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November 18, 1999

FASB Redeliberations Continue
on Proposed Interpretation of Opinion 25
Final Interpretation Now Scheduled
For Release in First Quarter of 2000

The Financial Accounting Standards Board (FASB) is now four months and eight meetings into its redeliberation process with respect to the proposed interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (Opinion 25).¹ To date, the FASB has resolved a majority of the issues in the proposed interpretation and plans to issue a final interpretation in the first quarter of 2000. Summarized below are the FASB's conclusions with respect to the most substantive issues that have been redeliberated thus far. A detailed outline of the proposed interpretation and the results of the FASB's redeliberations to date is presented in the Exhibit at the end of this letter.

Scope of Interpretation

- Opinion 25 will be strictly applied to only *employees* of the employer entity, as defined by common law and Internal Revenue Service (IRS) payroll tax rules; stock options or awards granted to independent contractors and other service providers who are not employees will *not* be accounted for under Opinion 25 (i.e., there *will be* compensation cost)
- The only exceptions to the employee definition are that (1) stock options or awards granted to independent members of an entity's board of directors will continue to be accounted for under Opinion 25, and (2) leased employees *may* qualify for Opinion 25 treatment for stock options or awards granted by a lessee entity, provided that several stringent requirements are met
- In *consolidated* financial statements, Opinion 25 will apply to all stock options or awards granted by *any* member of the consolidated group to *any other* member of the consolidated group
- In *separate* financial statements of a consolidated subsidiary, grants of parent-company stock options or awards to employees of the consolidated subsidiary will be accounted for under Opinion 25; however, grants of a consolidated subsidiary's stock options or awards to parent-company employees (or to employees of any other consolidated subsidiary) will *not* fall within the scope of Opinion 25

¹ Refer to our letter dated April 27, 1999 for a detailed summary of the Exposure Draft – *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25*, released March 31, 1999.

- Grants of parent-company stock options or awards to employees of a *nonconsolidated* entity (such as a joint venture or other equity investment) will not fall within the scope of Opinion 25

Award Modifications

- “Fixed” stock options that are repriced (i.e., there is a “direct” change to the exercise price or number of shares) or cancelled and reissued within 6 months of one another (i.e., there is an “indirect” or “synthetic” change to the exercise price or number of shares) will be accounted for prospectively as a “variable award” from the date of modification until the date of exercise
- Accelerated vesting provisions that are either discretionary or not pursuant to the original terms of the stock option or award will result in the remeasurement of compensation cost; the amount of newly measured compensation cost will be equal to the accelerated award’s “intrinsic value” as of the *modification date*, not the acceleration date
- Other modifications to outstanding stock options or awards will *not* result in a new “measurement date” (or variable award accounting), provided that the modifications do not directly or indirectly affect the exercise price or number of shares, or extend the option term

Cash Settlements and Repurchases

- Cash settlements of outstanding stock options or awards (or the repurchase of shares within 6 months of option exercise or issuance) will result in compensation cost equal to the sum of (1) the award’s original intrinsic value (if any), and (2) any cash paid in excess of the *lesser* of the award’s original intrinsic value or the intrinsic value as of the cash settlement date
- Stock-for-tax withholding in excess of “minimum statutory” withholding rates will result in compensation cost equal to the award’s total intrinsic value as of the excess withholding date; further, variable award accounting will be required (prior to actual excess withholding) for all stock options or awards granted pursuant to plans or agreements where either (1) the employee has “sole discretion” to elect excess withholding, or (2) the employer exhibits a “pattern of consistently approving” excess withholding
- Share repurchase features, such as puts, calls, and rights of first refusal, will not result in an otherwise fixed award becoming variable, so long as the purchase price is based on “fair value” and the shares are not expected to be repurchased within 6 months of option exercise or issuance; nonpublic entities may calibrate the purchase price on other than fair value, so long as the employee makes “a 100 percent investment” in the award at the date of grant using the purchase price or formula prescribed by the plan

Other Provisions

- Broad-based employee stock purchase plans meeting the criteria of the Internal Revenue Code (IRC) will continue to retain their status as “noncompensatory” under Opinion 25; thus, there will continue to be no recognition of compensation cost for purchase discounts of up to 15 percent at either grant or purchase

