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May 1, 2000
(Revised 08/02/02)

FASB Interpretation No. 44

Accounting for Certain Transactions Involving Stock Compensation

an Interpretation of APB Opinion No. 25

Overview of Opinion 25

- *In General* -- APB Opinion No. 25 (Opinion 25) is the longstanding accounting standard that provides guidance on how companies should account for stock compensation granted to employees; further accounting guidance and clarification of Opinion 25 has been provided over the years through FASB Interpretation No. 28 and numerous issues addressed by the Emerging Issues Task Force (EITF)

- *Measurement Date* -- The fundamental principle underlying Opinion 25 is that compensation cost for stock options or awards is measured at the first date that both the number of shares an employee is entitled to receive and the option or purchase price (if any) are known; this date is referred to as the award's "measurement date"
  - ⇒ A new measurement date is generally required if otherwise fixed stock options or awards are modified to "renew" the award or "extend" the exercise period of a stock option

- *Intrinsic Value* -- The amount of compensation cost (as measured on the measurement date) is equal to the excess of the fair market value of the stock underlying the award over the amount (if any) required to be paid for the award; this excess is referred to as the award's "intrinsic value"

- *Fixed Awards* -- Stock options or awards for which both the number of shares and the option or purchase price (if any) are fixed on the date of grant (or subsequent modification) are referred to as "fixed awards"; examples of fixed awards include time-vesting stock options and restricted stock

- *Variable Awards* -- Stock options or awards for which either the number of shares or the option or purchase price (if any) are dependent on future events (other than continued service) are referred to as "variable awards"; examples of variable awards include performance-vesting stock options, stock appreciation rights (SARs), and performance shares

- *Recognizing Compensation Cost* -- Compensation cost is generally recognized ratably over the vesting period, and is reversed only if the stock option or award is forfeited because the employee fails to "fulfill an obligation"; cash or other consideration paid to settle a stock option or award generally represents the final measure of compensation cost

- *If Opinion 25 Does Not Apply* -- Stock options or awards that are excluded from the scope of Opinion 25 (discussed below) are instead accounted for under the "fair value" provisions of FASB Statement No. 123 (Statement 123) and the measurement date provisions of EITF Issue No. 96-18; these provisions generally require companies to recognize as compensation cost the Black-Scholes or binomial value of stock options and the fair market value (less the purchase price, if any) of other stock-based awards, as measured on the award's *vesting date*

⇒ Compensation cost is generally recognized ratably over the vesting period, with interim fair value accruals between grant and vesting dates based on stock price changes during the period

Scope of Opinion 25

- *In General* -- Opinion 25 applies strictly to stock compensation granted (1) by a company with respect to its own stock, and (2) to an "employee" of the grantor company; Opinion 25 does *not* apply to stock compensation granted to individuals who are (1) not employees of the grantor company, (2) employees of a company other than the grantor company, or (3) employees of the grantor company, but the stock compensation is based on the stock of another company

- *Definition of Employee* -- An individual is considered an employee for purposes of Opinion 25 if (1) the individual qualifies as a "common law" employee of the grantor company, and (2) if applicable, the grantor company treats the individual as an employee for purposes of United States payroll tax compliance (in accordance with the twenty-factor guidance provided by Revenue Ruling 87-41); independent contractors and other nonemployee service providers are *not* considered employees for purposes of Opinion 25

- *Exception for Lease or Co-Employment Agreements* -- An individual who provides services to the grantor company pursuant to a lease or co-employment agreement *may be* considered an employee for purposes of Opinion 25 (even though the grantor/lessee company is not the "employer of record" for purposes of U.S. payroll tax compliance), provided (1) the individual qualifies as a common law employee of the grantor company and the lessor is contractually obligated to administer payroll taxes, and (2) the lessor and grantor company agree in writing that, among other things, the grantor company has the exclusive right to grant stock compensation to the individual, and the individual has the ability to participate on a "comparable" basis in the grantor company's employee benefit plans

- *Exception for Nonemployee Directors* -- Although technically not meeting the Opinion 25 definition of employee, Opinion 25 *does* apply to stock compensation granted to a nonemployee member of the grantor company's board of directors for services provided as a director, provided the nonemployee director was either (1) elected by shareholders, or (2) appointed to a board position that will eventually be filled by a shareholder election; Opinion 25 does *not* apply to stock compensation granted (1) to individuals who profide advisory or consulting services in a nonelected capacity, such as members of an "advisory board," or (2) to nonemployee directors (even if elected by shareholders) for services outside their role as a director, such as for legal or investment banking advice, or loan guarantees

- *Exception for Consolidated Financial Statements* -- Opinion 25 does not apply to stock compensation granted to individuals who are employees of a company other than the grantor company; in consolidated financial statements, however, Opinion 25 applies in an "umbrella" fashion to all stock compensation granted by *any member* of a consolidated group to employees of *any other member* of the consolidated group

  ⇒ That is, Opinion 25 applies in consolidated financial statements to all stock compensation granted by (1) the consolidated parent to employees of any consolidated subsidiary, (2) a consolidated subsidiary to employees of the consolidated parent, and (3) a consolidated subsidiary to employees of any other consolidated subsidiary within the consolidated group

  ⇒ The underlying rationale for Opinion 25 treatment is that (1) the determination of whether an individual is an employee for purposes of Opinion 25 is made at the consolidated group level, and (2) the stock compensation of a subsidiary is deemed to be stock compensation of the consolidated group

Opinion 25 does not apply to stock compensation granted to employees of a company that is not a member of the consolidated group (such as a joint venture or other equity investment), regardless of whether the stock compensation is granted “downstream” (that is, from the parent to employees of a nonconsolidated subsidiary), “midstream” (that is, from a consolidated subsidiary to employees of a nonconsolidated subsidiary, or vice versa), or “upstream” (that is, from a nonconsolidated subsidiary to employees of the parent)

⇒ FASB Interpretation No. 44 (Interpretation 44) does not provide guidance in regard to how a grantor company is to account for stock compensation granted to employees of a nonconsolidated company, but the EITF has concluded that the fair value of the stock compensation (as ultimately measured on the award's vesting date) is recognized as compensation cost over the service period with an offsetting contribution to capital (EITF Issue No. 00-12)

⇒ Interpretation 44 also does not provide guidance in regard to how to account for a stock option that is based on the stock of an unrelated entity, but the EITF has concluded 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) (EITF Issue No. 02-08 and 00-23, Issue 51)

- *Exception for Separate Financial Statements of a Consolidated Subsidiary* -- Except for the special rules dealing with consolidated financial statements, Opinion 25 does not apply to stock compensation based on the stock of a company other than the grantor company; in the *separate financial statements of a consolidated subsidiary*, however, Opinion 25 *does* apply to stock compensation granted by the consolidated parent to employees of the consolidated subsidiary

⇒ Opinion 25 applies (1) *only if* the subsidiary is consolidated with the parent, and (2) *only to* stock compensation granted by the consolidated parent to employees of the consolidated subsidiary

⇒ Opinion 25 does *not* apply to stock compensation granted (1) to employees of the consolidated subsidiary by another subsidiary of the consolidated group, or (2) by the consolidated subsidiary to employees of the parent or any other subsidiary of the consolidated group

