

March 7, 2002

**EITF Releases More Complex
Guidance Under Issue No. 00-23**
Favorable Outcome for Tax Reloads

The Emerging Issues Task Force (EITF) continued its deliberations on Issue No. 00-23 by addressing ten additional stock compensation issues and subissues that are briefly summarized in this letter and explained in greater detail in our summaries of EITF Issue No. 00-23 (00-23) ([click here for link](#)) and FASB Interpretation No. 44 (FIN 44) ([click here for link](#)) available on our website at www.fwcook.com. The EITF reached a “consensus” (or final conclusion) on seven of the issues, amended a previously reached consensus on two issues (Issues 35 and 41), and reached a “tentative conclusion” (which means the issue will be discussed further at a future meeting) on Issue 48 dealing with related-party broker cashless exercises. All new guidance is subject to a “prospective” application date beginning with transactions that occur subsequent to January 24, 2002.

Issue 47 -- Tax Reloads

- Issue:*
- Does a “tax reload” feature result in variable award accounting for an otherwise fixed stock option
- Previous Guidance:*
- FIN 44 permits fixed award accounting for stock options that include a reload feature in the original terms of the award for mature shares tendered in a stock-for-stock exercise; variable award accounting is required if the reload feature is added through a subsequent modification of the award or the design provisions are not consistent with the limited fact pattern in EITF Issue No. 90-7
 - The EITF in previous 00-23 deliberations decided not to overturn the FIN 44 guidance in regard to stock-for-stock reloads, but decided to reevaluate the continued appropriateness of tax reloads
- New Guidance:*
- Variable award accounting is not required if the original terms of an otherwise fixed stock option provide a reload feature for shares used to satisfy minimum statutory tax withholding obligations upon exercise
 - Further, the shares used to satisfy minimum statutory tax withholding obligations need not satisfy the 6-month holding period requirement in EITF Issue No. 84-18

Issue 35 -- Stock Option Loan Forgiveness

- Issue:*
- How to account for a stock option that is exercised with a recourse note negotiated at the date of exercise, if the terms of the note or another agreement provide that the note will be forgiven in whole or in part if specified “substantive” performance goals are achieved; that is, a loan forgiveness arrangement

- Previous Guidance:*
- FIN 44 provides no guidance in regard to stock option loan forgiveness arrangements
 - The EITF in previous 00-23 deliberations on Issue 35 concluded that variable award accounting is required if an otherwise fixed stock option is exercised using as consideration a recourse note that includes a loan forgiveness arrangement (because the exercise price is not fixed); further, any amount of the loan actually forgiven is recognized as additional compensation cost
 - The EITF stated it would provide additional guidance on how to apply variable award accounting in this fact pattern
- New Guidance:*
- Provided the performance goals are substantive and the stock option is considered “exercised” for accounting purposes (that is, the loan is not deemed to be “nonrecourse”), variable award accounting is required for the date of exercise; the EITF did not address loan forgiveness arrangements with “non-substantive” performance goals, but presumably the option exercise would not be recognized (because the loan is deemed to be nonrecourse) and thus variable award accounting would continue beyond exercise, resulting in potentially bizarre accounting consequences such as
 - ⇒ The stock options are legally exercised and the employee is able to sell the shares; if sold, the employer would be accounting for stock options even though the employee no longer holds the shares
 - ⇒ If deemed to be outstanding stock options for accounting purposes, the shares issued would not be considered outstanding for purposes of computing basic earnings per share (even if subsequently sold by the employee); stock option shares are considered outstanding for basic earnings per share once exercised
 - ⇒ The employee has paid income taxes on the exercise of the stock options
 - ⇒ The employer would have received a tax benefit upon exercise of the stock options
 - ⇒ There is no provision to accept the shares issued upon exercise of the stock option as full payment for the note; a nonrecourse note permits the borrower to tender the collateral in full repayment of the note, even if the fair value of the collateral is less than the amount due under the note
 - The EITF also did not address loan forgiveness arrangements that are “embedded in the terms of an option agreement” (rather than issued in conjunction with option exercise) or arrangements that are based on “continued service” (rather than specified performance goals), but presumably the same variable award accounting would apply because the exercise price is not fixed

