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An Update On the Continuing Deliberations of EITF Issue No. 00-23

As our readers are aware, the Emerging Issues Task Force (EITF) is in the midst of a significant project dealing with practice issues and questions on accounting for stock compensation that was undertaken by the EITF last year at the prodding of the Securities and Exchange Commission (SEC).[1] The project is referred to as EITF Issue No. 00-23 and it has become unprecedented in scope, with 47 specific issues and subissues deliberated as of this writing and at least 30 additional issues remaining to be discussed. Since our last mailing on the project, the EITF has met twice on April 19 and July 19, 2001 to discuss several issues which are briefly summarized below.

- There is no special treatment for modifications to, or employer payroll taxes associated with the exercise or vesting of, stock options or awards that were previously issued as *vested* awards in a purchase business combination; that is, the modifications or employer payroll taxes are accounted for in the same manner as all other employee stock compensation
- There are no adverse accounting consequences associated with the *early exercise* of a stock option that is subject to a contingent employer repurchase right during the remaining vesting period of the award, provided certain conditions are satisfied
- The *exercise* of a stock option with a full recourse loan will be respected for accounting purposes, provided certain requirements are met; that is, the shares received from the option exercise will not continue to be accounted for as a stock option
- There may be adverse accounting consequences if a stock option is exercisable using a full recourse loan that could be subsequently *forgiven* based upon the attainment of specified performance criteria
- An employer *offer* to cancel and replace stock 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
- Previously measured compensation cost for a fixed stock option or award is *never* reversed 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*

Purchase Business Combinations (Issues 10 and 32)

Anticipating the prohibition of the "pooling-of-interests" method of accounting this summer,[2] the EITF has been busy providing additional guidance on how to account for stock compensation in

[1] Refer to our letters dated October 11, 2000, January 9, 2001, and March 7, 2001.
[2] Refer to FASB Statement No. 141, *Business Combinations.*

"purchase business combinations."[3] As a refresher, FASB Interpretation No. 44 (FIN 44) states that the "fair value" of vested and nonvested stock options or awards exchanged in a purchase business combination is considered part of the purchase proceeds of the transaction. However, the "intrinsic value" of nonvested awards attributable to the *remaining* vesting period of the awards as of the consummation date is "carved out" of the purchase proceeds and reclassified as "unearned compensation." This reclassification is disadvantageous under normal circumstances because the unearned compensation must be recognized as compensation cost over the remaining vesting period of the exchanged awards, whereas the remaining purchase proceeds are typically allocated to "goodwill" which (under new accounting guidance) is recognized as a cost of the transaction *only if and when* the goodwill becomes "impaired."[4]

At its meeting in April 19, the EITF decided to withdraw its "tentative conclusion" previously reached on <u>Issue 10</u> which deals with the subsequent *modification* of stock options or awards that were previously exchanged in a purchase business combination. In that tentative conclusion, the EITF ruled that the accounting consequence of the modification depended on whether the previously exchanged awards were vested or nonvested on the consummation date of the transaction. The subsequent modification of *vested* awards would be treated as a "cancellation" of the previously exchanged awards and a grant of entirely "new" awards, whereas the modification of *nonvested* awards would be treated consistent with any other modification under FIN 44. The "SEC Observer" at the EITF deliberations objected to this bifurcated accounting treatment and stated that, in financial statements filed with the SEC, a subsequent modification of vested *or* nonvested awards previously exchanged in a purchase business combination should be accounted for as a modification under FIN 44 consistent with all other modifications of employee stock compensation.

Separately at the April 19 meeting, the EITF reached a "consensus" (which means a final conclusion) on <u>Issue 32</u> which deals with how to account for employer payroll taxes associated with the exercise or vesting of stock options or awards that were previously exchanged in a purchase business combination and that were *vested* on the consummation date of the transaction. The EITF concluded that 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 (for example, on the date of exercise for a nonqualified stock option), consistent with the guidance in EITF Issue No. 00-16. Further, the subsequent recognition of the liability and cost has no effect on the previous purchase accounting for the combination (that is, the purchase price is not "remeasured").