Interpretation 44 does not provide guidance in regard to how a subsidiary is to separately account for stock compensation granted to its employees by a company other than the consolidated parent (such as a nonconsolidated company or a consolidated company other than the parent), but the EITF has concluded that the fair value of the stock compensation (as ultimately measured on the award's vesting date) is recognized as compensation cost over the service period with an offsetting contribution to capital (EITF Issue No. 00-12 and 00-23, Issue 22); Interpretation 44 also does not provide guidance in regard to how a subsidiary is to separately account for stock compensation granted to employees of another member of the consolidated group (other than the grantor company), but the EITF has concluded that the fair value of the stock compensation (as measured on the *grant date*) is recognized as a *dividend* to the controlling company with an offsetting contribution to capital (EITF Issue No. 00-23, Issue 21)

- *Tracking Stock* -- Interpretation 44 does not provide guidance in regard to how “tracking stock” is to be accounted for under Opinion 25, but the EITF has concluded that if the tracking stock is “substantive,” the stock compensation should be accounted for in the separate subsidiary and consolidated financial statements under Opinion 25 and not Statement 123 (EITF Issue No. 00-23, Issue 28(a))

⇒ 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

⇒ A tracking stock is considered substantive if it is publicly traded (other criteria may also lead to the determination that the tracking stock is substantive)

⇒ 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

- *LLC Profits Interest Awards* -- Interpretation 44 does not provide guidance in regard to how to account for a profits interest in an LLC, but the EITF has concluded that the grantee of a profits interest award in an LLC should be considered an employee under Opinion 25 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 (EITF Issue No. 00-23, Issue 40(a))

  ⇒ The EITF also has concluded that if a grantee of a profits interest award is considered to be an employee for purposes of applying Opinion 25, the award should be accounted for as fixed or variable 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 (EITF Issue No. 00-23, Issue 40(b))

- *Application of Opinion 25* -- The application of Opinion 25 in consolidated and separate company financial statements under various grantor/employee scenarios is summarized below

Stock Compensation Granted By	Stock Compensation Granted to Employees of: Parent Company	Consolidated Subsidiary	Nonconsolidated Subsidiary
Consolidated Financial Statements:			
-- Parent company	Opinion 25 applies	Opinion 25 applies	Opinion 25 does not apply
-- Consolidated subsidiary	Opinion 25 applies	Opinion 25 applies	Opinion 25 does not apply
Subsidiary Financial Statements:			
-- Parent company	Not applicable	Opinion 25 applies	Opinion 25 does not apply
-- Consolidated subsidiary	Opinion 25 does not apply	Opinion 25 does not apply *	Opinion 25 does not apply
-- Nonconsolidated subsidiary	Opinion 25 does not apply	Opinion 25 does not apply	Opinion 25 does not apply *

* Opinion 25 does apply if the stock compensation is granted by a subsidiary to employees of that same subsidiary

Changes in Status

- *In General* -- There may be an accounting consequence for a grantor company if an individual with outstanding stock options or awards changes status to or from that of an employee, and the individual *continues to provide services* to the grantor company; a change in status can occur directly, such as when an employee transfers to a nonconsolidated company (such as a joint venture), or indirectly, such as when an employee works for a consolidated subsidiary that is subsequently deconsolidated

- *If a Change in Status Occurs* -- If a change in status occurs, the grantor company must "remeasure" compensation cost as if outstanding stock options or awards are newly granted as of the date of change in status, using the intrinsic value method under Opinion 25 if the individual changes status to an employee, or the fair value method under Statement 123 if the individual changes status to a nonemployee

- *If Outstanding Awards Are Not Modified* -- If the original terms of outstanding stock options or awards are not modified coincident with a change in status (that is, there is no change to the exercise period, vesting provisions, exercise price, or number of shares), only that portion of newly measured compensation cost attributable to the *remaining* vesting period is recognized over the remaining vesting period of the awards (if 40 percent of the vesting period has expired, for example, only the remaining 60 percent of newly measured compensation cost is recognized over the remaining vesting period of the award); compensation cost (if any) recognized prior to the change in status under the prior method of accounting is *not* reversed, unless the award is subsequently forfeited

⇒ There is no accounting consequence (that is, there is no remeasurement of compensation cost) if, as of the change in status, the outstanding stock options or awards are fully vested and not otherwise modified coincident with the change

- *If Outstanding Awards Are Modified to Continue or Accelerate Vesting* -- If the original terms of outstanding stock options or awards provide for the forfeiture of the awards upon a change in status and the awards are modified coincident with the change to continue or accelerate vesting, the awards are deemed to be "reinstated" and the *total amount* of newly measured compensation cost is fully recognized either immediately (if the awards become fully vested as a result of the modification) or over the remaining vesting period of the award; compensation cost (if any) recognized prior to the change in status under the prior method of accounting is fully reversed at the change in status date

- *If Outstanding Awards Are Modified Other Than to Continue or Accelerate Vesting* -- Interpretation 44 does not provide guidance in situations where the original terms of outstanding stock options or awards provide that the awards are to be *retained* upon a change in status (that is, the awards are not forfeited), but the awards are nevertheless modified other than to continue or accelerate vesting coincident with the change (that is, there is a change to the exercise period, exercise price, or number of shares); the EITF has concluded, however, that (1) compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change, and is recognized at the modification date only for the portion of newly measured compensation cost attributable to the *expired* vesting period of the award (in addition, variable award accounting is required prospectively for this portion of the award if the modification is a repricing that occurs concurrent with a change-in-status from employee to nonemployee), and (2) compensation cost is also remeasured at the modification date using the method of accounting appropriate for the grantee's status *after* the change (as if the award is newly granted), and is recognized over the remaining vesting period only for the portion of newly measured compensation cost attributable to the *remaining* vesting period of the award (EITF Issue No. 00-23, Issues 18, 19, and 20)

- *Exception for Spinoff Transactions* -- If an individual changes status from an employee to a nonemployee as a result of a spinoff transaction (that is, a pro rata distribution to company shareholders of shares of a subsidiary such that the company no longer consolidates the former subsidiary), the grantor company does *not* change its method of accounting from Opinion 25 to the fair value method for stock options or awards previously granted to the individual as an employee; thus, there is no accounting consequence to the grantor company provided the requirements for "equity restructurings" (discussed below) are satisfied

  ⇒ The exception applies solely to changes in status as a result of a spinoff transaction, and only for stock options or awards granted prior to the change in status (including adjustments to those awards coincident with the spinoff)

  ⇒ The exception does not apply to changes in status as a result of an exchange transaction such as a sale, public offering, split-off, or split-up, or to stock options or awards granted after the spinoff transaction (that is, the fair value method applies)

- *Consequence of a Change in Status* -- The accounting consequences of a change in status under various employment/modification scenarios are summarized on the following pages

