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FASB and EITF Issue Rulings on Accounting for Stock Compensation

In the two-plus months since the July 1 effective date of "FIN 44," the Financial Accounting Standards Board (FASB) and the Emerging Issues Task Force (EITF) have been busy providing additional guidance in regard to accounting for stock compensation.[1] The new guidance is provided in the form of three EITF Issues that clarify relatively minor technical issues, and an FASB "Staff Announcement" that provides a trap for the unwary in the area of stock option "repricings."[2] The remainder of this letter briefly summarizes these recent developments.

Cite: EITF Issue No. 00-12

Topic: Accounting for stock compensation granted by an investor (parent) company to employees of an investee (subsidiary) company that is not a member of the consolidated group (such as a joint venture or other equity investment).

Issue: How do the investor and the investee companies account for the stock compensation?

Background: FIN 44 provides that Opinion 25 does not apply to stock compensation granted to employees of a nonconsolidated company. However, FIN 44 does not provide guidance in regard to how the investor and the investee companies are to account for the stock compensation.

Guidance: Both the investor and the investee companies are to recognize compensation cost (in the same amount and over the same vesting period) equal to the "fair value" of the stock compensation as ultimately measured on the award's vesting date (in accordance with Statement 123 and EITF Issue No 96-18), with a corresponding credit to each company's capital account. Further, there are no net changes to the asset or equity accounts on the balance sheets of the investor and the investee companies, and the income statements and balance sheets of other investor companies (if any) are not affected by the recognition of the stock compensation cost.[3]

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[1] FIN 44 is the acronym used by accountants to cite FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation: an Interpretation of APB Opinion No. 25,* issued March 31, 2000. Refer to our letters dated May 1 and 10, 2000 for a detailed explanation and summary of FIN 44.

[2] It is our understanding that a Staff Announcement is not authoritative guidance *per se*, but rather an internal "staff position" on how the FASB would respond if asked (by companies, accountants, the SEC, etc.) what the appropriate method of accounting would be for a specific transaction.

[3] This guidance applies to situations in which an "equity method" investor incurs a compensation cost (based on the stock of the investor) on behalf of the investee without proportionate funding by the other investors (if any), and the investor does not receive any increase in the investor's ownership percentage in the investee.

Cite: EITF Issue No. 00-15

Topic: Classification in the statement of cash flows of the income tax benefit received by a company upon exercise of a nonqualified employee stock option.

Issue: How should the income tax benefit from a stock option exercise be reported in the statement of cash flows?

Background: A company generally recognizes an income tax benefit upon the exercise of a typical stock option. This income tax benefit does not flow through the income statement, but does result in an increase to the company's cash flow and capital account. In recent years, diversity in practice has developed for the classification of this benefit in the statement of cash flows, with some companies reporting the benefit as an "operating cash flow" and some reporting it as a "financing activity."[4]

Guidance: The income tax benefit credited to capital as a result of the tax deduction triggered by option exercise should be classified as an operating cash flow in the statement of cash flows, and *not* as a financing activity. Further, footnote disclosure of a material income tax benefit is required if the benefit is not reported as a separate line item in the statement of cash flows or the statement of changes in stockholders' equity.

Cite: EITF Issue No. 00-16

Topic: Recognition and measurement of employer payroll taxes on employee stock-based compensation.

Issue: When should an employer recognize a liability and corresponding cost for payroll taxes on employee stock compensation?

Background: The predominant current practice is to recognize these costs on the income statement and balance sheet when the event that triggers payment to the taxing authority occurs, e.g., upon exercise of a typical stock option. As recent as last year, however, some companies chose not to recognize these costs on the income statement, but rather to directly credit the costs to the capital account on the balance sheet, apparently using the same rationale as the treatment of the income tax benefit received from stock option exercises discussed above. This practice was curtailed last September with the issuance of FASB Staff Announcement Topic No. D-83, which stated that payroll taxes incurred upon option exercises would be viewed by the FASB staff as an operating cost that should flow through the income statement.[5]

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[4] Refer to "Stock Options Pad Cash Flow of Technology Highfliers," *The Wall Street Journal*, Monday, July 17, 2000.

[5] Refer to "Tech Firms Hide Payroll Taxes on Employees' Stock Options," *The Wall Street Journal*, Thursday, September 7, 2000.

Guidance: A liability (and corresponding cost) for employer payroll taxes incurred on employee stock compensation should be recognized on the date of the event triggering the income recognition and payment of tax to the taxing authority, e.g., on the date of exercise for a nonqualified stock option. No liability (or corresponding cost) should be a recognized until that event occurs, i.e., accruals based on estimates prior to exercise or vesting are not permitted.

Cite: FASB Staff Announcement Topic No. D-91

Topic: Granting "new" stock options with an exercise period that expires upon the earlier of (1) 10 years, or (2) 30 days after the date at which the company's stock price reaches the exercise price of previously granted "underwater" stock options.

Issue: Does the above transaction result in variable award accounting for the combined award?

Background: FIN 44 provides that variable award accounting is required for otherwise fixed stock options that are modified to *directly or indirectly* reduce the exercise price of the award. Variable award accounting applies from the date of repricing until the date the award is exercised or forfeited, or expires.

Guidance: The above transaction would be viewed as an "indirect" repricing of the underwater stock options, with variable award accounting required for the combined award from the date of grant of the new award to the date the underwater award is exercised or forfeited, or expires. However, the above transaction would *not* be viewed as an indirect repricing (and variable award accounting would *not* be required) if the exercise period for the new award expires upon the earlier of (1) 10 years, or (2) *at least 6 months* after the stock price target is attained.

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In a new development, the Securities and Exchange Commission (SEC) has identified 31 practice issues and questions relating to stock compensation accounting and forwarded the list to the FASB for resolution. The EITF has formed a working group to consider these issues. A summary of the working group's views and recommendations with respect to eight of these 31 issues was released on August 30 and is scheduled for discussion with the EITF on September 20. The project is identified as EITF Issue No. 00-23.

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General questions may be addressed to Thomas Haines in our Chicago office at (312) 332-0910. Specific questions should be referred to the company's professional accountants. Copies of this letter and other published materials are available on our website at www.fwcook.com.