- Stock options or awards that are awarded contingent on shareholder approval will *not* be deemed granted until shareholder approval is actually obtained, unless such approval is perfunctory
- Stock options or awards with a related cash bonus feature will be accounted for as a variable award *only if* the amount of the bonus is not fixed *and* payment is contingent upon exercise of the underlying award
- Deferred tax assets (i.e., future tax deductions) for fixed stock options or awards that have intrinsic value at grant will *not* be reduced for subsequent declines in stock price

Most important, the FASB has decided *not* to apply the new rules to transactions occurring *prior to the issuance* of a final interpretation, with two notable exceptions. The exceptions are that, pending further redeliberations by the FASB, stock option repricings (including synthetic repricings) and grants of stock options or awards to nonemployees (presumably independent contractors, employees of nonconsolidated entities, and other nonemployee service providers) will continue to be subject to the controversial December 15, 1998 “retroactive application date.” All other transactions, including award modifications, accelerated vesting, changes in employment status, and excess stock-for-tax withholding, that occur prior to the issuance of the final interpretation will *not* be subject to the new rules.²

The issues that remain to be redeliberated by the FASB are (1) changes in employment status, i.e., from employee to nonemployee and vice versa, (2) the amount of compensation cost to recognize if an award is modified and a new measurement date is required, (3) implementation issues with respect to synthetic repricings, i.e., indirect changes to the exercise price or number of shares, and (4) exchanges of stock options in pooling-of-interests and purchase business combinations.

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General questions about this letter may be addressed to Thomas Haines in our Chicago office (312-332-0910). Copies of this letter and other published materials are available on our website, www.fwcook.com.

² Interestingly, the Emerging Issues Task Force (EITF) guidance for excess stock-for-tax withholding transactions that occur prior to the release of a final interpretation is scheduled to expire on December 31, 1999; thus, there appears to be *no* guidance for excess stock-for-tax withholding transactions that occur subsequent to December 31, 1999 but prior to issuance of the final interpretation.

FASB Redeliberations on Proposed Interpretation of Opinion 25

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<i>Definition of Employee:</i>	<ul style="list-style-type: none"> Opinion 25 applies only to <i>common law</i> employees; presumption is that an individual designated as an employee for payroll tax purposes is also an employee for purposes of applying Opinion 25 	<ul style="list-style-type: none"> Opinion 25 applies only to employees as defined by common law <i>and</i> IRS Revenue Ruling 87-41 Presumption is that an individual designated as an employee under Opinion 25 should also be classified as an employee for purposes of U.S. payroll taxes, <i>except</i> for lease or co-employment agreements discussed below Opinion 25 does <i>not</i> apply to independent contractors or other service providers who are not employees
<i>Outside Directors:</i>	<ul style="list-style-type: none"> Opinion 25 does <i>not</i> apply to outside directors 	<ul style="list-style-type: none"> Opinion 25 <i>does</i> apply to outside directors
<i>Leased Employees/Co-Employment Arrangements:</i>	<ul style="list-style-type: none"> Opinion 25 applies only to <i>one</i> entity; presumption is that the qualifying entity is the one responsible for compensation and payroll tax administration (normally the lessor) 	<ul style="list-style-type: none"> In “dual employment” agreements, Opinion 25 applies to stock options or awards granted by a lessee to leased employees <i>only if</i> (1) the leased employees qualify as common law employees to the lessee and the lessor is contractually required to administer payroll taxes, and (2) the lessor and lessee agree in writing that, among other things, the lessee has the exclusive right to grant stock options or awards to the leased employees and the leased employees have the ability to participate on a "comparable" basis in the lessee’s employee benefit plans
<i>Consolidated vs. Nonconsolidated Entities:</i>	<ul style="list-style-type: none"> Opinion 25 applies only to grants of parent-company stock options or awards to employees of a <i>consolidated</i> entity Opinion 25 does <i>not</i> apply to grants of parent-company stock options or awards to employees of a nonconsolidated entity, such as a joint venture or other equity investment 	<ul style="list-style-type: none"> No changes from proposed interpretation other than clarification that, in consolidated financial statements, Opinion 25 applies to all grants or awards by <i>any</i> member of the consolidated group to <i>any other</i> member of the group

