MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Stell (ext. 211)		
Subject:	Minutes of the September 17, 2003 Board Meeting	**Date:**	September 24, 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: Modifications and Related Issues
Basis for Discussion:	Board memorandums dated September 5, 2003, September 9, 2003, and September 11, 2003
Length of Discussion:	2:15 p.m. to 4:25 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, and Seidman
Board members absent:	Trott (by phone)
Staff in charge of topic:	Tovey
Other staff at Board table:	Cassel, Zehyer, Stell, and Miller
Outside participants:	Willis (by phone)

Summary for ACTION ALERT:

The Board continued its discussion of accounting for modifications and settlements of employee equity-based compensation (EBC) awards, classified as equity, and reached the following decisions:

1. Certain principles would guide the accounting for modifications:
   a. Modifications represent a transaction between the employer and the option holder as an employee.
   b. Modifications generally represent a transfer of value (incremental value) from the employer to the employee, except when there is clear evidence to the contrary, for example, when the modification does not follow an adverse change related to the factors considered at the grant date used to measure fair value.
   c. An employer may never recognize less than the grant-date fair value of an equity-settled EBC award unless the employee fails to vest under the terms of the original award. Therefore, the total cumulative compensation cost associated with a modified award is equal to the grant-date fair value of the original award plus the incremental value of the modified award.
2. Incremental compensation cost would be measured by comparing the fair value of the modified award with the fair value of the original award immediately preceding the modification. This is consistent with the method proposed by the IASB in ED2, *Share-based Payment*.
3. If an entity is accounting for EBC awards at intrinsic value because it was not possible to reasonably estimate the fair value of the award at the grant date, then incremental compensation cost will be measured by comparing the intrinsic value of the modified award with the intrinsic value of the original award immediately preceding the modification date. A decrease in negative intrinsic value as a result of a modification would not result in incremental compensation cost.
4. Changes in vesting conditions of certain EBC awards (time-, performance-, or nonservice-based, but not market-based) would be accounted for consistently in accordance with the principles and methods above. That means that changes in vesting conditions would not result in an entity recognizing less than the original award's grant-date fair value except if original vesting conditions are not satisfied.

5. If vesting acceleration provisions included in the original terms of the EBC award are triggered, that event would not result in a modification; rather, the entity would be required to recognize all unrecognized compensation cost. Modifications that do result in vesting acceleration would be accounted for as other changes in vesting conditions.
6. Changes in the classification of EBC awards as a result of modifications would be accounted for as modifications rather than settlements. Modifications of EBC awards with multiple settlement features that change the awards' classification would be accounted for similar to awards with one settlement feature that change their classification as a result of a modification.
7. An *equity restructuring* would be defined as a nonreciprocal transaction between an entity and its shareholders, such as a stock dividend, spinoff, stock split, rights offering, or recapitalization through a special, large nonrecurring dividend that causes the market value per share of the stock underlying the option or award to change.
8. A *cancellation* of an EBC award would occur for accounting purposes if the award was legally cancelled (when all legal and regulatory requirements for cancellation have been met). The Board also considered a transaction in which an equity award is replaced with an award for a fixed monetary amount payable in the future based on meeting the equity award's original vesting conditions. The Board concluded that the transaction is a settlement of the original award and issuance of a new award because the new award's risk profile is distinct from the original award's risk profile.
9. In certain tax jurisdictions, an employer might be able to transfer a tax obligation to the employee via reimbursement or legal transfer. That tax obligation is based on a stock option's exercise-date intrinsic value. In those circumstances, the reimbursement or transfer would be deemed to represent additional exercise periods.
10. For long-term inducements, all facts and circumstances must be evaluated to determine the substance of the transaction. If a long-term inducement exists, incremental compensation would be measured for all EBC awards subject to the inducement, regardless of whether the employee elects to participate or not.

11. The removal of transferability restrictions on EBC awards would be evaluated as modifications.
12. In the event that the terms and conditions of an EBC award cease to be mutually understood, an EBC award would be measured at its fair value at each reporting date through vesting or exercise date, depending on the nature of the award. That concept would be similar to the notion of tainting introduced in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*
13. An enterprise's failure to adjust an EBC award, if that adjustment is required in connection with an equity restructuring, would be evaluated as a modification.
14. If the terms of an entire plan are modified, the new terms would be considered part of an EBC award's original terms only for awards granted after the plan modification date.

Matters Discussed and Decisions Reached:

Issues 1 and 2 of Memo No. 19: Principles of Accounting for Modifications and Method of Measuring Incremental Compensation Cost

The staff recommended that the Board agree to the following principles to account for modifications:

1. Principle 1: An employer may never recognize less than the grant-date fair value of an equity–settled EBC award unless the employee fails to vest under the terms of the original award. Therefore, the total cumulative compensation cost associated with a modified award is equal to the grant-date fair value of the original award plus the incremental value of the modified award.