Issue 39(d) -- Stock Option Repricings

- Issue:*
- Whether variable award accounting is required for a six-month-and-one-day at-the-money stock option repricing at other than a 1:1 replacement ratio, such as when the number of replacement stock options exceeds the number of canceled stock options
- Previous Guidance:*
- FIN 44 provides that if at the time a stock option is canceled, there exists any oral or written agreement or implied promise to compensate the employee for stock price increases until a new stock option is granted, the look-forward period becomes irrelevant and the new stock option is deemed to be a replacement award subject to variable award accounting, even if granted outside the look-forward period

Previous Guidance (cont.):

- The EITF in previous 00-23 deliberations concluded that a new replacement award granted more than 6 months after a canceled award could be viewed as compensating the employee for stock price increases if the new award was in-the-money” or was linked to a previously granted award through expiration terms (00-23, Issues 24, 39(b), and 39(e))

New Guidance:

- Variable award accounting is not required provided the number of new at-the-money replacement stock options is not determined by a formula that is either directly or indirectly linked to changes in the market price of the underlying stock
- Variable award accounting is required for the new replacement stock options (regardless of when granted) if judgement indicates that the formula is intended to compensate the grantee for stock price increases during the 6-month safe harbor

Issue 41 -- Stock Option Conversions

Issue:

- What is the accounting consequence of exchanging outstanding stock options based on a class of stock that is being eliminated into a surviving class of stock

Previous Guidance:

- FIN 44 only provides guidance for award exchanges that occur in connection with a “nonreciprocal” equity restructuring, such as a stock split or spinoff (refer to Issue 49 below)

- The EITF in previous 00-23 deliberations provided guidance for other types of award exchanges, such as the exchange of stock options among different members of a consolidated group, the exchange of one class of tracking stock options into another, and the exchange of an eliminated class of tracking stock options into a surviving class of common stock options (00-23, Issues 1, 28(b), and 41 (prior to the January 23, 2002 EITF meeting))

- Essentially, the exchange results in a new measurement date provided (1) the aggregate intrinsic value is not increased (or negative intrinsic value reduced), and (2) the ratio of exercise price to market price per share is not reduced; variable award accounting is required if the above two criteria are not met

New Guidance:

- The previous EITF guidance for award exchanges in other than a nonreciprocal equity restructuring (that is, either a new measurement date or variable award accounting) should be followed in event of the elimination or exchange of any class of stock, including a change from a multiple-class to a single class capital structure, and exchange of nonvoting for voting common stock, and the elimination of one of several tracking stocks

Issue 49 -- Stock Option Conversions

Issue:

- The accounting consequence of adjusting outstanding stock options or awards in connection with a nonreciprocal equity restructuring when the outstanding awards have “negative” intrinsic value

Previous Guidance:

- FIN 44 provides that there is no accounting consequence for otherwise fixed stock options or awards that are modified (regardless of whether the modification is pursuant to the original terms of the award or not) to adjust the exercise price and/or number of shares coincident with an equity restructuring provided (1) the aggregate intrinsic value of the award is not increased, and (2) the ratio of exercise price to market price per share is not reduced; variable award accounting is required if the above two criteria are not met

- Previous Guidance (cont.)*
- FIN 44 does not contemplate how the formula would apply for awards with “negative” intrinsic value on the date of the exchange (as does the guidance in Issue 41 above)
- New Guidance:*
- There is no accounting consequence as a result of the exchange provided (1) the aggregate negative intrinsic value is not reduced, and (2) the ratio of exercise price to market price per share is not reduced
 - If the second requirement of the formula is satisfied but the aggregate negative intrinsic value is reduced (that is, the first requirement is not satisfied), the exchange is accounted for as the grant of a new award (the number of additional stock options that would have been issued to maintain the same aggregate negative intrinsic value) and a deemed cancellation of those additional awards that would be subject to the look-back look-forward cancellation and replacement guidance in FIN 44 and 00-23, Issue 39(f)
 - If the second requirement of the formula is not satisfied, variable award accounting is required for the entire exchanged award