Scenario	Accounting Consequence at Change in Status if Original Terms of Award Provide for *		
	Accelerated Vesting	Continued Vesting	Award Forfeiture
<u>*Scenario 1*</u> • Grantee does not continue to provide services • Awards are not modified at the change in status	• No accounting consequence	• No accounting consequence	• Compensation cost (if any) recognized prior to the change in status is reversed in full in the period of forfeiture
<u>*Scenario 2*</u> • Grantee does not continue to provide services • Awards are modified to accelerate vesting at the change in status (including the use of "discretion" to accelerate vesting)	• Not Applicable	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full (if required in accordance with the appropriate method of accounting) at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested
<u>*Scenario 3*</u> • Grantee does not continue to provide services • Awards are modified other than to accelerate vesting at the change in status	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested; in addition, variable award accounting is required prospectively if the modification is a repricing that occurs concurrent with a change in status from employee to nonemployee	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested; in addition, variable award accounting is required prospectively if the modification is a repricing that occurs concurrent with a change in status from employee to nonemployee	• Compensation cost (if any) recognized prior to the change in status is reversed in full in the period of forfeiture
<u>*Scenario 4*</u> • Grantee continues to provide services • Awards are not modified at the change in status	• No accounting consequence	• Compensation cost is remeasured at the change in status date using the method of accounting appropriate for the grantee's status *after* the change (as if the award is newly granted), and is recognized over the remaining vesting period only for the portion of newly measured compensation cost attributable to the *remaining* vesting period of the award • No adjustment is made to compensation cost (if any) recognized prior to the change in status under the prior method of accounting, unless the grantee fails to fulfill an obligation	• Compensation cost (if any) recognized prior to the change in status is reversed in full in the period of forfeiture

* A change in grantee status refers to a *substantive* change from employee status to nonemployee status (or vice versa); "temporary" changes in status that are remedied are generally regarded as *not* substantive

The appropriate method of accounting is the "intrinsic value" method under APB Opinion No. 25 for employees, and the "fair value" method under FASB Statement No. 123 for nonemployees

Scenario	Accounting Consequence at Change in Status if Original Terms of Award Provide for *		
	Accelerated Vesting	Continued Vesting	Award Forfeiture
Scenario 5 • Grantee continues to provide services • Awards are modified to accelerate vesting at the change in status (including the use of "discretion" to accelerate vesting)	• Not Applicable	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full (if required in accordance with the appropriate method of accounting) at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *after* the change (as if the award is newly granted), and is recognized in full at the change in status if no remaining services are required by the grantee or over the remaining vesting (service) period of the award • Compensation cost (if any) recognized prior to the modification date (under the prior method of accounting) is reversed in full at the change in status, i.e., the original award is deemed to be forfeited
Scenario 6 • Grantee continues to provide services • Awards are modified other than to accelerate vesting at the change in status	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change • Any remaining or newly measured compensation cost is recognized in full at the change in status because no remaining services are required by the grantee, i.e., the award is substantively vested; in addition, variable award accounting is required prospectively if the modification is a repricing that occurs concurrent with a change in status from employee to nonemployee	• Compensation cost is remeasured at the modification date using the method of accounting appropriate for the grantee's status *prior* to the change, and is recognized at the modification date only for the portion of newly measured compensation cost attributable to the *expired* vesting period of the award; in addition, variable award accounting is required prospectively for this portion of the award if the modification is a repricing that occurs concurrent with a change in status from employee to nonemployee • Compensation cost is also remeasured at the modification date using the method of accounting appropriate for the grantee's status *after* the change (as if the award is newly granted), and is recognized over the remaining vesting period only for the portion of newly measured compensation cost attributable to the *remaining* vesting period of the award	• Compensation cost (if any) recognized prior to the change in status is reversed in full in the period of forfeiture
Scenario 7 • Grantee changes status as result of a spinoff	• No accounting consequence, provided the awards are modified in accordance with guidance for equity restructurings	• No accounting consequence, provided the awards are modified in accordance with guidance for equity restructurings	• Compensation cost (if any) recognized prior to the change in status is reversed in full in the period of forfeiture

* A change in grantee status refers to a *substantive* change from employee status to nonemployee status (or vice versa); "temporary" changes in status that are remedied are generally regarded as *not* substantive
The appropriate method of accounting is the "intrinsic value" method under APB Opinion No. 25 for employees, and the "fair value" method under FASB Statement No. 123 for nonemployees

<u>Noncompensatory Plans</u>

- *<u>In General</u>* -- Employee stock purchase plans meeting the criteria under Section 423 of the Internal Revenue Code are deemed to be "noncompensatory" under Opinion 25, and thus do not result in compensation cost to the grantor company; permissible provisions include (1) purchase discounts of up to 15 percent of the stock price at grant, and (2) purchase prices based on the *lesser of* the stock price on the date of grant or the date of purchase, i.e., "look-back" purchase prices

  ⇒ The EITF has concluded that compensatory plan accounting is required under Opinion 25 for any 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 (that is, the transaction is viewed as a repricing) (EITF Issue No. 00-23, Issues 42(a), 42(b), and 42(c))

<u>Modifications in General</u>

- *<u>In General</u>* -- Modifications are relevant only in regard to otherwise fixed stock options or awards because the final measure of compensation cost for variable awards does not occur until the awards are vested (or in some cases exercised), regardless of whether the awards are modified or not; certain modifications to the original terms of otherwise fixed stock options or awards may result in either (1) a new measurement date, or (2) potentially more punitive variable award accounting

- *<u>Modifications That Result in a New Measurement Date</u>* -- A new measurement date is required for otherwise fixed stock options or awards that are modified to either (1) extend the maximum contractual exercise period or the post-termination exercise period of a stock option, or (2) renew a stock option or award through the acceleration or continuation of vesting; if a new measurement date is required, compensation cost is remeasured (as if the award is newly granted) based on the award's intrinsic value as of the modification date

- *<u>Modifications That Result in Variable Award Accounting</u>* -- Variable award accounting is required for otherwise fixed stock options or awards that are modified to directly or indirectly change either (1) the exercise or purchase price of the award through a "repricing" or a "cancellation and replacement" of the award, or (2) the number of shares underlying the award through the addition of a "reload" feature; if variable award accounting is required, compensation cost is a measured each period (based on the stock price at the end of each period) until the modified award is exercised, is forfeited, or expires unexercised

- *<u>Modifications That Result in No Accounting Consequence</u>* -- Neither a new measurement date nor variable award accounting is apparently 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 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

  ⇒ The EITF has concluded that 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 (thereby avoiding the accounting requirements of Statement 123 and EITF Issue No. 96-18) (EITF Issue No. 00-23, Issue 46)

Extending the Exercise Period of a Stock Option

- *In General* -- A new measurement date is required for otherwise fixed stock options that are modified to *extend* either the maximum contractual exercise period or the post-termination exercise period of the award; modifications that *reduce* the exercise period of the award presumably do not result in a new measurement date (because the exercise period is not extended), but could result in an effective cancellation of the award for purposes of the cancellation and replacement provisions discussed below
    - ⇒ An indirect extension of the maximum contractual or post-termination exercise period may occur if a stock option is modified to permit exercise using a nonrecourse note that matures after the original exercise period of the award

- *Extension of Maximum Contractual Exercise Period* -- A modification that extends the maximum contractual exercise period of a stock option (including a modification contingent upon a future separation from employment) results in a new measurement date as of the modification date, with compensation cost equal to the excess of the award's intrinsic value as of the modification date over the award's original intrinsic value (if any); compensation cost is recognized over the remaining vesting period (or recognized immediately if the award is fully vested as of the modification date) *for any individual who could benefit from the modification*

- *Extension of Post-Termination Exercise Period* -- A modification that extends the exercise period of a stock option upon separation from employment (but not beyond the maximum contractual exercise period) results in a new measurement date as of the modification date, with compensation cost equal to the excess of the award's intrinsic value as of the modification date over the award's original intrinsic value (if any); compensation cost is recognized (either immediately or over the remaining vesting period, if any) *only if and when* a separation event occurs and the exercise period is extended
    - ⇒ Companies are to estimate as of the modification date (to the extent possible) the likelihood of an extension and begin to recognize compensation cost based on those estimates, with adjustments in later periods to the extent actual experience differs from prior estimates