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<i>Consolidated vs. Nonconsolidated Entities (cont):</i>		<ul style="list-style-type: none"> FASB will submit to the Emerging Issues Task Force (EITF) the issue of how to account at both the investor and investee level for stock options or awards granted by an equity method investor or joint venture owner to employees of a nonconsolidated entity
<i>Separate Financial Statements of a Subsidiary:</i>	<ul style="list-style-type: none"> Opinion 25 applies to the separate financial statements of a subsidiary for grants of parent-company stock options or awards <i>only if</i> the subsidiary is consolidated with the parent Opinion 25 does <i>not</i> apply to grants of parent-company stock options or awards in the separate financial statements of a nonconsolidated subsidiary 	<ul style="list-style-type: none"> No changes from proposed interpretation other than to <i>prohibit</i> the application of Opinion 25 in separate financial statements for transactions between members of a consolidated group that do not involve parent-company stock, e.g., stock options or awards of a subsidiary granted to employees of another subsidiary or the parent company FASB will submit to the EITF the issue of how to account in separate financial statements of the grantor and the employer of the grantee for stock options or awards granted by members of a consolidated group to employees of other members of the consolidated group
<i>Changes in Employment Status:</i>	<ul style="list-style-type: none"> Compensation cost is “remeasured” for <i>nonvested</i> stock options or awards upon a change in status to or from an employee (who <i>continues</i> to provide services to the entity) 	<ul style="list-style-type: none"> Open issue to be redeliberated
<i>Noncompensatory Plans:</i>	<ul style="list-style-type: none"> Employee stock purchase plans meeting the criteria of IRC Section 423 retain their status as “noncompensatory,” including plans with purchase discounts of up to 15 percent at grant and “look-back” purchase prices 	<ul style="list-style-type: none"> No changes from proposed interpretation

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<p><i>Award Modifications:</i></p>	<ul style="list-style-type: none"> • Compensation cost is remeasured (i.e., a new "measurement date" is required) at the modification date for stock options or awards if the modification results in a more than <i>de minimis</i> increase in "fair value"; fair value for stock options is calculated using an option pricing model (such as Black-Scholes) and the remaining contractual term of the stock option • The <i>amount</i> of newly measured compensation cost is generally equal to the sum of the award's (1) original "intrinsic value" (if any), and (2) intrinsic value as of the modification date <i>in excess</i> of the original intrinsic value (an exception applies if stock options or awards are cancelled and replaced with a different grant type) 	<ul style="list-style-type: none"> • Fair value concept is dropped • A new measurement date is <i>not</i> required for modifications that do not <i>directly or indirectly</i> affect the exercise price or the number of shares, or extend the term of a stock option or award • A new measurement date <i>is</i> required for modifications that <i>directly or indirectly</i> extend the term of the stock option; for modifications that extend the post-termination exercise period upon the occurrence of certain future events (e.g., death, disability, retirement, or change-in-control), compensation cost is recognized and measured in the same manner as "Accelerated Vesting" discussed below • FASB will discuss at a future meeting whether modifications that directly or indirectly change the exercise price or number of shares result only in a new measurement date, or in potentially more punitive "variable award" accounting treatment • FASB will also redeliberate at a future meeting the methodology for determining the <i>amount</i> of newly measured compensation cost
<p><i>Accelerated Vesting:</i></p>	<ul style="list-style-type: none"> • A new measurement date is <i>not</i> required if vesting is accelerated pursuant to the <i>original terms</i> of the stock option or award • A new measurement date <i>is</i> required if the acceleration (1) is discretionary or not pursuant to the original terms of the award, and (2) results in a more than <i>de minimis</i> increase in fair value • The <i>amount</i> of newly measured compensation cost is calculated in the same manner as "Award Modifications" discussed above 	<ul style="list-style-type: none"> • A new measurement date is <i>not</i> required if vesting is accelerated pursuant to the <i>original terms</i> of the stock option or award • A new measurement date <i>is</i> required if (1) the acceleration provision is discretionary or not pursuant to the original terms of the award, and (2) the acceleration event actually occurs (i.e., the fair value concept is dropped) • The <i>amount</i> of newly measured compensation cost is equal to the accelerated award's intrinsic value as of the <i>modification date</i>, not the acceleration date