Issues 42(a), 42(b), 42(c) -- Noncompensatory Plans

- Issue:*
- Whether “noncompensatory” stock compensation plans in tax jurisdictions outside the United States (such as “Save-As-You-Earn” plans in the United Kingdom) are noncompensatory under APB Opinion No. 25 (Opinion 25) if the purchase discount and exercise period provisions exceed permissible limits under Internal Revenue Code (IRC) Section 423 employee stock purchase plans
- Previous Guidance:*
- FIN 44 provides that employee stock purchase plans meeting the criteria of IRC Section 423 are deemed to be noncompensatory under Opinion 25, and thus do not result in compensation cost to the grantor company
 - Permissible IRC provisions include (1) purchase discounts of up to 15 percent of the stock price at grant, and (2) exercise periods of up to 27 months in the case of an exercise price based on the stock price at grant, or 5 years in the case of an exercise price based on the stock price at exercise
- New Guidance:*
- Compensatory plan accounting is required under Opinion 25 for an employee stock purchase plan with purchase discount or exercise period provisions that exceed IRC Section 423 limits, regardless of whether the plan is deemed noncompensatory outside the United States
 - Further, variable award accounting is required for such plans if the grantee can elect to cancel (and forfeit) one purchase contract and within 6 months enter into a new contract offered by the employer at a lower exercise price (the transaction is viewed as a repricing)

Issue 46 -- Transferability Restrictions

- Issue:*
- Is there an accounting consequence if an otherwise fixed stock option or award is modified to remove transferability restrictions (such as to a family member or unrelated third party)

- Previous Guidance:*
- FIN 44 implicitly provides that neither a new measurement date nor variable award accounting is required for otherwise fixed stock options or awards that are modified other than to (1) extend the maximum contractual or post-termination exercise period, (2) provide for an acceleration or continuation of vesting, or (3) change the exercise price or the number of shares underlying the award; examples of presumably permissible modifications include the addition of option gain deferral provisions, limited transferability provisions, and stock-for-stock exercise and minimum statutory stock-for-tax withholding provisions
- New Guidance:*
- The modification results in no adverse accounting consequence provided all relevant facts and circumstances indicate (1) the modification is not, in substance, a reacquisition of the award by the employer (for example, the employer pays cash or other consideration to reacquire the award), or (2) the employer directly or indirectly obtains an economic benefit as a result of the transfer of the stock option or award, such as when the employee transfers the award to a nonemployee who provides services to the employer

Issue 48 -- Cashless Exercises

- Issue:*
- Is there an accounting consequence for a “cashless exercise” affected using a broker that is a related party of the company
- Previous Guidance:*
- Neither FIN 44 nor 00-23 provide guidance in regard to related-party broker cashless exercises; in practice some accountants believe there is no accounting consequence, whereas others believe the use of an affiliated broker results in either a new measurement date or variable award accounting
- New Guidance:*
- Tentative conclusion that, assuming the broker is a substantive entity with operations separate and distinct from the grantor company, there is no adverse accounting consequence provided (1) the employee takes ownership of the shares prior to sale by the broker, and (2) the broker sells the share on the open market
 - The EITF plans to discuss this issue further at a future meeting

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General questions about this letter may be addressed to Tom Haines at (312) 332-0910 or tmhaines@fwcook.com. Copies of this letter and other related letters on this topic are available on our website at www.fwcook.com under the following links:

- September 15, 2000 – FASB and EITF Issue Rulings on Accounting for Stock Compensation – <http://www.fwcook.com/091500.html>
- October 11, 2000 – EITF Resolves Several Stock Option Accounting Issues – (<http://www.fwcook.com/101100.html>)
- January 9, 2001 – EITF Continues to Issue New Guidance on Accounting for Stock Compensation – (<http://www.fwcook.com/publications/pub2001/010901TMHrevised.html>)
- March 7, 2001 – EITF Continues its Deliberations on Issue No. 00-23 – (<http://www.fwcook.com/publications/pub2001/030701TMH.html>)
- August 16, 2001 – An Update on the Continuing Deliberation of Issue No. 00-23 – (http://www.fwcook.com/alert_letters/8-16-01-AnUpdateContDeliberEITF.pdf)
- December 27, 2001 – EITF Deliberations on Issue No. 00-23 Continue into Second Year – http://www.fwcook.com/alert_letters/12-27-01%20Revised%20EITF-%20TMH.pdf