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12/27/01

EITF Deliberations on
Issue No. 00-23 Continue into Second Year
But There Appears to be Light at the End of the Tunnel

On November 14, 2001 the Emerging Issues Task Force (EITF) entered its second year of deliberations on Issue No. 00-23 by addressing 18 additional stock compensation issues that are briefly summarized in this letter and explained in greater detail in our summaries of EITF Issue No. 00-23 (click here for link) and FASB Interpretation No. 44 (FIN 44) (click here for link) available on our website at www.fwcook.com.

The EITF reached a "consensus" (or final conclusion) on 14 of the 18 issues, with all new guidance subject to a prospective application date beginning with transactions that occur subsequent to November 15, 2001. Over two-thirds of the new guidance focuses on stock option repricings and cancellation/replacement transactions, and the remaining issues address award exchanges in equity restructurings, stock option loan forgiveness arrangements, nonpublic company share repurchase features at other than fair value, and LLC profits interest awards. Importantly, the EITF decided to bring *closure* to the 00-23 project by agreeing to address only 7 new issues (and who knows how many "subissues") in addition to the remaining 4 issues that must be further deliberated. The EITF's description of these 11 remaining issues is presented at the end of this letter. Lastly, the EITF decided *not* to reconsider the favorable fixed award accounting for stock options with a traditional "stock-for-stock" reload feature, but decided *to* reevaluate the continued appropriateness of stock options with a "tax" reload feature.

Reload Stock Options

As mentioned above, the EITF decided not to overturn the FIN 44 guidance permitting fixed award accounting for stock options with a reload feature. It is important to remember, however, that the FIN 44 fixed award protection is limited. First, the reload feature must be embedded in the *original terms* of the stock option, as FIN 44 requires variable award accounting if the reload feature is added through a subsequent *modification* of the award. Second, the reload design provisions must be consistent with the "limited fact pattern" in EITF Issue No. 90-7, which defines a reload as the automatic grant of a new at-the-money stock option for each mature share tendered in a stock-for-stock exercise. Lastly, the EITF still plans to address at a future meeting whether a tax reload provision taints an otherwise fixed stock option with a reload feature, as summarized by the EITF in "Potential Issue 25" at the end of this letter.

Offers to Cancel and Replace Stock Options

FIN 44 provides that an actual or "effective" cancellation of a stock option (or the "settlement" of a stock option for cash or other consideration) 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. An effective cancellation is deemed to occur if an outstanding stock option is modified to “reduce or eliminate the likelihood of exercise,” such as certain modifications that reduce the number of shares or the exercise period of the award, or increase the exercise price or the vesting period 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. In addition, if at the time a stock option is canceled there exists any agreement or implied promise to “compensate the grantee 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.

In previous 00-23 deliberations, the EITF concluded that it is the employer’s *offer* to cancel and replace within 6 months that triggers variable award accounting for *all* existing stock options subject to the offer, not the actual cancellation itself. Variable award accounting commences when the offer is made, and for stock options that are retained because the offer is declined, continues until the options are exercised, are forfeited, or expire unexercised. Variable award accounting is also required for any replacement stock options granted pursuant to the offer. Importantly, variable award accounting is *not* required for any existing or replacement stock options if the terms of the offer comply with the 6-month safe harbor between offer and replacement. At the November 14 meeting, the EITF further concluded the following:

1. 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). The replacement restricted stock is subject to fixed award accounting in accordance with FIN 44, regardless of when granted (Issues 39(a) and 39(b)).

2. 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 (Issues 36(d) and 36(e)).

3. 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 (Issue 39(c)).

4. 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) (Issue 39(e)).

5. 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) (Issue 39(f)).

6. As mentioned above, FIN 44 provides that an effective cancellation is deemed to occur if existing stock options are modified to reduce or eliminate the likelihood of exercise, such as by reducing (or truncating) the exercise period of the options. Whether an exercise period truncation actually reduces or eliminates the likelihood of exercise, however, depends on whether the stock options are in-the-money or underwater. 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. Further, 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 (Issues 39(g) and 45).

Award Exchanges in Equity Restructurings

Fin 44 provides that there is no accounting consequence for otherwise fixed stock options or awards if adjustments are made to the exercise price and/or number of shares in connection with a "nonreciprocal" equity restructuring (such as a stock dividend, stock split, spinoff, 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* (or negative intrinsic value reduced), and (2) the ratio of exercise price per share to market value per share is not *reduced*. If the above two criteria are *not* met, variable award accounting is required for the converted awards because the exchange is deemed to be an indirect repricing. In previous 00-23 deliberations, the EITF concluded that the conversion formula may be applied to award exchanges in *other than* a nonreciprocal equity restructuring (such as the exchange of parent-company stock options for subsidiary-company stock options in connection with an initial public offering or the conversion of one class of parent-company tracing stock into another class of tracking stock), with the accounting consequence being a new measurement date if the above two criteria *are* met or variable award accounting if the above two criteria are *not* met. At the November 14 meeting, the EITF further concluded the following:

1. The same accounting guidance above for award exchanges in other than a nonreciprocal equity restructuring applies if existing stock options based on a company's tracking stock are converted into stock options based on the company's *surviving common stock*. That is, the conversion results in a new measurement date if the above two criteria are met or variable award accounting if the above two criteria are not met. The EITF may provide further guidance in regard to similar transactions not necessarily involving tracking stock, such as the exchange of stock options due to a company's decision to restructure its capital from a multiple class structure to a single class structure or from a voting/nonvoting structure to a voting only structure (Issue 41).
2. 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) 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. 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 (Issue 43).

