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New York • Chicago • Los Angeles

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## **Executive Compensation Year in Review (2001)**

The following is a review of key accounting, legislative and regulatory developments of 2001 that impact the field of executive compensation. Additional details for each of these summaries may be found in corresponding “alert” letters on our website at [www.fwcook.com](http://www.fwcook.com).

### **Accounting Developments**

- During 2000, the Emerging Issues Task Force (“EITF”) began extensive deliberation on over 30 practice issues and questions regarding the accounting for stock compensation under APB Opinion No. 25 (“APB 25”) and FASB Interpretation No. 44 (“FIN 44”). This project, known as EITF Issue No. 00-23, has grown in scope to address over 60 practice issues and sub-issues. The following summarizes some of the key conclusions from these deliberations reached during 2001 (excludes conclusions summarized in our 2000 review alert letter dated [3/29/01](#)).
- Accounting for reload stock options has remained nearly unchanged. The EITF decided *not* to require variable award accounting for otherwise fixed stock options that include a reload feature as long as the reload was in the original terms of the award and the original shares are exercised using mature shares in a stock-for-stock exercise transaction. Further, tax reloads for the shares used to satisfy *minimum statutory* tax withholding obligations upon exercise do not create variable accounting.
- The exercise of a stock option with a full recourse note does *not* trigger variable accounting on the underlying shares as long as the note is (1) truly full-recourse (i.e., collateralized by the option-holders’ personal assets if the underlying shares are not sufficient), (2) at a market rate of interest (i.e., a rate that the borrower could get in the market taking effect of their personal creditworthiness), and (3) free of any forgiveness provisions.
- An offer to cancel and replace options within the 6-month proscribed time period results in variable award accounting treatment for all stock options subject to the offer, even if the offer is never accepted.
- The “clock” on the 6-month look-back look-forward period in an allowable cancellation-and-replacement option repricing begins when the offer to cancel is made and ends six months after the actual cancellation date. Therefore, a long offering period extends the window during which a grant of new awards would be variable.

- A new measurement date is required (but not variable award accounting) in the event of certain stock option exchanges that are *not* in connection to a spin-off (i.e., exchange of parent company options for subsidiary options in an IPO) so long as the aggregate intrinsic value of the award is not increased (or the negative value reduced), and the ratio of exercise price per share to market value per share is not reduced. If the two criteria are *not* met, then variable award accounting is required for the converted award because the exchange is deemed to be an indirect repricing.
- There are no adverse accounting consequences associated with the *early exercise* of a stock option that is subject to a contingent employer repurchase right (i.e., “call right”) during the remaining vesting period of the award, provided certain conditions are satisfied.
- Previously measured compensation cost for a fixed stock award is never subject to reversal unless the employee forfeits the award.
- There may be adverse accounting consequences if a full-value fixed stock award (such as restricted stock) is cancelled and replaced with new stock options; that is, the transaction is deemed to be an *upward repricing*.

*(For additional conclusions and further information, see alert letters dated [8/16/01](#), [8/23/01](#), [12/27/01](#), and [3/7/02](#))*

- The International Accounting Standards Board (“IASB”) was formed in January 2001 to produce common global accounting standards to be adopted by member nations. In September 2001, the IASB announced its intent to develop a new global accounting standard for employee stock options and other equity-based grants. The initial step in this process was a call for comment on a July 2000 discussion paper, “Accounting for Share-based Payments,” which advocates a P&L charge for the “fair value” of employee stock options, using option-pricing models at the vesting date. The IASB intends to use the July 2000 discussion paper and public comment to develop an exposure draft for release in mid-2002. Comments will be invited on the exposure draft, following which the IASB will finalize their new global accounting standard. Adoption of the new standard is voluntary, but all member nations’ accounting standard-setting bodies have pledged to support the IASB, including the United States. The new IASB standard, if adopted by FASB, would replace APB 25, which has governed stock option accounting in the U.S. since 1972, and SFAS No. 123, which was adopted by FASB in 1995 as an alternative to APB 25.