Acceleration or Continuation of Vesting

- *In General* -- A new measurement date is required for otherwise fixed stock options or awards that are modified to *accelerate or continue* the vesting period of the award; modifications that *extend* the vesting period of the award presumably do not result in a new measurement date (because there is no renewal of the award), but could result in an effective cancellation of the award for purposes of the cancellation and replacement provisions discussed below
    - ⇒ A new measurement date is *not* required for otherwise fixed stock options or awards if vesting is accelerated pursuant to the *original terms* of the award

- *Using Discretion or Modifying an Award to Accelerate or Continue Vesting* -- Using discretion or modifying the original terms of an otherwise fixed stock option or award to accelerate or continue vesting (whether unconditionally or upon the occurrence of a specified future event) results in a new measurement date as of the date discretion is used or the award is modified, with compensation cost equal to the excess of the award's intrinsic value as of the modification date over the award's original intrinsic value (if any); compensation cost is recognized *only if and when* an individual becomes vested in an award that, pursuant to the original terms of the award, would have been forfeited absent the acceleration or continuation

⇒ Compensation cost is not recognized if the employee continues to provide services and eventually becomes vested pursuant to the original vesting provisions of the award

⇒ Companies are to estimate as of the modification date (to the extent possible) the likelihood of an acceleration or continuation and begin to recognize compensation cost based on those estimates, with adjustments in later periods to the extent actual experience differs from prior estimates

- <u>*Early Exercise of Nonvested Stock Options*</u> -- Interpretation 44 does not provide guidance in regard to 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), but the EITF has concluded that 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 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 (EITF Issue No. 00-23, Issue 33(a))

⇒ 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 EITF also has concluded that if the strike price for the employer call right is based *solely* on the original exercise price paid by the employee (that is, *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; 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 (EITF Issue No. 00-23, Issue 33(b))

⇒ 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

<u>Stock Option Repricings and Cancellation/Replacement Awards</u>

- <u>*In General*</u> -- Variable award accounting is required for otherwise fixed stock options that are modified to directly or indirectly *reduce* the exercise price of the award; modifications that *increase* the exercise price of the award are not directly addressed by Interpretation 44, but could result in an effective cancellation of the award for purposes of the cancellation and replacement provisions discussed below

⇒ Variable award accounting applies from the date of modification until the date the award is exercised, is forfeited, or expires unexercised

The EITF has concluded that modifications that increase the exercise price of the award result in either a new measurement date or variable award accounting, depending on all relevant facts and circumstances (EITF Issue No. 00-23, Issue 26)

- ⇒ A new measurement date is required if it is possible to conclude that further changes to the exercise price will not occur in the future, such as when unusual modifications are sometimes made to comply with the regulatory environment
- ⇒ Variable award accounting is required if there is no practical way to ascertain whether further changes to the exercise price will occur in the future; factors to consider include (1) whether the award has been similarly modified in the past, (2) whether the modification is related to the grantee's job performance, or (3) whether other factors indicate that similar modifications are possible in the future
- ⇒ The EITF also has concluded that a "settlement" of nonvested stock awards in connection with the grant of new "at-the-money" stock options represents an "upward repricing" that should be evaluated in accordance with the guidance in Issue 26 (EITF Issue No. 00-23, Issue 37(b))

The EITF also has concluded that the exercise price of a stock option is not fixed (and thus variable award accounting is required) if either (1) the award is modified to add a "short-term inducement" to exercise the stock option (EITF Issue No. 00-23, Issue 30), or (2) the exercise price is denominated in multiple currencies or in a currency other than the currency of the "primary economic environment of either the employer or the employee" (EITF Issue No. 00-23, Issue 31)

- *Stock Option Repricings* -- A "repricing" is a direct or an indirect reduction to the exercise price of a fixed stock option such that the fair value of the exercise price after modification is *less than* the fair value of the exercise price prior to the modification; examples of indirect repricings include modifications that provide for a (1) cash bonus arrangement that is contingent upon option exercise, (2) below-market interest loan to facilitate option exercise, or (3) reduction to the exercise price if a specified future event occurs (such as the attainment of a performance condition)
  - ⇒ The FASB Staff has concluded that an indirect repricing also occurs if a "new" stock option is granted with a lower exercise and an exercise period that expires upon the earlier of (1) the normal exercise period (10 years), or (2) 30 days after the date at which the company's stock price reaches the exercise price of previously granted "underwater" stock options; an indirect repricing is *not* deemed to occur, however, if the expiration of the exercise period occurs *at least 6 months after* the stock price test is attained (FASB Staff Announcement Topic No. D-91)
  - ⇒ The EITF has concluded that the fact pattern in FASB Staff Announcement Topic No. D-91 should be clarified to provide that variable award accounting is required for stock options that could expire *prior to vesting* because of a truncation provision for reasons other than the grantee's termination of employment (because the number of shares is not fixed); variable award accounting applies until the stock options become vested (EITF Issue No. 00-23, Issue 45)

- *Cancellation and Replacement Awards* -- An actual or "effective" cancellation of a stock option combined with the "replacement" of a new stock option at a lower exercise price during a 6-month "look-back look-forward" period is deemed to be a reduction in exercise price that requires variable award accounting for the replacement award from the date of cancellation (or the date of replacement, if later) until the date the replacement award is exercised, is forfeited, or expires unexercised
  - ⇒ The settlement of a stock option for cash or other consideration is also considered a cancellation that can be combined with a replacement award

- *Effective Cancellations* -- An effective cancellation is deemed to occur if an outstanding stock option is modified to "reduce or eliminate the likelihood of exercise," including modifications that (1) reduce the exercise period, (2) extend the vesting period, (3) increase the exercise price, or (4) reduce the number of shares of the award; an effective cancellation is also deemed to occur if, at the time the replacement award is granted, an agreement exists (in any form) to cancel or settle an outstanding stock option at a specified future date (including a "tandem" award, whereby the exercise of one award cancels the other, and vice versa)

⇒ The EITF has concluded that a "statutory transfer" of an employer's United Kingdom employment tax liability through a modification to an otherwise fixed award is *not* deemed to be an effective cancellation, because the modification is not expected to reduce the likelihood of exercise (EITF Issue No. 00-23, Issue 17)

The EITF also has concluded that whether reducing (or "truncating") the exercise period of stock options actually reduces or eliminates the likelihood of exercise depends on whether the stock options are in-the-money or underwater (EITF Issue No. 00-23, Issue 39(g))

⇒ The truncation of in-the-money stock options generally should *not* reduce the likelihood of exercise (in fact, the truncation may actually *increase* the likelihood of exercise), and thus should not result in an effective cancellation of the options; judgment should be applied in evaluating relevant facts and circumstances when making this determination

⇒ The truncation of underwater stock options does reduce the likelihood of exercise, however, resulting in an effective cancellation and a window of evaluation for identifying replacement awards that begins 6 months prior to announcement of the truncation (or 6 months prior to the event triggering the truncation if the truncation is pursuant to the embedded terms of the option) and ending 6 months after the options expire; refer to discussion of the look-back look-forward period below