Other EITF Guidance

1. *Stock Option Loan Forgiveness Arrangements* -- In previous 00-23 deliberations, the EITF debated on how to account for a stock option that is exercised with a recourse note, if the terms of the note or

another agreement provide that the note will be forgiven in whole or in part if specified performance goals are achieved. The EITF previously was unable to reach a conclusion, but the "SEC Observer" at those deliberations stated an inclination to require variable award accounting for stock option loan forgiveness arrangements in financial statements filed with the SEC.

At the November 14 meeting, the EITF concluded that variable award accounting is required if an otherwise fixed stock option is exercised using as consideration a recourse note that includes a loan forgiveness arrangement (because the exercise price is not fixed). Further, any amount of the loan actually forgiven is recognized as additional compensation cost. The EITF may provide further guidance on *how* to apply variable award accounting in this fact pattern. That is, should there be a final measurement date on the exercise date, or should the exercise not be recognized because of the loan forgiveness provision (and variable award accounting continue to apply as long as the loan is outstanding).

The EITF did not address recourse 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 performance goals, but presumably the same variable award accounting would apply because the exercise price is not fixed (Issue 35).

2. *Nonpublic Company Share Repurchase Features at Other Than Fair Value* -- FIN 44 provides that share repurchase features for nonpublic companies may be based on other than fair value, provided the employee makes a "substantial investment" *and* bears the "risks and rewards" of share ownership for a reasonable period of time. At the November 14 meeting, the EITF 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 (Issue 38).

3. *LLC Profits Interest Awards* -- FIN 44 provides that 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 U.S. payroll tax compliance (in accordance with the twenty-factor guidance provided by Revenue Ruling 87-41). At the November 14 meeting, the EITF concluded that the grantee of a profits interest award in an LLC should be considered an employee if the grantee qualifies as a common law employee. The fact that the LLC does not classify the grantee as an employee for payroll tax purposes is not relevant. The EITF is further considering whether the terms of a profits interest award in an LLC make it similar to a stock appreciation right (resulting in variable award accounting) or to a share of stock or equity (Issues 40(a) and 40(b)).

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General questions about this letter and our related letters dated
October 11, 2000 (http://www.fwcook.com/101100.html),
January 9, 2001 (http://www.fwcook.com/publications/pub2001/010901TMHrevised.html),
March 7, 2001 (http://www.fwcook.com/publications/pub2001/030701TMH.html), and
August 16, 2001 (http://www.fwcook.com/alert_letters/8-16-01-AnUpdateContDeliberEITF.pdf) may be addressed to Tom Haines at (312) 332-0910 or tmhaines@fwcook.com. Copies of this letter and other published materials are available on our website at www.fwcook.com.

Issues Remaining to be
Discussed Under EITF Issue No. 00-23[*]

Issue 39(d) -- The accounting consequence if the number of options to be granted at a future date differs from the number of options held at the date the offer is extended to the employee.

Issue 40(b) -- If a grantee is considered to be an employee for purposes of applying Opinion 25 (including by analogy), whether variable accounting should be required for a profits interest award.

Issue 42 -- Whether "Save-As-You-Earn" (SAYE) plans in the UK (and tax-qualified plans in other jurisdictions) are noncompensatory under Opinion 25.

Issue 44 -- The accounting for stock options granted by an acquiring entity subsequent to completion of a business combination to employees that formerly were employees/option holders of the target company if the acquiring entity decides not to assume the outstanding target company options in connection with the business combination.

Potential Issue 4 (SEC Item 6) -- Whether changes in features such as transferability, other restrictions, and tax attributes (of the option to the holder) are ever viewed to trigger modification accounting under Interpretation 44.

Potential Issue 9 (SEC Item 30) -- Whether an option granted to employees in shares of stock of an unrelated entity is a derivative that must be accounted for in accordance with Statement 133.

Potential Issue 10 -- Relating to the consensus on Issue 1 (SEC Item 12) reached at the September 20-21, 2000 EITF meeting, in an exchange of parent/subsidiary options that results in a new measurement date but not variable accounting, whether the exchange is viewed as a cancellation such that other option awards after (or within) six months would be subject to the repricing model.

Potential Issue 11 -- When applying the guidance in Issue 1 of Issue 00-23, Question 11(c) of Interpretation 44, or Issue 43 of Issue 00-23, whether an award must be viewed as a single instrument or whether it should be bifurcated.

Potential Issue 16 -- How to account for an option that is exercised with a full recourse note when that note is changed sometime in the future to a nonrecourse note (that is, the award is converted back to an option). Would *EITF Abstracts*, Topic No. D-93, "Accounting for the Rescission of the Exercise of Employee Stock Options," apply (since this transaction is effectively a rescission of the original exercise and the issuance of an option)? If a conclusion is reached that Topic D-93 applies, how should the guidance be applied to this fact pattern (for example, when does variable accounting cease if the expressed reason for the "rescission" is not driven by tax issues)?

Potential Issue 25 -- In practice, some reload features, as part of the option's original terms, provide for not only the automatic grant of a new option at the then-current market price in exchange for each previously owned share tendered by an employee in a stock-for-stock exercise, but also "reload" shares withheld from the underlying option exercise to pay tax withholding. The issue is whether an accounting consequence results from the reload of shares withheld from the underlying option exercise to pay tax withholding or whether the "limited fact pattern" described in Issue 90-7 should apply.

Potential Issue 29 -- Whether a "cashless exercise" effected using a broker-assisted exercise results in a new measurement of compensation cost if the transaction is executed though a brokerage subsidiary of the grantor.

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[*] As reported in the November 14-15, 2001 EITF meeting minutes.