2. Principle 2: Modifications represent a transaction between the employer and the option holder as an employee.

3. Principle 3: Modifications generally represent a transfer of value (incremental value) from the employer to the employee, except when there is clear evidence to the contrary, for example, when the modification does not follow an adverse change related to the factors considered at the grant date used to measure fair value.

4. <u>Principle 4</u>: Because the modified grant-date approach determination of fair value is not revised to recognize additional compensation cost for favorable changes (to the option holder) relating to factors that are relevant in measuring fair value, it is inappropriate to offset any such unrecognized compensation cost in determining whether incremental value is being transferred to an employee as a result of a modification. To accomplish that result, factors that are used to measure incremental value should not be more favorable as they relate to the original award than they are for the modified award at the modification date.

The staff also recommended that transfers of value to both vested award holders and unvested award holders should be accounted for as additional compensation cost.

The Board then discussed whether to retain the principle and method of measuring incremental compensation cost found in paragraphs 35 and 36 of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. The staff also presented three other alternatives to the method found in Statement 123 (referred to as Method 1).

Method 1 would require that the fair value of the modified award be compared with the value of the original award immediately before the modification. That method would require that the value of the original award be calculated by using the shorter of the expected life of the modified award or the remaining original expected life of the original award (referred to as the shorter-of clause) if the award is an option. That method would restrict the possibility of obtaining decremental value as well as a reduced (or zero) incremental value from a modification, supported by the notion that modifications occur to provide additional benefits to the employees.

The IASB's approach in ED 2 proposes that incremental compensation cost be measured by comparing the fair value of the modified award with the fair value of the original award immediately before the modification (referred to as Method 2). Method 2 differs from Method 1 in that it does not specify the expected life that should be used in valuing an option award; Method 2 precludes the recognition of decremental value.

The staff also presented two other methods: a variation of Method 2 (referred to as Method 3), which would require an enterprise to recognize both incremental and decremental value, and a method proposed by Mr. Schieneman (referred to as Method 4), which would not involve a calculation of an increment. Method 4 views the modified award as a new award that should be accounted for as such. That method would require that recognized compensation cost associated with the original award not be reversed.

The staff recommended that the Board select Method 1 and noted that if the Board agreed on Method 1 in principle, then the staff would develop a "work-around" solution to the difficulties associated with applying the shorter-of clause when using a lattice approach that considers contractual life and employee early exercise behavior. The staff also noted that if Board members agreed on another method, then the staff would modify the principles to fit the appropriate method.

Mr. Schieneman supported Method 4 and asserted that the method was more operational, more understandable, and simpler for constituents to use. He also added that he was not sure if a modification always creates incremental cost. Mr. Batavick also supported Method 4 and noted that the method would be much easier to explain to constituents. Ms. Seidman, too, supported Method 4.

Mr. Trott stated that he would support Method 2 but questioned the staff on whether Method 1 could be used with a lattice approach that uses contractual life and employee early exercise behavior. Mr. Tovey replied that a work-around solution could be developed. Mr. Cassel agreed with those comments. Mr. Crooch indicated that his initial preference would be Method 1; however, he could support Method 2, due to computational difficulties associated with applying Method 1 when an enterprise uses a lattice approach that incorporates contractual life and employee early exercise behavior to estimate the fair value of option awards. He added that he would support Method 1 if a sound work-around solution could be developed.

Mr. Herz stated that Method 3 is the theoretically correct answer but that he would support Method 2. Ms. Schipper also indicated her support of Method 2 for several reasons. She noted that selecting Method 2 would help achieve convergence with the IASB and that there would be clear advantages associated with comparing the fair value of the modified award with the fair value of the original award immediately before the modification. She also stated that under Method 1, preparers might encounter a high degree of difficulty calculating the work-around solution for use with the binomial approach; therefore, Method 2 would be easier for constituents to consistently apply.

The Board members voted to on the method of accounting for modifications. One Board member (GMC) supported Method 1 (but would support Method 2). Three Board members (KAS, EWT, RHH) supported Method 2, and three Board members (GSS, GJB, LFS) supported Method 4. Mr. Herz then asked if any of the Board members would object to Method 2, and no one objected. Mr. Tovey noted that the principles would have to be slightly revised to accommodate Method 2 (that is, principle 4 would be eliminated).