The EITF also has concluded that, if existing stock options are canceled without the company providing substantial consideration in exchange for the cancellation, a rebuttable presumption exists that the cancellation is linked to a previous stock option with a lower exercise price; thus, if the presumption is not overcome, variable award accounting is required for the previous stock option even if granted more than 6 months prior to the cancellation (the 6 month safe harbor is not relevant if there is evidence of an implied agreement at grant to cancel a stock option in the future) (EITF Issue 00-23, Issue 39(f))

- <u>*Look-Back Look-Forward Period*</u> -- In identifying potential replacement awards with a lower exercise price, companies are to first "look back" to the period that begins 6 months prior to the actual or effective cancellation date (or the grant date of the canceled stock option, if more recent), first identifying awards with grant dates in the closest proximity to the cancellation date; if the number of canceled stock options exceeds the number of replacement awards identified in the look-back period, companies are to then "look forward" to the period that ends 6 months after the actual or effective cancellation date (again, first identifying awards with grant dates in the closest proximity to the cancellation date)

⇒ If the number of canceled stock options exceeds the number of replacement awards identified in the look-back look-forward period, no further identification of potential replacement awards is required

⇒ If the number of stock options granted during the look-back look-forward period exceeds the number of canceled stock options, the excess number of shares granted are not considered to be replacement awards (that is, variable award accounting is not required for stock options granted during the look-back look-forward period in excess of the number of canceled stock options)

⇒ 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; the EITF has concluded that the grant of a new "in-the-money" stock option more than 6 months after cancellation of an underwater stock option results in variable award accounting for the new stock option, unless all relevant facts and circumstances indicate the new stock option was not "intended to compensate the grantee for stock price increases after cancellation of the old stock option" (EITF Issue No. 00-23, Issue 24); the EITF also has concluded that the grant of new "at-the-money" stock options more than 6 months after cancellation of underwater stock options results in variable award accounting for the new stock options if the number of new stock options [presumably] exceeds the number of canceled stock options and is based on a formula that is either directly or indirectly linked to changes in the market price of the underlying stock (because the formula is presumably intended to compensate the grantee for stock price increases) (EITF Issue No. 00-23, Issue 39(d))

⇒ If the canceled stock option was previously accounted for as a variable award because of a prior direct or indirect reduction in exercise price, *any* stock option granted during the look-back look-forward period is eligible to be a replacement award subject to variable award accounting (not just stock options with a lower exercise price)

- *Employer Offers to Cancel and Replace* -- Interpretation 44 does not provide guidance in regard to an employer's "offer" to cancel existing stock options and (upon acceptance of the offer) grant new replacement awards, but the EITF has concluded the following

⇒ An employer's offer to grant new replacement stock options with a lower exercise price *within 6 months of* the cancellation date of the existing stock options (that is, an offer to "reprice" the existing stock options) results in variable award accounting for *all* existing stock options subject to the offer; variable award accounting commences when the offer is made, and for the stock options that are retained because the offer is declined, continues until the options are exercised, are forfeited, or expire unexercised (EITF Issue No. 00-23, Issue 36(a))

⇒ If existing stock options are subject to variable award accounting because of an employer's offer to reprice, 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) (EITF Issue No. 00-23, Issue 36(b))

⇒ An employer's offer to grant new replacement stock options with an "at-the-money" exercise price *more than 6 months after* the cancellation of the existing stock options results in no adverse accounting consequences for existing stock options subject to the offer provided the 6-month "safe harbor" provisions of Interpretation 44 are satisfied (in substance, the employer has only offered to "cancel" the existing stock options, not "reprice" the options) (EITF Issue No. 00-23, Issue 36(c))

⇒ If the terms of the offer call for replacement in the form of *restricted stock*, all existing stock options subject to the offer become subject to variable award accounting, even if the offer calls for replacement more than 6 months after cancellation; the rationale is that an offer to grant restricted stock more than 6 months after cancellation is in substance the same as an offer to grant restricted stock immediately upon cancellation (because restricted stock protects the grantee from stock price increases subsequent to cancellation, regardless of when granted) (EITF Issue No. 00-23, Issues 39(a) and 39(b))

⇒ The look-back look-forward period for purposes of identifying replacement awards in connection with a cancellation/replacement offer begins 6 months prior to commencement of the offer period (that is, the date the offer is communicated to employees), continues *through* the offer period, and ends 6 months after the existing stock options are legally canceled (that is, the date that all legal and regulatory requirements for cancellation are met, such as the date an election to cancel can no longer be revoked); thus, the effect of a lengthy offer period or the existence of multiple offers is to *lengthen* the 6-month look-back look-forward period for purposes of identifying replacement awards (EITF Issue No. 00-23, Issues 36(d) and 36(e))

⇒ If the terms of a cancellation offer provide for the *reinstatement* of previously canceled stock options or the *acceleration* of the grant of new replacement awards during the 6-month safe harbor period upon the occurrence of certain events (such as death, involuntary termination, or change-in-control), the cancellation date and related commencement of the 6-month look-forward period cannot occur until the canceled stock options can no longer be reinstated or the grant of new replacement awards can no longer be accelerated; thus, the cancellation date is generally the same date the new replacement awards are granted, resulting in a violation of the 6-month safe harbor and variable award accounting for all existing stock options subject to the offer and all new replacement stock options (EITF Issue No. 00-23, Issue 39(c))

⇒ If the terms of a cancellation offer provide for a portion of the new replacement stock options to be granted immediately upon cancellation (to protect the grantee against stock price increases during the 6-month safe harbor) and a portion to be granted more than 6 months after cancellation (to avoid variable award accounting for that portion of the grant), variable award accounting is required for the initial replacement stock options granted immediately upon cancellation because the 6-month safe harbor is violated; variable award accounting is also required for a portion of the remaining replacement stock options granted more than 6 months after cancellation if the exercise period for the initial replacement stock options expires *within* 6 months of the grant of the remaining stock options, consistent with the indirect repricing guidance in FASB Staff Announcement Topic No. D-91; the number of remaining replacement stock options subject to variable award accounting is equal to the number of initial stock options granted (fixed award accounting applies to any remaining replacement stock options in excess of the number of initial replacement stock options granted); variable award accounting is *not* required for the remaining replacement stock options granted more than 6 months after cancellation if either (1) the exercise period for the initial replacement stock options expires *more than 6 months after* the grant of the remaining replacement stock options, or (2) the initial stock options are granted in the form of restricted stock, regardless of when granted (because restricted stock is always viewed as a "replacement award," rather than as "consideration for stock price increases" during the 6-month safe harbor) (EITF Issue No. 00-23, Issue 39(e))

- *Cancellation and Replacement With Stock* -- If a fixed or variable stock option is canceled and replaced with a stock award that requires no exercise or purchase price from the employee (such as the grant of restricted stock), a new measurement date is required with respect to the stock award resulting in compensation cost equal to the award's intrinsic value at the date of grant

⇒ Variable award accounting is not required for the new stock award because future reductions in the exercise price are not possible

⇒ However, any shares canceled in excess of the number of new stock awards granted can be combined with other replacement awards (that are subject to variable award accounting) during the look-back look-forward period

Equity Restructurings

- *In General* -- 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" (defined as a "nonreciprocal" transaction such as a stock dividend, spinoff, stock split, rights offering, or large nonrecurring dividend that causes a company's stock price to decrease), 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*

⇒ The above criteria are deemed satisfied even if stock options of the divested company are "stapled to" or "blended with" stock options of the divesting company

⇒ If the above criteria are not met, variable award accounting applies from the date of modification until the date the award is exercised or forfeited, or expires