<u>Early Exercise of Nonvested Stock Options (Issue 33)</u>

A tax-motivated stock option technique has emerged among technology-sector and west-coast companies (sometimes referred to as a "California Style" stock option) whereby employees are allowed to "early exercise" a nonvested stock option, but the shares received upon exercise are subject to a contingent repurchase ("call") right by the company until the underlying award vests. To achieve the desired capital gains tax treatment, the repurchase price is typically based on the *lesser of* the fair value of the stock on the call date or the original exercise price of the underlying award.

[3] Refer to EITF Issue No. 00-23, Issues 8, 9, 11, 12, 13, 14, 29(a), and 29(b).

[4] Refer to FASB Statement No. 142, *Goodwill and Other Intangible Assets.*

The EITF reached a consensus at the July 19 meeting that an employer call right in connection with an early exercise is in substance a vesting provision that does *not* result in adverse accounting consequences for an otherwise fixed stock option, provided the call right (1) expires at the end of the original vesting period of the award, (2) becomes exercisable only if a termination event occurs that would have caused the award to be forfeited, and (3) is priced at the *lower of* the employee's exercise price or the fair value of the stock on the date the call is exercised. Further, the shares received upon early exercise are not considered "issued" for purposes of computing basic earnings per share (EPS) or determining whether the shares are "mature." If the employee subsequently terminates employment before vesting and the employer fails to exercise the call right, the failure is accounted for as a modification of the award to accelerate vesting. Lastly, the above guidance applies regardless of whether the early exercise provision is pursuant to the original terms of the stock option or added through a subsequent modification of the award.

<u>Stock Option Exercises With Recourse Loans (Issue 34)</u>

It has long been thought that the exercise of a stock option using a "full recourse" (as opposed to a "nonrecourse") loan would be respected for accounting purposes.[5] That is, the shares acquired from the option exercise would *not* continue to be accounted for by the company as a stock option. FIN 44 and EITF Issue No. 00-23, <u>Issue 23</u> indicate only that a recourse loan provision that does not bear market rate of interest "introduces variability" to the exercise price and necessitates variable award accounting treatment for the underlying stock option, regardless of whether the loan provision is pursuant to the original terms of the stock option or added through a subsequent modification of the award.

At the July 19 meeting, the EITF discussed whether there are circumstances under which the exercise of a stock option with a full recourse note should *not* be accounted for as an exercise of the option award. The EITF reached a consensus that the legal form of a recourse loan should be respected (and thus the option exercise should be recognized), unless (1) the employer has legal recourse to the employee's other assets but does not intend to seek repayment beyond the shares issued, (2) the employer has a history of not demanding repayment of loan amounts in excess of the fair value of the shares, or (3) the employee does not have sufficient assets or other means (beyond the shares) to justify the recourse nature of the loan. In addition, all other relevant facts and circumstances should be evaluated when determining whether the note should be accounted for as nonrecourse, including whether the loan is ultimately forgiven or whether a portion of the exercise price can be paid with a nonrecourse loan and the remainder with a recourse loan. If the facts and circumstances indicate the loan arrangement is nonrecourse in substance, the arrangement should continue to be accounted for as a stock option in accordance with the complex guidance in EITF Issue No. 95-16 (that is, the exercise is not recognized for accounting purposes).

<u>Recourse Loans With Forgiveness Provisions (Issue 35)</u>

It also has long been thought that the presence of a "loan forgiveness" provision in a bona fide full recourse loan would not taint the fixed award accounting treatment of the underlying stock option.[6] That is, the loan forgiveness provision should be accounted for as a compensation

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[5] In a recourse loan, the lender has access to the borrower's personal assets in event of loan default. In a nonrecourse loan, the indebtedness is secured only by the acquired shares.

[6] Typically, the loan forgiveness provision would be based on service- or performance-vesting contingencies. The fact pattern in this issue is based on a performance-vesting contingency.

arrangement separate from the underlying stock option. The EITF at the July 19 meeting discussed this issue but was unable to reach a consensus or even a tentative conclusion. The SEC Observer at the meeting stated that, pending any new information brought forth to the EITF, such loan forgiveness arrangements would require variable award accounting treatment for the underlying stock option in financial statements filed with the SEC. The EITF plans to further discuss this issue at a future meeting.

