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New York • Chicago • Los Angeles

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EITF Finally Concludes Deliberations on Issue No. 00-23

Amidst the fanfare surrounding recent developments in executive compensation, the Emerging Issues Task Force (EITF) has quietly concluded deliberations on its long-running stock compensation project referred to as Issue 00-23. Over the 2-year duration of the project, the EITF met nine times to resolve 71 specific practice issues and subissues on the accounting for stock compensation under longstanding Opinion 25 and the more recent Interpretation 44. The result is new guidance that is lengthier and more complex than Opinion 25 and Interpretation 44 combined, making it more difficult than ever to conclude with certainty whether a design provision or employer/employee action will have an adverse accounting consequence. As a result, we have maintained for our readers detailed summaries of Issue 00-23 and Interpretation 44 on our website at www.fwcook.com, and have urged our clients to verify all stock compensation design provisions and employer/employee actions with their professional accountants. We have also summarized the final 00-23 issues that were resolved at the March 20-21 and June 19-20, 2002 EITF meetings at the end of this letter.

Because it has become virtually impossible to keep track of all the restrictive provisions in the new guidance, perhaps a more efficient exercise is to summarize what remains permissible under the new rules. Here is our short list:

1. Plain vanilla at-the-money (or out-of-the-money) stock options and restricted stock that vest solely on continued service (with or without performance-accelerated vesting provisions)
2. Broad-based employee stock purchase plans meeting the requirements of IRC Section 423
3. Stock compensation within the financial statements of a consolidated group based on parent company common or "tracking stock," or subsidiary company stock
4. Stock compensation in the separate financial statements of a consolidated subsidiary based on the stock of the consolidated parent
5. Stock compensation granted to shareholder-elected outside directors for services as a director
6. Stock compensation granted to certain "leased" employees provided certain requirements are met
7. Profits interest awards in a limited liability corporation (LLC)
8. Modifications to out-of-the-money (underwater) stock options to accelerate vesting or extend exercise period provisions
9. Stock-for-tax withholding up to the minimum statutory tax rates
10. Stock-for-stock and stock-for-tax reloads that are part of the original terms of the award (not added through a subsequent modification) provided certain requirements are met
11. Equitable adjustments to the number of shares and/or exercise price in connection with certain equity restructurings

12. Awards that contractually vest upon specified terminations of employment or a "change-in-status" to a nonemployee service provider
13. Broker assisted "cashless exercises" (through an unrelated or related party broker dealer) provided certain requirements are met
14. Share repurchase features (employer "calls" and employee "puts") based on fair value that do not occur within 6 months of option exercise or share issuance
15. Employer offers to cancel and replace stock options using the "six-month-and-one-day" technique
16. Employer offers to cancel underwater stock options and replace with restricted stock (but be careful because any options not cancelled because the offer is rejected are subject to variable accounting)
17. Stock options with an exercise period that "truncates" more than 6 months after a specified stock price goal is attained
18. Combined cash and stock awards so long as the cash payment is contingent on something other than option exercise
19. The "early exercise" of a nonvested stock option coupled with an employer repurchase right during vesting (sometimes referred to as a "California Style" stock option) provided certain requirements are met
20. Accelerated vesting of outstanding nonvested target company stock options or awards in a purchase business combination (keeps compensation cost off of acquiring company's books, but obviously creates retention issues with target company employees)

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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
- March 7, 2002 – EITF Releases More Complex Guidance Under Issue No. 00-23 – http://www.fwcook.com/alert_letters/03-07-02EITFIssuesMoreComplexGuidance.pdf

EITF Issue No. 00-23

Issues Resolved at the March 20-21 and June 19-20, 2002 EITF Meetings

Issue / Topic	EITF Consensus
Issue 33(a) -- How to account for the "early exercise" of a stock option if the employer has a contingent repurchase or "call" right until the award is vested with a strike price equal to the *lesser of* fair value of the stock at the call date or the original exercise price paid by the employee (sometimes referred to as a "California Style" stock option)	• The contingent call right is in substance a forfeiture provision that preserves the original vesting schedule of the award and results in no adverse accounting consequences for the early exercise 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; an acceleration of vesting occurs if the employee terminates employment prior to vesting and the employer fails to exercise the call right • In addition, 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" • The guidance above 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 • The guidance above applies prospectively to stock options granted or modified after July 19, 2001
Issue 33(b) -- Same fact pattern as Issue 33(a) except that the strike price for the employer call right is based solely on the original exercise price paid by the employee (i.e., *not* the lesser of fair value of the stock at the call date or the original exercise price)	• The early exercise is *not* recognized for accounting purposes if the employer strike price is based solely on the original exercise price of the stock option; rather, any cash paid for the exercise price is considered a deposit or prepayment of the exercise price that should be recognized by the employer as a liability • The stock options should only be accounted for as exercised when the awards become vested and the employer repurchase right lapses; an acceleration of vesting occurs if the employee terminates employment prior to vesting and the employer fails to exercise the call right • The guidance above applies prospectively to stock options granted or modified after March 21, 2002
Issue 40(a) -- Whether a grantee who provides services to an LLC (or other pass-through entity) should be considered an employee for purposes of accounting for capital- or equity-based compensation (profits interest awards) granted by the LLC	• The grantee of a profits interest award should be considered an employee if the grantee qualifies as a common law employee; the fact that the LLC does not classify the grantee as an employee for payroll tax purposes is not relevant • The guidance above applies prospectively to profits interest arrangements of an LLC (or other pass-through entity) after November 15, 2001
Issue 40(b) -- If a grantee of a profits interest award is considered to be an employee for purposes of applying APB Opinion No. 25, whether that award should be accounted for as a fixed or variable award	• A profits interest award should be accounted for based on its substance, taking into consideration all relevant facts and circumstances including the investment required, liquidation or prepayment provisions, and provisions for the realization of value • The guidance above applies prospectively to profits interest awards granted after March 21, 2002
Issue 44 -- The accounting consequence of an acquiring company's decision *not* to assume outstanding target company stock options or awards in connection with a purchase business combination	• So long as no legal obligation exists to assume outstanding target company stock options or awards, those awards and any new awards granted by the acquiring company should not be linked for accounting purposes (and any target awards not assumed would not be deemed to be "effectively canceled" for purposes of the cancellation and replacement guidance in FASB Interpretation No. 44)