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<i>Accelerated Vesting (cont.):</i>		<ul style="list-style-type: none"> • Thus, discretionary and modified accelerated vesting provisions will result in the recognition of compensation cost <i>only if and when</i> there is an actual acceleration event; the amount of compensation cost is measured as of the date discretion is used or the award is modified
<i>Cash Settlements:</i>	<ul style="list-style-type: none"> • Compensation cost is remeasured if cash is paid to settle an earlier grant of stock options or awards, or to repurchase the shares within 6 months after option exercise or issuance • The <i>amount</i> of newly measured compensation cost is equal to the sum of (1) the award's original intrinsic value (if any), and (2) any cash paid in excess of that value (net of any cash paid by the employee) 	<ul style="list-style-type: none"> • The <i>amount</i> of compensation cost is redefined to equal the sum of (1) the award's original intrinsic value (if any), and (2) any cash paid in excess of the <i>lesser of</i> the award's original intrinsic value or the intrinsic value as of the cash settlement date
<i>Stock Option Repricing and Cancellation/ Reissuances:</i>	<ul style="list-style-type: none"> • Variable award accounting is required for an otherwise "fixed" stock option if the award is repriced (i.e., there is a change to the exercise price or number of shares) or cancelled and reissued within 6 months; variable award accounting applies from the date of modification until the date of exercise • Variable award accounting is <i>not</i> required for changes to the exercise price or number of shares in connection with stock splits, stock dividends, and other similar equity restructurings, so long as such changes do not result in a more than <i>de minimis</i> increase in fair value 	<ul style="list-style-type: none"> • No changes from proposed interpretation; but presumably the fair value concept for "equity restructurings" will be dropped • "Synthetic repricings" (i.e., indirect change to the exercise price or number of shares) remain an open issue
<i>Puts, Calls, and Rights of First Refusal:</i>	<ul style="list-style-type: none"> • Variable award accounting is <i>not</i> required for stock options or awards with a share repurchase feature based on fair value, so long as the shares are not expected to be repurchased within 6 months of option exercise or issuance 	<ul style="list-style-type: none"> • No changes from proposed interpretation other than to clarify for nonpublic companies that a substantial investment is defined as "... a 100 percent investment (other than by providing services) determined as of the grant date, using the formula repurchase or book value prescribed by the plan ..."

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<p><i>Puts, Calls, and Rights of First Refusal (cont.):</i></p>	<p>Nonpublic entities (including nonpublic entities with public debt, but excluding “controlled” subsidiaries of public entities) may calibrate the repurchase price on other than fair value, so long as the employee “... has a substantial investment and bears risk for a reasonable period ...”</p>	
<p><i>Stock-for-Tax Withholding:</i></p>	<ul style="list-style-type: none"> • Variable award accounting is required for stock options or awards if shares can be, or actually are, withheld upon exercise or issuance to satisfy taxes <i>in excess</i> of “minimum required” federal, state, and payroll withholding rates • For plans that do not expressly permit or prohibit excess withholding, variable award accounting is <i>not</i> required unless excess shares are actually withheld or a “pattern” of excess withholding emerges (in which case all awards granted under the plan become variable) 	<ul style="list-style-type: none"> • No changes from the proposed interpretation regarding the principal conclusions that (1) required tax withholding is based on the employer's "minimum statutory withholding rates," and (2) actual excess withholding results in a new measurement date for the total award (i.e., compensation cost is equal to the total intrinsic value of the award on the excess withholding date) • The FASB did, however, clarify when variable award accounting is required (prior to the actual excess withholding event) by differentiating between withholding elections that are at the sole discretion of the employee or the employer, as summarized below • Variable award accounting <i>is</i> required for stock options or awards if the election to withhold excess shares is at the <i>sole discretion of the employee</i> • Variable award accounting is <i>not</i> required for stock options or awards if the election to withhold is at the <i>discretion of the employer</i> (regardless of whether the grant provisions permit, or are silent about, excess withholding), unless the employer “... exhibits a pattern of consistently approving excess withholding...”

