6. Questions have been raised regarding the consensus reached on instruments issued as stock-based compensation. Some interpreted the consensus to indicate that unvested instruments were not participating securities while others believed the consensus only indicated that Issue 03-6 did not provide guidance on unvested equity-based compensation awards.

7. At the September 29–30, 2004 meeting, the Task Force agreed that Issue 03-6 provides no guidance about whether unvested instruments that are issued as stock-based compensation are participating securities. The Task Force acknowledged that instruments issued as equity-based compensation possess certain characteristics that are different from the instruments addressed in Issue 03-6, such as vesting, and agreed to add to its agenda an Issue to address whether such instruments, including options and unvested restricted stock, that receive dividends declared on common stock are participating securities.

Accounting for dividends or dividend equivalents

8. Based on the consensus reached by the Task Force in Issue 2 of Issue 03-6 that the form of participation does not have to be a dividend for a security to qualify as participating, the FASB staff believes that the accounting for dividends or dividend equivalents declared or paid on an instrument issued as equity-based compensation does not affect whether that instrument is a participating security. However, for background, the FASB staff has summarized the accounting for such dividends and dividend equivalents on equity-based compensation awards below.

9. Paragraph 31 of FAS 123 requires an entity to charge retained earnings for dividends or dividend equivalents paid to employees on the portion of an equity award that vests. FAS 123 also requires an entity to recognize compensation expense for nonforfeitable dividends or dividend equivalents paid on equity awards that do not vest. An entity may choose to either estimate forfeitures at the grant date or recognize the effect of forfeitures as they occur. Recently, the Board reaffirmed a tentative decision to carry forward this guidance in its project on equity-based compensation with the exception that entities will be required to estimate forfeitures at the grant date.

10. Under APB 25 and related interpretations, dividends, or dividend equivalents may be charged to retained earnings or recognized as compensation expense depending on the form of the equity-based instruments (that is, stock option, unvested stock, or other instruments) and depending on whether the dividend or dividend equivalent is forfeitable.

Scope

11. This Issue addresses when unvested instruments issued as equity-based compensation that provide the right to receive a dividend or dividend equivalent with common stock may be participating securities. This Issue does not address vested equity-based compensation. Vested equity-based compensation was addressed in Issue 2(a) of Issue 03-6.

Accounting Issues and Alternatives

Issue 1: Whether unvested instruments issued as equity-based compensation (including options and non-vested stock) that provide the right to participate in dividends or dividend equivalents with common stock of the issuer are participating securities if the right to the dividends is contingent on factors other than employee service and the passage of time. For example, if such right is contingent on the exercise of a stock option or the achievement of specified performance targets (including those embedded in the vesting feature of a host instrument).

12. The FASB staff believes that such instruments are not participating securities based on the consensus reached in Issue 2(b)(i) of Issue 03-6. In Issue 2(b)(i), the Task Force concluded that

securities are not participating securities if the right to receive value when dividends are declared on the issuer's common stock is contingent. Specifically, the Task Force noted that a transfer of value contingent on the exercise of an option or warrant is not a participation right. The FASB staff believes that contingencies, other than vesting based only on employee service and the passage of time, that impact whether value is transferred are not participation rights. The FASB staff will ask Task Force members whether they agree that a right to participate in dividends or dividend equivalents that is contingent on factors other than service and the passage of time is not a participation right.

13. The FASB staff acknowledges that some might view vesting that is based only on employee service and the passage of time as a contingency that would preclude a related right to receive dividends from being a participation right, similar to contingencies that require satisfaction of performance or stock price targets. However, the FASB staff believes that such vesting provisions are unique to employee compensation arrangements and, therefore, are outside the scope of Issue 03-6. Accordingly, as part of Issue 2, the FASB staff will ask the Task Force to consider whether rights to dividends that require only employee service and the passage of time should be considered participation rights.

Issue 2: Whether unvested instruments issued as equity-based compensation (including options and non-vested stock) that provide the right to participate in dividends or dividend equivalents with common stock of the issuer are participating securities if the right is nonforfeitable or contingent only on employee service and the passage of time.

View A: Unvested equity-based compensation awards are not participating securities.

14. Proponents of View A believe that unvested equity-based compensation awards are not participating securities. Proponents of View A believe treatment of unvested equity-based compensation awards as participating securities would be inconsistent with FAS 128, which states that fixed awards (as defined in FAS 123) and nonvested stock are considered options and should be included in diluted EPS using the treasury stock method.

15. Opponents of View A note that FAS 128 prescribes the treatment of other participating securities in diluted EPS and, accordingly, they believe that whether FAS 128 prescribes treatment is not relevant in determining whether a security is participating. They also note that, when the right to receive the dividend is nonforfeitable, View A would result in different accounting treatment for economically similar instruments depending on whether the instrument is issued to an employee or non-employee. That is, an equity-based award issued to a non-employee and that provides a nonforfeitable right to dividends is within the scope of Issue 03-6 and is a participating security per the guidance therein.

View B: Unvested equity-based compensation awards that provide the nonforfeitable right to participate in dividends or dividend equivalents with common stock of the issuer are participating securities. Other unvested equity-based compensation awards are not participating securities.

16. Proponents of View B believe that unvested instruments issued as equity-based compensation meet the definition of participating securities in Issue 2 of Issue 03-6 when the instruments provide a nonforfeitable right to participate in dividends or dividend equivalents with common stock of the issuer. That is, the employee is entitled to the dividend regardless of whether (a) the employee vests in the underlying equity-based award or (b) an underlying contingency is met. They point to the arguments set forth by the Task Force in Issue 2(b)(i) of Issue 03-6 that a security with the noncontingent right to receive value when dividends are declared on the issuer's common stock is a participating security.