Issue / Topic	EITF Consensus
<u>*Issue 44 -- (cont.)*</u>	• However, post-acquisition awards should be accounted for as consideration for the purchase business combination if there is evidence of an oral or implied agreement at acquisition to grant new awards to target grantees in exchange for target company stock options or awards after the acquisition (a grant made within 1 year of acquisition to target employees that differs significantly from the acquiring company's normal grant pattern may provide evidence of such an implied agreement) • The guidance above applies prospectively to business combinations consummated after March 21, 2002
<u>*Issue 46*</u> -- The accounting consequence of a transferability provision on an otherwise fixed stock option or award (either pursuant to the original terms of the award or through a subsequent modification of the award)	• A transferability provision (either pursuant to the original terms of the award or through a subsequent modification of the award) does not result in an accounting consequence, unless all relevant facts and circumstances indicate (1) the subsequent transfer results in a reacquisition of the award by the employer (for example, the transfer results in the payment of cash or other consideration by the employer to reacquire the award), or (2) the employer facilitates the transfer to circumvent existing accounting rules, as would be the case if the employer uses the employee as a conduit to transfer the award to a nonemployee service provider of the employer (thereby avoiding the accounting requirements of FASB Statement No. 123 and EITF Issue No. 96-18) • The guidance above applies prospectively to awards granted or modified after March 21, 2002
<u>*Issue 48*</u> -- The accounting consequence of a "cashless exercise" of a stock option effected through a broker	• There is no accounting consequence for a cashless exercise of a stock option effected through a broker that is *unrelated* to the grantor, provided that the employee makes a valid exercise of the stock option and the grantor concludes the employee is legal owner of all option shares (that is, the employee assumes market risk from the moment of exercise until the broker effects the sale on the open market); if the employee is never legal owner of the shares, the stock option would be in substance a stock appreciation right (SAR) for which variable accounting would be required (such as when it is illegal for individuals in certain countries to own shares in foreign corporations or for companies in certain countries to allow share ownership by foreign nationals) • If the broker is a *related party* of the grantor, there is no accounting consequence for a cashless exercise provided (1) the employee takes legal ownership of the option shares as discussed above, (2) the broker dealer assisting the exercise is a substantive entity with operations that are separate and distinct from those of the grantor (except in circumstances in which the broker-dealer itself is the grantor) and sells the option shares on the open market, and (3) the cashless exercise process is the same whether or not the exercise is being performed for a related entity or an independent entity • The guidance above applies as of June 30, 2002 to all outstanding awards and prospectively to all new awards that permit broker-assisted exercise
<u>*Issue 50*</u> -- The accounting consequence of converting a recourse note (that represents consideration for a previous stock compensation transaction) to a note considered to be nonrecourse	• The conversion should be accounted for as the repurchase of the shares previously exercised with a recourse note, and the simultaneous grant of a new stock option in return for a nonrecourse note • The repurchase amount is equal to the sum of (1) the then-current principal balance of the recourse note, (2) accrued interest (if any), and (3) the intrinsic value of the new stock option • If the repurchase amount exceeds the fair value of the option shares repurchased and the note conversion occurs *more than* 6 months after option exercise or share issuance, the repurchase is accounted for as a treasury stock transaction and compensation cost is recognized for the excess of the repurchase amount over the fair value of the shares on the conversion date

Issue / Topic	EITF Consensus
Issue 50 -- (cont.)	• If the repurchase amount exceeds the fair value of the option shares repurchased and the note conversion occurs *within* 6 months after option exercise or share issuance, the repurchase is accounted for as the acquisition of immature shares and compensation cost is recognized in accordance with the guidance for award settlements provided in FASB Interpretation No. 44 ⇒ In measuring compensation cost under that guidance, the "amount of cash paid to the employee" is the repurchase amount as defined above • If the fair value of the option shares repurchased exceeds the repurchase amount (and the employee is not required to pay the difference), the grantor is deemed to have forgiven that portion of the recourse note and thus all existing and future recourse notes issued in conjunction with option exercises should be accounted for as nonrecourse notes pursuant to the guidance provided in Issue 34 of Issue No. 00-23 • The new stock option is accounted for under the nonrecourse note guidance provided in EITF Issue No. 95-16 • The guidance above applies prospectively to recourse/nonrecourse note conversions that occur after March 21, 2002
Issue 51 -- How to account for a stock option that is based on the stock of an unrelated entity	• The EITF reached a consensus that this issue is not within the scope of APB Opinion No. 25 or FASB Statement No. 123 because the underlying stock is not an equity instrument of the employer/grantor • The EITF in Issue No. 02-08 decided that the fair value of such an option award should be accounted for as a "derivative" under FASB Statement No. 133 in the determination of net income (both during and subsequent to vesting)