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<p><i>Business Combinations:</i></p>	<ul style="list-style-type: none"> • A new measurement date is <i>not</i> required for changes to the exercise price or number of shares of outstanding stock options (whether vested or nonvested) in a pooling-of-interests transaction, provided that (1) the aggregate intrinsic value of the options immediately after the exchange is <i>no greater than</i> the aggregate intrinsic value immediately prior to the exchange, (2) the ratio of exercise price per option to market value per share is <i>not reduced</i>, and (3) any other modification (such as changes in vesting or option term) does not result in a more than <i>de minimis</i> increase in fair value • A new measurement date is <i>not</i> required in a purchase business combination for <i>nonvested</i> stock options granted by an acquirer in exchange for nonvested stock options of an acquiree, provided that the exchange does not result in a more than <i>de minimis</i> increase in fair value; if the increase in fair value is more than <i>de minimis</i>, compensation cost is recognized to the extent that the intrinsic value of the new stock options exceeds the intrinsic value of the exchanged stock options • Stock options granted by an acquirer in exchange for <i>vested</i> stock options of an acquiree in a purchase business combination are <i>not</i> accounted for under Opinion 25; rather, they are considered part of the purchase proceeds pursuant to Opinion 16 	<ul style="list-style-type: none"> • Open issue to be redeliberated; but presumably the fair value concept will be dropped
<p><i>Shareholder Approval:</i></p>	<ul style="list-style-type: none"> • Stock options or awards that are awarded contingent on shareholder approval are <i>not</i> deemed granted until shareholder approval is actually obtained, unless such approval is perfunctory 	<ul style="list-style-type: none"> • No changes from proposed interpretation

<u>Issue</u>	<u>Original Proposed Interpretation</u>	<u>Results of FASB Redeliberations to Date</u>
<i>Deferred Taxes:</i>	<ul style="list-style-type: none"> Deferred tax assets (i.e., future tax deductions) for fixed stock options or awards that have intrinsic value at grant are <i>not</i> reduced in event of a subsequent decline in stock price (below the stock price at grant) 	<ul style="list-style-type: none"> No changes from proposed interpretation
<i>Cash Bonuses:</i>	<ul style="list-style-type: none"> Variable award accounting is required for stock options or awards with a related "cash bonus" feature, if such bonus is contingent upon either <i>vesting or exercise</i> of the underlying award 	<ul style="list-style-type: none"> Variable award accounting is required for stock options or awards with a related cash bonus feature <i>only if</i> the amount of the bonus is not fixed <i>and</i> payment is contingent upon exercise of the underlying award Variable award accounting is <i>not</i> required for stock options or awards with a related cash bonus feature that is either fixed in amount or not contingent upon exercise of the underlying award (i.e., cash bonuses contingent upon <i>vesting</i> of the underlying award do not result in variable accounting)
<i>Effective Date:</i>	<ul style="list-style-type: none"> Effective upon issuance of the final interpretation, and applied <i>prospectively</i> to all grants, modifications, and changes in employment status occurring <i>subsequent to</i> December 15, 1998; compensation cost is <i>not</i> recognized for amounts attributable to vesting periods occurring before the effective date Provisions with respect to stock-for-tax withholding transactions apply only to grants made <i>subsequent to</i> December 31, 1999; guidance provided by the EITF in Issue No. 87-6 Section C, as modified on March 24-25, 1999, applies to stock options or awards granted prior to this date (the EITF guidance requires entities to recognize as compensation cost the value of shares withheld <i>in excess of</i> the minimum required rate) 	<ul style="list-style-type: none"> The final interpretation will be effective <i>no earlier than issuance</i> for all provisions other than stock option repricings (including synthetic repricings) and grants of stock options or awards to nonemployees Pending final redeliberations by the FASB, stock option repricings (including synthetic repricings) and grants of stock options or awards to nonemployees will continue to be subject to the December 15, 1998 "retroactive application date" Provisions with respect to stock-for-tax withholding transactions will apply <i>no earlier than</i> issuance of the final interpretation