⇒ If the above criteria are met but the awards are otherwise modified to extend the exercise period or accelerate vesting, a new measurement date is required pursuant to the guidance for extensions and accelerations (discussed above); cash or other consideration paid to restore an employee's economic position is recognized as compensation cost

Interpretation 44 does not provide guidance in regard to how to adjust outstanding stock options or awards that have *negative* intrinsic value at the time of restructuring, but the EITF has concluded the following (EITF Issue No 00-23, Issue 49)

⇒ There is no accounting consequence 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 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 discussed above

⇒ If the second requirement is *not* satisfied, variable award accounting is required for the entire exchanged award

- *<u>"Reciprocal" Equity Restructurings</u>* -- Interpretation 44 does not provide guidance in regard to how companies are to account for outstanding stock options or awards that are exchanged in connection with a transaction that is *not* a nonreciprocal equity restructuring (such as the exchange of parent-company stock options for subsidiary-company stock options in an initial public offering or the conversion of one class of parent-company tracking stock into another class of tracking or common stock), but the EITF has concluded that the exchange results in a new measurement date if the above criteria *are* met and in variable award accounting if the criteria are *not* met (EITF Issue No. 00-23, Issues 1, 28(b), and 41); if the exchange involves subsidiary-company stock options or awards that were outstanding when the parent company *first gained control* of the subsidiary, the exchange is accounted for by the purchase method rather than as a modification (that is, the fair value of exchanged parent-company stock options or awards is included as part of the purchase consideration for the subsidiary) (EITF Issue No. 00-23, Issue 12)

- *<u>Failure to Adjust Awards</u>* -- Interpretation 44 also does not provide guidance in regard to the accounting consequence of a company's *failure* to adjust outstanding stock options or awards in connection with an equity restructuring, but the EITF has concluded the following (EITF Issue No. 00-23, Issue 43)

⇒ If the embedded terms of stock options or awards *require* equitable adjustments in connection with an equity restructuring but the company nevertheless *fails to do so*, the accounting consequence of such failure is a deemed modification resulting in either (1) a repricing requiring variable award accounting if the effect is a *reduction* in exercise price, or (2) either a new measurement date or variable award accounting (depending on all relevant facts and circumstances consistent with the guidance in EITF Issue No. 00-23, Issue 26) if the effect is an *increase* in exercise price; further, if the failure to adjust awards results in a reduced likelihood of exercise, the awards are deemed to be effectively canceled similar to the guidance in EITF Issue No. 00-23, Issue 39(g)

⇒ If in connection with a stock split, reverse stock split, or stock dividend treated as a stock split, the embedded terms of [presumably underwater] stock options provide for equitable adjustment to the exercise price but *not* the number of shares, any such adjustment is deemed to be a repricing requiring variable award accounting (because the aggregate *negative* intrinsic value is reduced)

⇒ If the embedded terms of stock options or awards are *silent* in regard to equitable adjustments in connection with an equity restructuring (or if adjustments are at the *discretion* of the company), the accounting guidance above applies in event of a stock split, reverse stock split, or stock dividend treated as a stock split; the accounting guidance above also applies in event of a spinoff or large nonrecurring cash dividend unless relevant facts and circumstances provide sufficient evidence of a reason *not* to make equitable adjustments, such as the existence of legal or contractual prohibitions such as debt convenants

Reload Stock Options

- *In General* -- Variable award accounting is required for otherwise fixed stock options or awards that are modified to *increase* the number of shares underlying the award; modifications that *reduce* the number of shares underlying the award are not directly addressed by Interpretation 44, but could result in an effective cancellation of the award for purposes of the cancellation and replacement provisions discussed above

  ⇒ Variable award accounting applies from the date of modification until the date the award is exercised or forfeited, or expires

  The EITF has concluded that modifications that reduce the number of shares underlying the award result in either a new measurement date or variable award accounting, depending on all relevant facts and circumstances (EITF Issue No. 00-23, Issue 26)

  ⇒ A new measurement date is required if it is possible to conclude that further changes to the number of shares will not occur in the future, such as when unusual modifications are sometimes made to comply with the regulatory environment

  ⇒ Variable award accounting is required if there is no practical way to ascertain whether further changes to the number of shares will occur in the future; factors to consider include (1) whether the award has been similarly modified in the past, (2) whether the modification is related to the grantee's job performance, or (3) whether other factors indicate that similar modifications are possible in the future

  The EITF also has concluded that the number of shares underlying a stock option is not fixed if the award is modified to add a "short-term inducement" to exercise the stock option (EITF Issue No. 00-23, Issue 30)

- *Awards Modified to Add a Reload Feature* -- Variable award accounting is required for otherwise fixed stock options that are modified to add a reload feature (defined as any feature that provides for the grant of a new stock option upon the *exercise* of the modified stock option), regardless of the method used to determine the exercise price, number of shares, or exercise period of the reload grant; variable award accounting is also required for the reload grant itself, if it too is subject to a reload feature

- *Reload Feature Pursuant to Original Terms of Award* -- Variable award accounting is not required for an otherwise fixed stock option if the reload feature is pursuant to the *original terms* of the award *and* the requirements of EITF Issue No. 90-7 are satisfied; that is, (1) the reload feature provides for the automatic grant of a new stock option with an exercise price equal to the market price on the reload grant date, and (2) the shares tendered in the reload stock-for-stock exercise are "mature" (that is, owned for at least 6 months)

  ⇒ The EITF has concluded that 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, that is, a "tax reload" feature; further, the shares tendered to satisfy minimum statutory tax withholding obligations need not satisfy the 6-month holding period requirement in EITF Issue No. 84-18 (EITF Issue No. 00-23, Issue 47)

Measuring and Recognizing Compensation Cost

- *Measuring Compensation Cost* -- If an otherwise fixed stock option or award is (1) canceled (other than an effective cancellation discussed above), (2) modified such that a new measurement date or variable award accounting is required, or (3) settled for cash or other consideration within 6 months after option exercise or share issuance, the final measure of compensation cost is determined as follows:

⇒ *Always* recognize as compensation cost the intrinsic value of the award (if any) as of the award's original measurement date

⇒ Recognize as *additional* compensation cost the intrinsic value of the modified or newly variable award (or the amount paid to settle the award, less any amount paid by the employee to acquire the shares) that exceeds the *lesser of* (1) the intrinsic value of the award (if any) at the original measurement date, or (2) the intrinsic value of the award (if any) immediately prior to the cancellation, modification, or settlement of the award

⇒ Thus, the final measurement of compensation cost for a typical stock option is equal to the award's intrinsic value as of the modification or settlement date

- *Recognizing Compensation Cost* -- The final measure of compensation cost calculated above is recognized (1) over the remaining vesting period of the award, or (2) immediately if the award is or becomes fully vested as of the date of the cancellation, modification, or settlement of the award

  ⇒ Compensation cost is reversed only if the award is forfeited because the employee fails to "fulfill an obligation"; this guidance applies even if a nonvested fixed stock option is canceled and not replaced with a new award (EITF Issue No. 00-23, Issue 37(a))

  ⇒ Compensation cost for newly variable awards is *never* adjusted below the original intrinsic value of the award, unless the award is forfeited because the employee fails to fulfill an obligation

  The EITF has concluded that the accelerated accrual methodology prescribed by FASB Interpretation No. 28 is applicable only to variable awards; compensation cost for fixed awards with pro rata vesting can be recognized either on a pro rata or accelerated basis, so long as the methodology is consistently applied (EITF Issue No. 00-23, Issue 7)

