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FASB Releases Exposure Draft on Proposed Interpretation of Opinion 25

As promised, the Financial Accounting Standards Board (FASB) on March 31 released an Exposure Draft of its proposed interpretation of APB Opinion No. 25 (Opinion 25).[1] The Exposure Draft is the culmination of a nearly 3-year "Repairs and Maintenance Project" which was undertaken by the FASB in August of 1996, and which is expected to be concluded with the issuance of a final interpretation in September of this year. The stated purpose of the proposed interpretation is to provide additional guidance, within the existing framework of Opinion 25, in several areas where questionable application and diversity in practice have evolved over the years. While many provisions of the proposed interpretation do nothing more than codify existing widespread practice, *several provisions* would require substantive changes to the manner in which companies grant and account for stock options or awards. Among the most notable provisions of the proposed interpretation are:

- Nonemployee directors, independent contractors, leased employees, and employees of nonconsolidated entities such as joint ventures would no longer fall within the scope of Opinion 25
- Stock options which are repriced or cancelled and reissued within 6 months would be accounted for prospectively as a variable award
- Stock-for-tax withholding in excess of minimum statutory withholding rates would result in an otherwise fixed award being accounted for as a variable award
- Modifying outstanding stock options or awards to provide for accelerated vesting at a future date, such as death, disability, retirement, or change-in-control, could result in a remeasurement of compensation cost at that future date
- Share repurchase features, such as puts, calls, and rights of first refusal, would not result in an otherwise fixed award becoming variable, provided certain requirements are met
- The assumption of nonvested stock options in a purchase business combination should be accounted for under Opinion 25, rather than as part of the purchase consideration
- Employee stock purchase plans meeting the criteria of IRC Section 423 would retain their status as "noncompensatory," including plans with discounts of up to 15 percent at grant and "look-back" features

A detailed summary of the Exposure Draft is presented in the Attachment to this letter. The following discussion further explores the most substantive provisions of the proposed interpretation.

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[1] *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25,* released March 31, 1999

Overview of Opinion 25

Opinion 25 is the longstanding accounting standard that provides guidance on how companies should account for stock options or awards granted to employees. The fundamental principle underlying Opinion 25 is that compensation cost should be measured as of the first date on which are known both the number of shares and the purchase price (if any) of the award, i.e., the award's "measurement date." The amount of compensation cost is equal to the excess of the fair market value of the underlying stock on the measurement date over the amount required to be paid (if any) for the stock, i.e., the award's "intrinsic value."

Awards for which the number of shares and the purchase price are fixed on the date of grant are referred to as "fixed awards." Examples of such awards include time-vesting stock options and restricted stock. Awards for which the number of shares or purchase price 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.

Limitations on Scope of Opinion 25

Current Practice – Notwithstanding its intended scope, *Accounting for Stock Issued to Employees*, Opinion 25 is almost universally applied in practice to stock-based transactions involving certain nonemployee service providers, such as outside directors and employees of nonconsolidated subsidiaries.

Proposed Interpretation – The scope of Opinion 25 would be strictly limited to "common law employees." As such, stock options or awards granted to outside directors, independent contractors, and leased employees (even if common law employees) would no longer fall within the scope of Opinion 25. Further excluded from Opinion 25 would be transactions involving the issuance of parent-company stock to employees of a nonconsolidated entity such as a joint venture, and nonvested stock options or awards held by former employees who continue to provide services to the company, such as employees who change status to independent contractors or who are transferred to a nonconsolidated subsidiary.[2]

Practical Application – Stock options or awards excluded from the scope of Opinion 25 would instead be accounted for under the "fair value" provisions of Statement 123 and the measurement date provisions of Emerging Issues Task Force (EITF) Issue No. 96-18.[3] Essentially, these provisions would require companies to recognize as compensation cost the Black-Scholes or binomial value of stock options and the fair market value of other stock-based awards, as measured on the award's *vesting date*. Compensation cost would generally be recognized ratably over the vesting period, with interim fair value accruals between grant and vesting dates based on stock price changes during the period.

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2 Also presumably excluded from the scope of Opinion 25 would be awards granted by a subsidiary company to employees of a nonconsolidated parent, although this issue is not directly addressed by the proposed interpretation

3 SFAS No. 123, *Accounting for Stock-Based Compensation*, released October 1995
EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*

The following example illustrates how compensation cost would be calculated and recognized for a 10-year at-the-money stock option granted to a nonemployee, assuming the award vests in full after 3 years:

		Grant Date	End of Year 1	End of Year 2	End of Year 3
a.	Stock price (assumed)	$20.00	$40.00	$30.00	$50.00
b.	Black-Scholes value*	$6.60	$21.75	$13.50	$30.20
c.	-- % stock price at grant (b ÷ $20.00)	33%	109%	68%	151%
d.	Cumulative compensation cost				
e.	-- % total (pro rata)	0%	33%	67%	100%
f.	-- $ amount (b x e)	$0.00	$7.18	$9.05	$30.20
g.	Previously recognized compensation cost	$0.00	$0.00	$7.18	$9.05
h.	Currently recognized compensation cost (f – g) **	$0.00	$7.18	$1.87	$21.15