Issue 3 of Memo No. 19: Method of Accounting for Modifications of Vesting Conditions

The Board discussed several issues related to the method of accounting for modifications of vesting conditions. The Board first discussed whether changes in vesting conditions (time-, performance-, or nonservice-based) of all equity-based awards should be treated consistently. The staff recommended that such changes be accounted for similarly using Method 2, which was previously selected by the Board members in their discussion of Issues 1 and 2. The Board members unanimously agreed with the staff's recommendation.

The Board also discussed methods of accounting for modifications of performance conditions. Board members stated that the staff should develop a narrow definition of the term *performance condition* to ensure consistent application, and Mr. Cassel clarified that performance conditions would be defined as those that are not based on market conditions. Mr. Tovey asked the Board members if they would agree to using Method 2 for accounting for modifications of performance conditions and Board members agreed. However, Mr. Herz was concerned with how Method 2 would interact with what he characterized as synthetic cash settlements.

The Board also determined whether certain vesting-acceleration events represent a modification, and if so, how such modifications should be accounted for. With respect to original award provisions that accelerate vesting upon occurrence of a specified event, the staff recommended that those provisions, when triggered, do not result in a modification. With respect to other modifications that result in vesting acceleration, the staff recommended that those modifications be accounted for as modifications of other performance conditions using Method 2.

Issues 4 and 5 of Memo No. 19: Method of Accounting for Modifications That Result in a Change in Classification of the Award and Modifications of EBC Awards with Mulitple Settlement Features

Mr. Tovey opened the discussion by noting that Statement 123 does not provide specific guidance on modifications that result in a change in classification of the award. EBC awards can be modified in a variety of ways that result in an award classified as equity being classified as a liability and vice versa. He added that a subset of this issue involves modifications of EBC awards with multiple settlement features, in which a settlement feature is added or eliminated. He also asked the Board to address the accounting for a situation in which equity-settled EBC awards are replaced with awards based on fixed monetary amounts to be paid in cash upon completion of the original vesting terms.

The Board briefly discussed those issues. Ms. Seidman noted that the guidance in Statement 123 might be inconsistent with the guidance in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, with respect to tandem award plans. The staff agreed with Ms. Seidman and noted that the Board would have to continually evaluate the interaction between

Statements 123 and 150 as the application of the recently-released Statement 150 evolves over time.

The staff recommended that changes in the status of the award be accounted for as modifications rather than settlements (and that Method 2 be used to account for such). The staff also recommended that modifications of awards with multiple settlement features that change their classification should be accounted for consistently as single awards that change their classification. The Board unanimously agreed to both recommendations.

Issue 1 of Memo No. 18: Definition of Equity Restructuring

The staff noted that Statement 123 does not provide a definition of the term *other equity restructurings*, but FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, provides a definition of *equity restructuring* in the context of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The staff stated that that guidance, with some modifications, would be useful to include in the Exposure Draft because it would provide a basis for constituents to understand what is intended by the term other equity restructurings. The staff recommended that the following definition of equity restructuring be included in the Exposure Draft:

> An equity restructuring is a nonreciprocal transaction between an entity and its shareholders, such as a stock dividend, spinoff, stock split, rights offering, or recapitalization through a special, large nonrecurring dividend that causes the market value per share of the stock underlying the option or award to change.

The Board members unanimously agreed with the staff's recommended definition of equity restructuring.

Issue 2 of Memo No. 18: Definition of Cancellation

The staff informed the Board members that Statement 123 does not provide a definition of the term *cancellation*. However, Interpretation 44 describes the notion of *substantive cancellations* and gives guidance with respect to that notion, as well as guidance on when the "repricing clock" begins. The staff noted that portions of that definition might be retained but a more suitable and restrictive definition exists in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44." Considering the guidance from Issue 00-23 with some modifications, the staff recommended that the following definition of cancellation be included in the Exposure Draft:

> An EBC award is deemed cancelled or settled for accounting purposes if and when the award is legally cancelled (that is, if and when all legal and regulatory requirements for cancellation have been met). If the acceptance of an offer to cancel or settle an EBC award is revocable after the date an employee elects to cancel (for example, through the end of the offer period), then the EBC award is legally cancelled on the date at which the election to cancel can no longer be revoked.

The Board members unanimously agreed with the staff's recommendation. The Board also addressed situations in which an entity converts an equity-settled EBC award to an award based on a fixed amount of cash that retains the original vesting provisions of the equity-settled EBC award. The Board members discussed those conversions and whether they should be accounted for as separate awards issued to award holders. Six Board members (EWT, KAS, GJB, GMC, LFS, GSS) agreed that conversion from an equity-settled EBC award to an award based on a fixed amount of cash that retains the original vesting provisions of the equity-settled EBC award should be accounted for as two separate awards. One Board member (RHH) objected and noted that the conversion should be accounted for as a single award.