Share Repurchase Features

- *Public Companies* -- For *public* companies (including "controlled" subsidiaries of public companies), variable award accounting is required for any stock option or award with a repurchase feature between an employee and the grantor company (such as a put, call, or right of first refusal) that is not based on the *fair value* of the stock at the repurchase date, unless the repurchase feature is *not expected to be exercised* (the award is considered an "indexed liability")

  ⇒ Variable award accounting applies until the earlier of expiration or exercise of the repurchase feature

  ⇒ The SEC Staff has concluded that the "rescission" of a previously exercised stock option followed by a reinstatement of the original option is, in essence, an employee put to the company that could be at other than fair value; among other negative accounting consequences, such a transaction results in variable award accounting for the reinstated stock option until the *earlier of* expiration or forfeiture of the reinstated option or the end of the tax year in which the reinstated options are exercised (SEC Staff Announcement Topic No. D-93)

- *Nonpublic Companies* -- For *nonpublic* companies (including nonpublic companies with publicly traded debt), variable award accounting is *not* required for an otherwise fixed award if the repurchase price is based on other than fair value (such as "book value") provided the employee (1) makes a "substantial investment" in the award (defined as an amount equal to 100 percent of the stated share repurchase price calculated at the date of grant), and (2) bears the "risks and rewards," of share ownership for a reasonable period of time; if a substantial investment is not made (as is typically the case with the grant of a "plain-vanilla" stock option), variable award accounting is required from the date of grant until the date the award is exercised (or purchased) and a substantial investment is made

⇒ The EITF has concluded that fixed award accounting applies (so long as the repurchase price is based on fair value) even if the exercise price of a stock option is based on other than fair value, such as a discount from fair value (EITF Issue No. 00-23, Issue 3)

⇒ The EITF also has concluded that share repurchase features based on other than fair value for nonpublic companies may *not* meet the substantial investment criterion (even if the employee invests an amount at least equal to the formula share repurchase price calculated at the date of grant) if the formula results in a *de minimis* employee investment that does not approximate fair value (because the employee does not share in the *risks* of ownership); further, share repurchase features that result in an employee investment of zero *never* meet the substantial investment criterion (EITF Issue No. 00-23, Issue 38)

- *6-Month Holding Period Requirement* -- Notwithstanding the guidance provided above, variable award accounting is required for otherwise fixed stock options or awards with a share repurchase feature if the shares (1) are *expected to be* repurchased within 6 months after option exercise or share issuance, (2) *can be* repurchased within 6 months at the volition of the employee, or (3) for public companies, can be repurchased at any time (even after 6 months) for a *premium* that is not fixed and determinable over the then-current stock price

⇒ For public companies, a repurchase price based on a *fixed* premium (at least 6 months after option exercise or share issuance) results in additional compensation cost in an amount equal to the premium

⇒ If shares that were not expected to be repurchased within 6 months after option exercise or share issuance are in fact repurchased, the transaction is treated as a cash settlement of the award (discussed above)

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 (EITF Issue No. 00-23, Issues 23(a), 23(b), 23(c), and 23(d))

⇒ 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 (that is, 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 accounting consequences of various employer call and employee put right scenarios are summarized on the following page

Scenario	Employer / Employee Share Repurchase Rights				
	Active Rights, i.e., Not Contingent on Future Events		Contingent Rights, i.e., Contingent on Future Events		
	Employer Representation Not to Call (consistent with relevant facts and circumstances)	No Employer Representation	Within Control of Employer or Employee	Outside 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

Stock-for-Tax Withholding

- *In General* -- A new measurement date is required for otherwise fixed stock options or awards if shares are withheld upon option exercise or share issuance in excess of the *minimum statutory* federal, state, and payroll tax withholding rates applicable to supplemental income; compensation cost is equal to the award's intrinsic value as of the excess withholding date

- *Variable Award Accounting* -- Variable award accounting is required for otherwise fixed stock options or awards if (1) the ability to withhold in excess of minimum statutory rates is at the volition of the employee, or (2) the grantor company exhibits "a pattern of consistently approving excess withholding transactions"

Business Combinations

- *Pooling of Interests* -- There is no accounting consequence for otherwise fixed stock options that are exchanged in a pooling-of-interests transaction, provided (1) the aggregate intrinsic value of the stock option is not *increased*, and (2) the ratio of exercise price to market price per share is not *reduced*; modifications other than to the exercise price or number of shares of the award are not addressed by Interpretation 44 because such modifications would generally preclude pooling

  ⇒ The EITF has concluded that the "stock out" of vested and nonvested stock options on a fair value basis results in a new measurement date, with compensation cost equal to the intrinsic value of the new stock awards (EITF Issue No. 00-23, Issue 4)

  ⇒ The EITF also has concluded that the "accounting attributes" of stock options or awards exchanged in a pooling-of-interests transaction "carry forward" from the combining company to the issuer; if the combining company accounts for stock options as variable awards because of a prior repricing, for example, the issuer must also account for the exchanged stock options as variable awards (EITF Issue No. 00-23, Issue 8)

- *Purchase Business Combinations* -- The fair value of vested and nonvested stock options or awards exchanged in a purchase business combination is considered part of the purchase proceeds; however, the intrinsic value of nonvested awards attributable to the remaining vesting period of the award (calculated as the intrinsic value of the exchanged award as of the consummation date multiplied by the fraction that is the remaining vesting period divided by the total pre- and post-consummation vesting period) is deducted from the purchase proceeds and allocated to "unearned compensation," which is recognized as compensation cost over the remaining vesting period of the award

  ⇒ The EITF has concluded that the accounting attributes of stock options or awards exchanged in a purchase business combination do *not* carry forward from the acquiree to the acquirer; the exchanged stock options or awards are accounted for prospectively as "new awards" (EITF Issue 00-23, Issue 8)

  The EITF also has provided guidance on several other issues dealing with the accounting for stock options and awards exchanged in a purchase business combination, including:

  ⇒ The subsequent *repurchase, modification, or forfeiture* of stock options or awards that were previously exchanged in a purchase business combination (EITF Issue No. 00-23, Issues 9, 10, and 11, respectively)

  ⇒ The appropriate dates that should be used by an acquirer in a purchase business combination to (1) value the stock options or awards exchanged as part of the purchase consideration, and (2) measure the intrinsic value (if any) of the exchanged stock options or awards for purposes of allocating a portion of the purchase price to unearned compensation cost (EITF Issue No. 00-23, Issue 13)

- ⇒ The exchange of acquirer stock options or awards in a purchase business combination for nonvested stock options or awards of an acquiree that are held by *nonemployees* of the acquiree, and the grantees became nonemployees of the acquiree in a prior spinoff transaction (EITF Issue No. 00-23, Issue 14)
- ⇒ The "income tax benefit" from the exercise of *vested* stock options (including the portion of nonvested stock options attributable to the *expired* vesting period at the consummation date) that were issued in a purchase business combination is recognized as a *reduction* to the purchase price of the acquired business to the extent that the deduction reported for tax purposes does not exceed the fair value of the awards included in the purchase price; the tax benefit of any remaining excess tax deduction is treated as a contribution to capital (EITF No. 00-23, Issues 29(a) and 29(b))
- ⇒ 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* at the date the combination was consummated) should be recognized as a liability and corresponding cost on the date of the event triggering the income recognition and payment of tax to the taxing authority (e.g., on the date of exercise for a nonqualified stock option), consistent with the guidance in EITF Issue No. 00-16 (EITF Issue No. 00-23, Issue 32)