*(For further information, see alert letters dated [6/22/01](#), [8/9/01](#), and [10/3/01](#))*

### **Legislative and Regulatory Developments**

- For many years, the law has been unclear as to whether employee stock purchase plans (“ESPPs”) were afforded the same exemption from employment taxes (i.e., FICA and FUTA) as incentive stock options (“ISOs”). In January 2001, the Internal Revenue Service (“IRS”) issued Notice 2001-14, which eliminated the exemption for ISOs and suspended the collection of employment taxes on both ESPPs *and* ISOs

until at least January 1, 2003, subject to clarification of the law, and opened the issue for public comment. Since then, the comment period has ended and the IRS has released its proposed regulations. The proposed regulations provide for the imposition of FICA and FUTA taxes on gains from exercise of options granted under tax-qualified ESPPs *and* from ISOs. The IRS also released two notices relating to the proposed regulations. The first notice, IRS Notice 2001-72, proposes that no income tax withholding will be required on ESPP and ISO transactions upon a disqualifying or other disposition, but will require that income resulting from disqualifying dispositions must be reported on an employee's Form W-2. The second notice, IRS Notice 2001-73, addresses ways to ease the administrative burden of collecting the related employment taxes. As of this date, the regulations have not been finalized.

In response to IRS Notice 2001-14, the Chairman of the House Ways and Means Oversight Subcommittee, Amo Houghton (NY), introduced a bill into Congress that would exempt ESPPs and ISOs from employment taxes at exercise and income tax withholding at exercise or at a disqualifying disposition. The bill's purpose is to avoid diminishing or eliminating the use of ESPPs and ISOs by companies seeking to build broad-based employee ownership. In August 2001, the bill was introduced into the Senate by Senator Hillary Rodham Clinton (NY) and co-sponsored by Senator Pat Roberts (KA). As of this date, the bill has not yet passed.

*(For further information, see alert letters dated [10/1/01](#) and [1/11/02](#))*

- In December 2001, the Securities and Exchange Commission ("SEC") voted unanimously to require more thorough disclosure of equity incentive plan details in company proxy statements and annual reports (Form 10-K). Companies are now required to disclose details for shareholder-approved *and* non-shareholder-approved plans. Companies with multiple incentive plans may report the data in aggregate, except shareholder-approved and non-shareholder-approved plan details must remain separate. Disclosure requirements include:
  - Number of securities to be issued upon exercise of outstanding options, warrants and rights
  - Weighted-average exercise price of outstanding options, warrants and rights
  - Number of securities available for future awards, excluding shares for which the company is currently seeking shareholder approval
  - Information regarding individual arrangements and assumed plans with shares available for future awards (may be combined with the aggregate data of the appropriate disclosure category)
  - A brief narrative of non-shareholder-approved plans, which outlines major provisions, similar to disclosure required for shareholder-approved plans

A company must report equity incentive plan details in Form 10-K on an annual basis, and in the company proxy statement during years in which an equity incentive plan is the subject of a vote. Companies must comply with the new disclosure rules

for Form 10-K for fiscal years ending on or after March 15, 2002, and for proxy statements for annual meetings on or after June 15, 2002.

*(For further information, see alert letters dated [2/23/01](#) and [1/7/02](#))*

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Questions regarding the topics covered in this letter may be directed to the consultant(s) referenced at the end of the corresponding “alert” letters. General questions regarding this letter may be directed to David Yang in our Chicago office at (312) 332-0910. Additional information regarding our firm and other executive compensation topics may be found on our website at [www.fwcook.com](http://www.fwcook.com).

**Referenced "Alert" Letters by Date**

- 1) **February 23, 2001** - "Proposed SEC Disclosure Rules for Equity Compensation Plans"
- 2) **June 22, 2001** - "New International Accounting Standards Board May Try to Impose an Earnings Charge for Stock Options Under U.S. GAAP"
- 3) **August 9, 2001** - "IASB Announces Project to Change Accounting Standards for Stock Options"
- 4) **August 16, 2001** - "An Update On the Continuing Deliberation of EITF Issue No. 00-23"
- 5) **August 23, 2001** - "Potentially Negative Accounting Changes For Stock Options with a Reload Feature"
- 6) **October 1, 2001** - "Bill Introduced into Congress Exempting Employee Stock Purchase Plans and Incentive Stock Options from Employment Taxes and Income Tax Withholding"
- 7) **October 3, 2001** - "International Accounting Standards Board Reopens Controversial Stock Option Accounting Project"
- 8) **December 27, 2001** - "EITF Deliberations on Issue No. 00-23 Continue into Second Year"
- 9) **January 7, 2002** - "SEC Adopts New Disclosure Rules for Equity Incentive Plans"
- 10) **January 11, 2002** - "IRS Issues Proposed Regulations on the Taxation of Employee Stock Purchase Plans and Incentive Stock Options"
- 11) **March 7, 2002** - "EITF Releases More Complex Guidance Under Issue No. 00-23"