17. Additionally, proponents of View B note that, in Issue 2(a) of Issue 03-6, the Task Force indicated that any potential common share may be a participating security if that security meets the definition in Issue 2 of Issue 03-6 in its current form. Proponents of View B interpret this to mean that the extent to which the potential common shares are, or are expected to become, issuable is not relevant to the determination of whether that security is participating. Rather, they believe the determination of whether a security is participating should focus exclusively on whether the security has a current, non-contingent right to participate in the undistributed earnings of the issuer.

18. Proponents of View B believe that only those instruments that are assured of participating in the undistributed earnings of the issuer in their current form are participating securities. Accordingly, they believe that a right that is forfeitable if the employee does not continue to provide service for the requisite period does not have a right to share in undistributed earnings in its current form. Further, they believe a vesting requirement represents a contingency and, based on the consensus reached on Issue 2(b)(i) of Issue 03-6, conclude that a right to receive dividends or dividend equivalents that is contingent on vesting is not a participation right.

19. Some opponents of View B believe that all unvested equity-based compensation that provides rights to participate in dividends are participating securities regardless of whether the rights are forfeitable. They believe that Issue 03-6 indicates that a right to receive value when dividends are declared on the issuer's common stock is not a participation right when it is contingent on the ultimate exercise of an option. However, they believe vesting that requires only that the employee render service for a specified period is substantially different from the contingency contemplated by the Task Force in Issue 2(b)(i). They believe such vesting provisions are unique to compensation arrangements and, therefore, that if the Task Force were to reach consensus that instruments subject only to such vesting requirements are participating, such consensus would not conflict with Issue 2(b)(i) of Issue 03-6.

View C: Unvested equity-based compensation awards are participating securities if the right to receive dividends or dividend equivalents is nonforfeitable or if the awards are expected to vest. Other unvested equity-based compensation awards are not participating securities.

20. Proponents of View C share many of the same views as proponents of View B regarding nonforfeitable dividend rights, however, they believe an equity-based compensation award should not be precluded from being a participating security simply because the right to the dividends or dividend equivalents will be forfeited if the employee does not provide the requisite service. Proponents of View C believe that those securities expected to vest (that is, those securities expected to retain their right to share in dividends with common shareholders) should be considered participating securities.

21. Proponents acknowledge that View C would result in different treatment of a given security depending on whether vesting required (a) only employee service and the passage of time or (b) satisfaction of a performance target or some other contingency. They believe this difference is justified based on the significant increase in control that a holder possesses when an instrument requires only that they continue to provide service for the specified period, compared to an instrument whose vesting is dependent on factors outside of the employees' control. They note that FAS 128 recognizes this difference by requiring that potential common shares underlying fixed awards (that is, awards that require only the passage of time to vest) be considered outstanding in computing diluted EPS while potential common shares underlying performance awards (that is, awards for which vesting depends on both the passage of time and achievement of a specified performance target or targets) be considered outstanding in computing diluted EPS only when the performance target has been satisfied or would be satisfied if the end of the current period were the end of the contingency period.

22. Proponents of View C also note that, under FAS 123, issuers currently have the option to estimate forfeitures at the grant date and that, under the Board's tentative conclusions on equity-based compensation, issuer's will be required to estimate forfeitures.

View D: Unvested equity-based compensation awards are participating securities if they are expected to vest. Other unvested equity-based compensation awards are not participating securities.

23. Proponents of View D believe the evaluation of whether a security is a participating security should focus on whether the security will vest. They note that such treatment is consistent with the accounting for equity-based compensation under FAS 123 and tentative conclusions reached in the Board's ongoing project on equity-based compensation.

View E: Unvested equity-based compensation awards are participating securities regardless of whether the rights are forfeitable.

24. Proponents of View E believe that unvested equity-based compensation awards that provide a right to participate in dividends or dividend equivalents with common stock meet the definition of a participating security in Issue 2 of Issue 03-6. Further, they believe View E is consistent with allocation principles in Issue 3 of Issue 03-6.

25. Opponents believe View E is not consistent with conclusions reached in Issue 2(b)(i) of Issue 03-6; namely, that securities with the contingent right to receive value when dividends are declared on the issuer's common stock are not participating securities. Opponents of View E acknowledge that vesting based only on employee service and the passage of time may be substantially different from the contingencies deliberated by the Task Force in Issue 2(b)(i), however, they believe that treating securities that are not expected to vest as participating securities is inconsistent with the underlying principles of the consensus in Issue 2(b)(i).

Transition and effective date

26. If the Task Force reaches a consensus on Issue 04-12 at the November 17-18, 2004 EITF meeting, the FASB staff recommends that the consensus be applied by restating previously reported earnings per share. This transition is consistent with transition of other consensuses related to EPS, including Issue 03-6.

27. With regard to the effective date, the FASB staff recommends the Task Force consider two alternatives:

View A: The guidance in this Issue should be effective for periods ending after December 15, 2004.

View B: The guidance in this Issue should be effective for periods beginning after December 15, 2004, with the ability to apply the provisions of this Issue at any point after FASB ratification of the consensus.

28. Finally, the FASB staff recommends codification of any consensus reached regarding this Issue with the consensuses reached in Issue 03-6.