Offers to Cancel and Replace Stock Options (Issues 36(a), 36(b), 36(c), 36(d), and 36(e))

Under FIN 44, the cancellation of a 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. Variable award accounting is not required, however, 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 exists on the cancellation date to grant the new stock option). At the July 19 meeting, the EITF discussed a series of issues dealing with an employer's "offer" to cancel existing fixed stock options and (upon acceptance of the offer) grant new replacement stock options:

⇒ The EITF reached a consensus in Issue 36(a) that if the employer offer is to grant new stock options with a lower exercise price *within 6 months* of the cancellation date of the existing awards (that is, an offer to "reprice" the existing awards), the offer results in variable award accounting for *all* existing awards subject to the offer. Variable award accounting commences when the offer is made, and for the awards that are retained because the offer is declined, continues until the awards are exercised, forfeited, or expired.

⇒ The EITF reached a consensus in Issue 36(b) that, because the existing awards in Issue 36(a) are subject to variable award accounting due to a repricing, upon acceptance of the offer and cancellation of the existing stock options, *any* new stock options granted during the 6-month look-back look-forward period are eligible to be replacement awards subject to variable award accounting treatment (not just new stock options with a *lower* exercise price)

⇒ The EITF reached a consensus in Issue 36(c) that if the employer offer is to grant new stock options with an "at-the-money" exercise price *more than 6 months after* the cancellation of the existing awards, the offer results in no adverse accounting consequences for existing awards subject to the offer provided the 6-month "safe harbor" provisions of FIN 44 are satisfied (in substance, the employer has only offered to "cancel" existing awards, not "reprice" the awards)

⇒ The EITF was unable to reach a consensus or tentative conclusion in Issue 36(d) dealing with whether the *length* of the offer period would affect the conclusion reached in Issue 36(c). The SEC Observer stated, however, that a lengthy offer period (or the possibility of multiple offers) would "cast doubt" on whether a measurement date had been established for the original award. The EITF plans to further discuss this issue at a future meeting.

⇒ The EITF was unable to reach a consensus or tentative conclusion in Issue 36(e) dealing with the appropriate date that stock options are deemed to be cancelled when a employer makes an offer to cancel existing stock options and replace with new stock options (for example, the offer date, the acceptance date, or the date the option is legally cancelled

and all regulatory requirements for cancellation have been met). The EITF plans to further discuss this issue at a future meeting.

Other Conclusions (Issues 37(a) and 37(b))

The EITF at the July 19 meeting reach a consensus in Issue 37(a) on how to account for the intrinsic value at the original measurement date of a nonvested fixed stock option that is cancelled and not replaced with a new award. Consistent with the compensation cost recognition guidance for fixed awards in FIN 44, the EITF ruled that companies should (1) *always* recognize as compensation cost the intrinsic value of the award (if any) at the original measurement date, and (2) *never* reverse previously measured compensation cost for a fixed award unless the employee "fails to fulfill an obligation."

The EITF at the July 19 meeting also reached a consensus in Issue 37(b) on how to account for the "settlement" of nonvested stock awards (for example, restricted stock) with new "at-the-money" stock options. The EITF ruled that the transaction is deemed to be an "upward repricing" and the guidance in Issue 26 should be followed to determine whether a new measurement date or variable award accounting is required for the new stock options. Regardless of how the new stock options are accounted for, the original intrinsic value of the settled nonvested awards should be recognized as compensation cost consistent with the guidance in Issue 37(a) (that is, the previously measured cost should *not* be reversed).

Other Information Available on the Internet

Detailed summaries of EITF Issue No. 00-23 and FIN 44 (which have been updated to include all relevant EITF Issues covered to date) can be accessed via our website at www.fwcook.com under the following document titles:

⇒ EITF Issue No. 00-23: Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 (dated as of this letter)

⇒ FASB Interpretation No. 44- Accounting for Certain Transactions Involving Stock Compensation (originally dated May 1, 2000 and revised as of the date of this letter)

In addition, a detailed summary of the remaining issues to be covered by EITF Issue No. 00-23 can be temporarily accessed via the FASB's website at:

http://accounting.rutgers.edu/raw/fasb/eitf/0023WGWPlan.pdf.

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This letter is intended to "alert" compensation professionals to accounting developments that could affect their companies. Companies interested in more specific information should contact their accounting representatives. General questions may be addressed to Thomas Haines at (312) 332-0910 or tmhaines@fwcook.com. Copies of this letter and other published materials are available on our website at www.fwcook.com.