Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

March 7, 2001

# EITF Continues its Deliberations on Issue No. 00-23

The Emerging Issues Task Force (EITF) is in the midst of an extensive deliberation of over 30 practice issues and questions on the accounting for stock compensation under APB Opinion No. 25 and FASB Interpretation No. 44.[1] At its meeting on September 21, 2000, the EITF reached a "consensus" on seven issues.[2] At its meeting on November 16, 2000, the EITF reached a consensus on 14 issues and a "tentative conclusion" on one other issue.[3] And most recently, at its meeting on January 17, 2001, the EITF reached a consensus on an additional 14 issues. Further discussion of the tentative conclusion reached at the November 16, 2000 meeting and of an unspecified number of additional issues is expected at a future meeting(s). This letter briefly summarizes the conclusions reached at the January 17, 2001 meeting.

## Share Repurchase Features (Issues 23(a), (b), (c), and (d))

FIN 44 provides that variable award accounting is required for otherwise fixed stock options or awards with a share repurchase feature if (1) an employer "call" right is *expected to* be exercised within 6 months after option exercise or share issuance, or (2) an employee "put" right *can be* exercised at the volition of the employee within 6 months after option exercise or share issuance.

The EITF has provided complex guidance to help companies determine when an employer call right is "expected to" be exercised and when an employee put right "can be" exercised. Essentially, all employer call rights are presumed to be exercised (and thus variable award accounting is required) unless (1) an employer with an "active" call right (i.e., a call right that is not contingent on future events) makes a "stated representation" not to call the shares and that representation is consistent with all "relevant facts and circumstances," or (2) the call right is "contingent" upon an event that is outside the control of the employer and the event is not expected to occur. All employee put rights are presumed to be exercised (and thus variable award accounting is required) unless the put right is contingent upon an event that is outside the control of the employee and the event is not expected to occur (there are special rules for put rights at a "premium" to fair value). The last page of this letter summarizes the accounting consequences of various employer call and employee put right scenarios.

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1 EITF Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*

2 Refer to our letter dated October 11, 2000

3 Refer to our letter dated January 9, 2001

**Cancellation and Replacement Awards (Issue 24)**

Under FIN 44, the cancellation of a (presumably "underwater") stock option followed by the grant of a new stock option with a lower exercise price within 6 months after cancellation of the old stock option results in variable award accounting for the new stock option. An example in FIN 44 clearly illustrates that variable award accounting does *not* apply if the new stock option is granted "at-the-money" and at least 6 months and one day after cancellation of the old stock option (even if an agreement existed on the cancellation date to grant the new stock option).[4] The EITF has concluded, however, that if the new stock option is granted "in-the-money" (i.e., with an exercise price lower than the stock price at grant) variable award accounting is required for the new stock option unless all relevant facts and circumstances clearly indicate the new in-the-money stock option was not "intended to compensate the grantee for stock price increases" after cancellation of the old stock option.

**Increase Exercise Price or Reduce Number of Shares (Issue 26)**

FIN 44 does not specifically provide guidance for modifications to otherwise fixed stock options or awards that *increase* the exercise price and/or *reduce* the number of shares, other than to indicate that such modifications will generally result in an "effective cancellation" of the awards for purposes of the cancellation and replacement rules. The EITF has concluded that the modification results in either a new measurement date or variable award accounting, depending on all relevant facts and circumstances. A new measurement date is required if it is possible to conclude that further changes to the exercise price or number of shares will not occur in the future, such as when unusual modifications are sometimes made to comply with the regulatory environment.[5] Variable award accounting is required if there is no practical way to ascertain whether further changes to the exercise price or number of shares will occur in the future, such as when the award has been similarly modified in the past or other factors indicate that similar modifications are possible in the future.

**Tracking Stock (Issues 28(a) and (b))**

Tracking stock is considered for legal and accounting purposes to be equity of the parent company, and not equity of the unit or subsidiary to which the stock tracks. If the tracking stock is "substantive" (e.g., if the tracking stock is publicly traded), the stock compensation should be accounted for in the separate subsidiary and consolidated financial statements under APB Opinion No. 25 (and not FASB Statement No. 123). If the tracking stock is not substantive, the award should be accounted for as a cash-based or formula arrangement in both the separate subsidiary and consolidated financial statements. Tracking stock is also treated as parent-company stock for purposes of determining whether a new measurement date or variable award accounting is required if the tracking stock is "exchanged" for the stock in another member of the consolidated group.[6]