- *Failure to Assume Awards* -- Interpretation 44 does not provide guidance in regard to the accounting consequence of a company's *failure* to assume outstanding target company stock options or awards in connection with a purchase business combination, but the EITF has concluded that 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 Interpretation 44) (EITF Issue No. 00-23, Issue 44)
  - ⇒ 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)

Others Issues

- *Shareholder Approval* -- Stock options or awards that are awarded contingent upon shareholder approval are *not* deemed granted until shareholder approval is actually obtained, unless such approval is perfunctory; thus, a measurement date does not occur *unless and until* shareholder approval is obtained
  - ⇒ The EITF has concluded that the above guidance applies even if the company is not *required* to obtain shareholder approval, but nevertheless chooses to do so (EITF Issue No. 00-23, Issue 5)
- *Deferred Tax Assets* -- Deferred tax assets (that is, future tax deductions) for fixed stock options or awards that have intrinsic value at grant are *not* reduced in event of a subsequent decline in stock price (below the stock price at grant)
- *Combined Cash and Stock Awards* -- Variable award accounting is required if the original terms of an otherwise fixed stock option provide for a cash bonus feature that is (1) not fixed and determinable at grant, and (2) payable solely upon option exercise; modifications to *add* a cash bonus feature payable solely upon option exercise (regardless of whether the bonus is fixed and determinable or not) are considered to be a repricing of the original award (discussed above)

- ⇒ Compensation cost is determined separately for all other combined cash/stock arrangements; that is, compensation cost is measured separately for the cash and stock components of the award (even if the cash bonus is payable only upon option *vesting*)
- ⇒ The EITF has concluded that cash payments in the form of dividend equivalents that are paid currently or contingent upon vesting do *not* result in variable award accounting for an otherwise fixed award (EITF Issue No. 00-23, Issue 6)
- ⇒ The EITF also has concluded that variable accounting is required if the cash bonus feature is contingent upon the employee's *sale* of stock received from a previous option exercise, because the exercise of the stock option is one of two conditions that must be met in order for the employee to receive the cash bonus (EITF Issue No. 00-23, Issue 27)
- ⇒ The EITF also has provided guidance on several issues dealing with an employee's reimbursement to an employer of certain United Kingdom employment taxes imposed on employers for an employee's option profit at exercise (EITF Issue No. 00-23, Issues 15, 16, and 17)

Interpretation 44 does not provide guidance in regard to how companies are to account for the indirect guarantee of option profits on otherwise fixed stock options by providing for a cash bonus or loan forgiveness if a specified level of intrinsic value is not attained, but the EITF has concluded that the guaranteed minimum gain (generally, the loan or bonus amount) is to be recognized as compensation cost over the applicable service period (with no reversal of cost unless the employee fails to fulfill an obligation); any amount of the bonus *not* paid or loan *not* forgiven (because the specified level of intrinsic value is attained) is treated as a contribution to capital (EITF Issue No. 00-23, Issue 2)

- *Stock Option Exercises With Recourse Loans* -- Interpretation 44 does not provide guidance in regard to 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 has concluded 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, (3) the employee does not have sufficient assets or other means (beyond the shares) to justify the recourse nature of the loan, or (4) the employer has accepted a recourse note upon option exercise and subsequently converted the recourse note to a nonrecourse note (EITF Issue No. 00-23, Issue 34)
  - ⇒ 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 continues to be accounted for as a stock option in accordance with the guidance in EITF Issue No. 95-16 (that is, the exercise is not recognized for accounting purposes)

  The EITF also has concluded that the conversion of a recourse note (that represents consideration for a previous stock compensation transaction) to a nonrecourse note 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, where 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 (EITF Issue No. 00-23, Issue 50)

  - ⇒ 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

⇒ 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 Interpretation 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 EITF Issue No. 00-23, Issue 34

⇒ The new stock option is accounted for under the nonrecourse note guidance provided in EITF Issue No. 95-16

The EITF also has concluded that the exercise price of a stock option is not fixed (and thus variable award accounting is required) if the *original terms* of the award provide for exercise with a full recourse note that *may not* bear a market interest rate on the date of exercise (EITF Issue No. 00-23, Issue 25)

⇒ 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 (based on the credit standing of the grantee)"

- <u>*Recourse Loans With Forgiveness Provisions*</u> -- Interpretation 44 does not provide guidance in regard to 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; the EITF has concluded that 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, (because the exercise price is not fixed for a recourse note arrangement that does not bear market terms); further, any amount of the loan actually forgiven is recognized as additional compensation cost (EITF Issue No. 00-23, Issue 35)

⇒ 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

⇒ 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 substantive performance goals, but presumably the same variable award accounting would apply because the exercise price is not fixed

- <u>*Broker Assisted Cashless Exercises*</u> -- Interpretation 44 does not provide guidance in regard to the accounting consequence of a "cashless exercise" of a stock option effected through a broker, but the EITF has concluded that there is no accounting consequence if the broker is *unrelated* to the grantor and (1) the employee makes a valid exercise of the stock option, and (2) 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)

The EITF also has concluded that 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 (EITF Issue No. 00-23, Issue 48)

Effective Date

- *In General* -- The provisions of Interpretation 44 become effective on July 1, 2000 and (except as noted below) apply to (1) grants of new awards, (2) changes in employee status, (3) modifications to outstanding awards, and (4) exchanges of awards in business combinations that occur on or after that date

  ⇒ The provisions covering share repurchase features and excess stock-for-tax withholding transactions apply to stock options or awards granted (or new repurchase features added) on or after July 1, 2000

- *Exception for New Grants to Nonemployees* -- The provisions of Interpretation 44 that exclude stock options or awards granted to nonemployees from the scope of Opinion 25 apply on a prospective basis (beginning July 1, 2000) to new grants to nonemployees that occur *after December 15, 1998*

- *Exception for Stock Option Repricings and Cancellation/Replacement Awards* -- The provisions of Interpretation 44 dealing modifications to otherwise fixed stock options to directly or indirectly reduce the exercise price apply on a prospective basis (beginning July 1, 2000) to modifications that occur *after December 15, 1998*

- *Exception for Modifications to Add a Reload Feature* -- The provisions of Interpretation 44 dealing with modifications to otherwise fixed stock options to add a reload feature apply on a prospective basis (beginning July 1, 2000) to modifications that occur *after January 12, 2000*

- *Prospective Application* -- The provisions of Interpretation 44 apply only on a prospective basis (beginning July 1, 2000) for stock options or awards subject to the "retroactive application dates" discussed above; that is, compensation cost is *not* recognized for amounts attributable to vesting periods or option exercises that occur prior to the July 1, 2000 effective date of Interpretation 44

  ⇒ The only exception is that, for the presumably few companies that previously accounted for stock compensation granted to nonemployee directors under the fair value provisions of Statement 123, the initial application of Opinion 25 is to be reported as a "cumulative effect of a change in accounting principle"

- *EITF Issue No. 00-23* -- The provisions of EITF Issue No. 00-23 generally apply prospectively beginning after the meeting date on which the specific issue was discussed

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General questions may be addressed to Thomas Haines in our Chicago Office at (312) 332-0910 or by email at tmhaines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this letter and other published materials are available on our web site, www.fwcook.com.