July 25, 1997

FASB AFFIRMS FIXED-PLAN ACCOUNTING FOR DEFERRALS OF STOCK OPTION GAINS UNDER LIMITED CIRCUMSTANCES

The Emerging Issues Task Force (EITF), an arm of the Financial Accounting Standards Board (FASB) that deals with interpretations of FASB accounting standards, met on July 23 to decide whether pre-tax deferrals of gains from stock option exercises would result in a new measurement date, and hence additional compensation expense, under APB Opinion 25.(1)

Background

An increasing number of companies have enhanced their stock option plans to permit employees to voluntarily defer the option gain pre-tax in share units when they exercise their options. The transaction works by the employee making an election to defer the option gain at least six months before exercise, and then exercising the option in a stock-for-stock manner, i.e., by surrendering already-owned "mature" company shares(2) having a value equal to the option price. Upon exercise, the employee receives the number of shares which he or she surrendered and a number of deferred share units equal in value to the pre-tax option gain. The deferred share units will be paid in actual shares at some future date, such as retirement or other termination. Some companies have gone further and permitted executives to diversify out of company stock by converting their deferred share units into another investment account similar to the investment alternatives employees can elect under 401(k) plans.

These types of option gain deferral transactions were not contemplated when APB Opinion 25 was adopted in 1972. Therefore, the EITF was asked to determine the accounting implications.

Issues and Resolution

Issue 1: Does the pre-tax option gain deferral into stock units, with ultimate payout in actual company stock, involve a new measurement date and additional compensation expense on the company's income statement?

(1) EITF Issue No. 97-5

(2) "Mature" shares are those which have been owned at least six months by the employee

No. The essential tests for grant date accounting under APB Opinion 25 are that the number of shares to be issued and the price to be paid are known at the grant date. These conditions have been met and are not changed by the option gain deferral and the delayed share delivery.

Issue 2: Does the answer change if six months after the option exercise the employee can convert the deferred share units into alternate investment accounts (e.g., S&P 500 index fund), with ultimate payout in cash or equivalent value in company stock?

Yes. A payout in cash or equivalent value in company stock results in a new measurement date creating variable compensation expense because (1) the number of shares to be issued is not known at the grant date, and (2) the cash paid to settle a stock or option grant measures compensation expense. In substance, the transaction is no different than an SAR paid in cash.

Issue 3: Does the answer in issue 2 above change if the deferred stock is put into a "rabbi trust" and after six months the trust sells the stock on the open market and uses the proceeds to make diversified investments on the executives' behalf?

No. The use of a rabbi trust and selling shares on the market does not change the substance of the transaction. It is a variable plan with cash paid measuring compensation expense.

While we believe the above information factually represents the EITF's consensus, decisions are not final until the minutes are approved by the EITF. This is expected to be done August 7.

Implications

We believe the EITF made the right decisions. Clarification of the accounting treatment for option gain deferrals should (1) encourage companies to add a deferral enhancement to their stock option plans and (2) reduce the number of programs whereby executives could diversify out of company stock without paying taxes or selling shares.

The next evolutionary development we see is the combination of option gain deferrals with option "reload" or restoration grants that would help executives increase their ownership positions while avoiding the need for "tax reloads."

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General questions about the option deferral technique may be directed to any member of our firm. Copies of this letter and other published materials are available on our web site, WWW.FREDERICWCOOK.COM.