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4 FASB Interpretation No. 44, Illustration 4(e), paragraphs 194 to 197; note that variable award accounting would be required for the new stock option if the facts in the example were reversed so that an agreement existed at the grant date to cancel the old stock options at some future date

5 Refer to EITF Issue No. 00-23, Issue 17

6 Refer to EITF Issue No. 00-23, Issue 1

**Other Conclusions**

- Variable award accounting is required if the original terms of an otherwise fixed stock option provide for exercise with a full-recourse note that *may not* bear a market interest rate on the date of exercise; variable award accounting is not required if the interest rate is established *upon exercise* (rather than grant), provided the interest rate is "a market rate based on the rate environment at the date of exercise" (Issue 25)
- Variable award accounting is required for a combined cash bonus and stock option award if the cash bonus is contingent upon the employee's *exercise* of the option or *sale* of the stock received from the option exercise; variable award accounting is not required if the cash bonus is contingent solely upon *vesting* of the related award (Issue 27)
- All or a portion of the "income tax benefit" from the exercise of vested stock options that were issued in a purchase business combination is recognized as a *reduction* to the purchase price of the acquired business, i.e., a reduction of "goodwill" (Issues 29(a) and (b))
- Variable award accounting is required if an otherwise fixed stock option is modified to add a "short-term inducement" to exercise the stock option, e.g., an additional cash bonus or increased number of shares for a short period of time (Issue 30)
- Variable award accounting is required if the exercise price of a stock option is denominated in multiple currencies or in a currency other than the "primary" currency of the employer or employee (Issue 31)

A detailed summary of the issues covered to date under EITF Issue No. 00-23 can be accessed via our website. In addition, our detailed summary of FIN 44 (originally dated May 1, 2000) has been updated to include the EITF issues covered to date, and can also be accessed via our website.

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General questions about this letter may be addressed to Thomas Haines in our Chicago office (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, www.fwcook.com.

| | Employer / Employee Share Repurchase Rights | | | | |
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| | Active Rights, i.e., Not Contingent on Future Events | | Contingent Rights, i.e., Contingent on Future Events | | |
| | | | | Outside Control of Employer or Employee | |
| Scenario | Employer Representation Not to Call (consistent with relevant facts and circumstances) | No Employer Representation | Within Control of Employer or Employee | Event Expected to Occur | Event Not Expected to Occur |
| *Repurchase Right at Fair Value Within 6 Months of Option Exercise or Share Issuance (substantial investment has been made for nonpublic company)*:* | | | | | |
| -- Employer Call Rights | Fixed Award Accounting | Variable Award Accounting | Assess Under "Active Rights" | Assess Under "Active Rights" | Fixed Award Accounting |
| -- Employee Put Rights | Not Relevant | Variable Award Accounting | Variable Award Accounting | Variable Award Accounting | Fixed Award Accounting |
| *Repurchase Right at Other Than Fair Value (substantial investment has not been made for nonpublic company)**:* | | | | | |
| -- Employer Call Rights | Fixed Award Accounting (unless call right is at less than fair value) | Variable Award Accounting | Assess Under "Active Rights" | Assess Under "Active Rights | Fixed Award Accounting |
| -- Employee Put Rights | Not Relevant | Variable Award Accounting (unless put right is at fixed premium over fair value)*** | Variable Award Accounting (unless put right is at fixed premium over fair value)*** | Variable Award Accounting (unless put right is at fixed premium over fair value)*** | Fixed Award Accounting |

* For all fair value repurchase rights, if the terms of the right do not allow repurchase within 6 months after option exercise or share issuance, the repurchase right does *not* result in variable award accounting; if variable award accounting is required, it should continue until the *earlier of* (1) when the expectation of repurchase no longer exists, (2) when the call or put right expires or is exercised, or (3) when the shares subject to the call or put right are no longer "immature" (compensation cost recognized while the award was accounted for as a variable award should not be reversed if the award is subsequently accounted for as a fixed award)

** Whether the repurchase is expected to occur within 6 months after option exercise or share issuance is not relevant for repurchase rights at other than fair value (unless the repurchase right is at a fixed premium to fair value); if variable award accounting is required, it should continue until the earlier of expiration or exercise of the call or put right (or, for nonpublic companies, 6 months after the employee makes a substantial investment)

*** A put right at a fixed premium over fair value results in either (1) variable award accounting (until the earlier of expiration or exercise of the put right, or 6 months after option exercise or share issuance) if the put right is exercisable within 6 months after option exercise or share issuance, or (2) additional compensation cost in an amount equal to the fixed premium (to be recognized over the vesting period) if the put right is *not* exercisable within 6 months after option exercise or share issuance