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EITF Resolves Several Stock Option Accounting Issues

The FASB's Emerging Issues Task Force (EITF) met on September 20-21 to address EITF Issue No. 00-23 which contains eight of the 31 stock compensation issues under FIN 44 and APB 25 that the Securities and Exchange Commission (SEC) has asked the EITF to address.[*] The EITF resolved seven of the eight issues, and put off the remaining issue (dealing with payroll taxes for leased employees) to a future meeting when it presumably will discuss the other stock compensation accounting issues identified by the SEC.

Here is a summary of the seven issues resolved by the EITF on September 20-21:

EXCHANGE OF PARENT OPTIONS
<u>FOR SUBSIDIARY OPTIONS AND VICE VERSA</u> -- What are the accounting consequences under APB 25 for the exchange of a "fixed" stock option award in one entity of a controlled group for a fixed stock option award in another controlled entity?

— e.g., exchange of parent options for subsidiary options as part of an initial public offering (IPO) of the subsidiary's stock

<u>EITF Consensus</u> -- The exchange results in a new measurement date, but not variable award accounting, so long as certain conditions are met.

— The two conditions are (1) no increase in aggregate "intrinsic value" (or decrease in aggregate intrinsic loss), and (2) no reduction in the ratio of exercise price per share to market price per share

— If the two conditions are not met, variable award accounting is required for all exchanges occurring after December 15, 1998 (i.e., the exchange is deemed to be an "indirect repricing")

A new measurement date means that compensation cost is recognized for the aggregate intrinsic value of the exchanged stock options at the exchange date. The new guidance applies prospectively for exchanges that occur after September 21, 2000.

<u>OPTION GAIN GUARANTEES</u> -- What are the accounting consequences under Opinion 25 of linking a guaranteed bonus or loan forgiveness to a fixed stock option such that, if the stock appreciates a certain amount, the bonus is <u>not</u> paid or the loan is <u>not</u> forgiven?

[*] Refer to our letter dated September 15, 2000, page 3.

EITF Consensus -- The guaranteed bonus or loan to be forgiven should be expensed over the service period, with no reversal if the bonus is not paid or loan not forgiven (unless the employee "fails to fulfill a service obligation"). The related stock option presumably retains its fixed award status.

- Any amount of the bonus not paid or loan not forgiven is treated as a contribution to capital
- New guidance applies prospectively to new arrangements entered into after September 21, 2000

PRIVATE COMPANY OPTIONS AT A DISCOUNT TO FMV -- A nonpublic entity issues a stock option with an exercise price of $10.00 (based on a formula) when the "fair value" of the stock is $12.00. If the option is exercised, the repurchase price for the stock is set at fair value on the date of repurchase (which cannot occur within six months of the option's exercise). The issue is whether such a situation would be accounted for as a fixed award (in which case $2 of compensation expense would be amortized over the vesting period) or a variable award.

EITF Consensus – Fixed award accounting applies. The option is treated as a discount option, with terms fixed at grant.

"STOCK OUT" OF UNVESTED OPTIONS IN A POOLING TRANSACTION -- Does a "stock out" (i.e., buying out stock options with an equivalent value of stock on a fair value basis) of outstanding stock options in a business combination to be accounted for as a pooling-of-interests result in a new measurement date under FIN 44? If so, would a new measurement date conclusion be consistent with the requirement in APB Opinion No. 16, *Business Combinations*, that no alteration of equity interests occur?

EITF Consensus -- New measurement date is required pursuant to FIN 44 (i.e., compensation cost is recognized for the intrinsic value of the awarded stock); no alteration of equity interests occurs under APB 16.

OPTIONS CONDITIONED ON VOLUNTARY SHAREHOLDER APPROVAL -- When does a measurement date occur under APB 25 if an entity is not *required* to obtain shareholder approval but nonetheless chooses to do so? For purposes of this issue, if the shareholders do not give their approval, the grant will not be made.

EITF Consensus -- Measurement date is delayed until shareholder approval is obtained (i.e., compensation cost is recognized for any increase in intrinsic value between grant date and shareholder approval date).

DIVIDENDS ON RESTRICTED STOCK -- Does variable award accounting apply if dividends on restricted stock are paid only if the restricted stock vests? Since the payment of cash dividends is tied to vesting, it appears variable accounting would not be required. However, there is no concept of "exercise" for restricted stock.

EITF Consensus -- Variable award accounting is not required.

ALLOCATING COMPENSATION COSTS FOR SERIAL VESTING -- There is a mixed practice in terms of the accrual of compensation cost for fixed awards in future service periods when pro rata, rather than cliff, vesting is in place. Specifically, if restricted stock is granted with an intrinsic value of $100, and the award vests 25 percent each year rather than 100 percent at the end of year four, how should the $100 in cost be recognized? Should the accrual be spread equally over the vesting period, or "front-loaded" (i.e., each vesting tranche is accounted for as a separate grant) as suggested by FASB Interpretation 28?

EITF Consensus -- Either approach is acceptable so long as it is consistently applied.

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This letter is intended to provide information of interest to compensation professionals about technical developments that may affect compensation design and practice. Questions about specific application to a company should be addressed to the company's accounting staff. General questions may be addressed to Fred Cook at (212) 986-6330 or fwcook@fwcook.com, or Tom Haines at (312) 332-0910 or tmhaines@fwcook.com. Copies of this letter and other published materials are available on our website at www.fwcook.com.