Issue 3 of Memo No. 18: Modification to Take on Employer Liability

The staff noted that this issue relates to Issues 15, 16, and 17 of Issue 00-23, which deals with a payroll tax liability related to stock options issued to employees in the United Kingdom. Certain legislation allows UK employers to statutorily transfer their payroll tax liability related to stock options issued to employees to the employees or to be reimbursed for such tax by employees. The Board then discussed whether modifying an equity award to reimburse an employer liability represents additional exercise proceeds of the award and agreed that it does. The staff then asked the Board whether it believes modifying an equity award to make an award holder the primary obligor of an employer's liability is an equity transaction that should not result in the reversal of the accrued liability to the income statement. The Board members agreed with the staff's recommendation; however, Ms. Seidman was concerned that the transaction might not be an equity transaction because an ordinary employee (shareholder) of an entity would not agree to such provisions—in other words, an enterprise would force the payroll tax liability on its employees.

Issue 4 of Memo No. 18: Long-Term Inducements

The staff recommended different treatment for long-term inducements be and short-term inducements, in that incremental value should be calculated on all awards subject to the inducement (not just those that accept the inducement). The Board unanimously agreed with the staff's recommendation.

Issue 5 of Memo No. 18: Modification of a Stock Option or Award to Remove Transferability Restrictions on a Stock Option or Award

The Board considered the accounting for the following examples found in Issue 46 of Issue 00-23 that address the issue of modifications of transferability:

> Example 1: An employer modifies a stock option award to permit…the employee to transfer the option to an immediate family member, family partnership, or family trust. Upon transfer of the option, the employee may be required to pay a gift tax on the fair value of the option transferred, measured at the transfer date, or estate tax on future appreciation. If the option is not fully vested on the transfer date, the employee must continue providing services in order for the award to vest and for the family member, partnership, or trust to be entitled to exercise the award. [The option would not be transferable to any parties, even after vesting.]
>
> Example 2: An employer modifies a stock option to permit…the employee to freely transfer that option to a third party. The employee transfers the option to a car dealer as partial consideration for the purchase of a new car. [paragraph 238]

In Example 1, the staff noted that such a modification would not result in any incremental compensation cost because a de facto transferability restriction continues to be in place (i.e., the employee could not transfer it to an independent third party). However, in Example 2, making an award transferable significantly increases the probability of optimal exercise; therefore, early exercise patterns would cease to play a role in the valuation of such an option. That modification would result in incremental compensation cost under the FASB's or IASB's method. The staff also added that all facts and circumstances must be considered when dealing with modifications of EBC awards. The Board agreed with the staff's assessment for the two examples.

Issue 6 of Memo No. 18: Whether Terms and Conditions of an EBC Award Can Cease to Be Mutually Understood

The Board discussed the issue of whether mutually understood terms and conditions of a EBC award can cease to be mutually understood resulting in the effective rescission of grant date, which would result in an option award being measured at fair value at each reporting period with changes being recognized in the income statement through exercise date because grant date is only deemed to occur on exercise date. The staff recommended that the Board consider the following language for inclusion in the Exposure Draft:

> In determining whether the terms and conditions are mutually understood, an entity must consider all facts and circumstances surrounding the award, including (a) whether the entity has a history or practice of modifying awards and (b) whether employees have a reasonable basis to conclude that it is probable that an award's terms and conditions will be changed prior to vesting or exercise. A reasonable basis to conclude that it is probable that an award's terms and conditions will be changed prior to vesting or exercise should be based on all available evidence, including extraneous employment or compensation agreements, oral contracts, and the entity's history or practice of modifying, settling, or canceling awards.

Ms. Seidman noted that this issue was similar to the issue of tainting for Statement 115 held-to-maturity securities; she suggested that the guidance be modified such that any rescission of grant date related to one award would affect the whole class to which that award belongs. The Board members agreed to accept the staff's recommended language, revised for Ms. Seidman's suggestions.

Issue 7 of Memo No. 18: Accounting Consequence of an Entity's Failure to Adjust an Award in Connection with an Equity Restructuring

The Board members and staff briefly discussed this issue, and the Board agreed that such failures to comply with award provisions should be considered modifications.

Issue 8 of Memo No. 18: When Are Modified Plans Provisions Considered to Be Original Award Terms

The staff recommended that footnote 4 of Interpretation 44 be incorporated into the Exposure Draft:

> If the terms of an entire plan are modified, the new terms are considered part of an award's original terms only for any stock option or award granted after the plan modification date.

The Board did not object to the staff's recommendation to include this language in the Exposure Draft.

<u>Follow-up Items:</u>

None.

<u>General Announcements:</u>

None.