* Assumes stock price volatility of 20%, dividend yield of 2%, risk-free interest rate of 6%, and remaining contractual term of option

** Interim accrual methodology as prescribed in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, released December, 1978

In the above example, the final measure of compensation cost is calculated at the end of the 3-year vesting period, when the Black-Scholes value is $30.20 as opposed to the $6.60 value at grant. Further, volatile fair value accruals of $7.18, $1.87, and $21.15 are required between grant and vesting dates based on the assumed stock price changes during the period. The same measurement date and interim accrual provisions would also apply to an award of restricted stock, except that fair value would be based on the award's fair market value rather than an option pricing valuation.

If in the above example the stock option is originally granted to an employee who later changes status to a nonemployee, only the portion of newly measured compensation cost attributable to the remaining vesting period would be recognized prospectively following the change. If the change in status occurs at the end of year 2, for example, only one-third ($10.07) of the final measure of compensation cost calculated in year 3 ($30.20) would need to be recognized.[4]

<u>Stock Option Repricings and Cancellation/Reissuances</u>

<u>Current Practice</u> – Following the stock market plummet in October of 1987 and the escalation of stock option repricings which followed, the EITF provided guidance to companies that essentially preserved fixed award accounting for repriced options, so long as the new exercise price and number of shares were fixed on the date of grant.[5] Although the controversial practice is far from widespread, companies that initiate stock option repricings do so today without adverse accounting consequences.

4 This assumes that no significant modifications are made to the award at the change in status; if significant modifications are made to the award, the <u>entire amount</u> of newly measured compensation cost ($30.20) would need to be recognized in year 3

5 EITF Issue No. 87-33, *Stock Compensation Issues Related to Market Decline*

Proposed Interpretation – Stock option repricings and cancellation/reissuances occurring within 6 months of one another would be viewed, in substance, as a change to the exercise price and/or number of shares of the original fixed award, which *could* occur again. As such, variable award "mark-to-market" accounting would apply to the repriced or newly issued stock options from the date of modification until the date of exercise.

Practical Application – If, for example, an otherwise fixed stock option is granted when the stock price is $30.00, repriced when the stock price declines to $15.00, and exercised when the stock price increases to $40.00, total compensation cost for the repriced award would equal $25.00 on the date of exercise, with interim mark-to-market accruals required for stock price changes occurring between the modification date and the exercise date.

Stock-for-Tax Withholding

Current Practice – It is commonplace today for companies to withhold shares to satisfy tax obligations arising from the exercise of stock options or the earnout or vesting of other stock-based awards. Under guidance provided by the EITF in 1987, companies are supposed to limit these "stock-for-tax" withholding transactions to the "minimum required" statutory rate.[6] The EITF's guidance does not specify the consequences of exceeding the limitation, however, and presumably as a result, many companies today permit excess stock-for-tax withholding transactions with no apparent adverse accounting effects.

Proposed Interpretation – Stock-for-tax withholding transactions in excess of the minimum required rate would be viewed, in substance, as a "put" to the company requiring variable award accounting for the *entire* underlying fixed award. Importantly, the proposed variable award treatment would apply only to stock options or awards *granted after* December 31, 1999. Awards granted prior to that date (including all currently outstanding awards) would be subject to new EITF guidance released earlier this year which requires companies to recognize compensation cost equal to the value of shares withheld *in excess of* the minimum required rate. The new EITF guidance applies to all stock-for-tax withholding transactions occurring after March 25, 1999.[7]

Practical Application – Companies must now recognize compensation cost for all excess stock-for-tax withholding transactions occurring after March 25, 1999. The amount of such cost depends on whether the underlying fixed awards are granted on or before, or after, December 31, 1999, as follows:

Awards Granted on or before December 31, 1999:

- EITF consensus decision applies
- Effective for all applicable stock-for-tax withholding transactions occurring after March 25, 1999
- Compensation cost equal to value of shares withheld in excess of the minimum required rate

6 EITF Issue No. 87-6 Section C, *Use of Stock Option Shares to Cover Tax Withholding*

7 See our letters dated March 10 and April 5, 1999

Awards Granted after December 31, 1999:	• FASB proposed interpretation applies • Effective for all applicable stock-for-tax withholding transactions occurring after December 31, 1999 • Compensation cost equal to the intrinsic value of underlying shares, i.e., variable accounting for the entire award

<u>Acceleration of Vesting</u>

<u>*Current Practice*</u> – Most stock plans and/or award agreements drafted today contain provisions that provide for the acceleration of vesting upon the occurrence of certain events, such as death, disability, retirement, or change-in-control. These acceleration provisions are often amended, both for new grants as well as for outstanding awards, in response to changes in the regulatory and/or competitive environment. In practice, neither the addition of the acceleration provision nor the actual acceleration event itself are deemed to result in a new measurement date, with one notable exception. A new measurement date is created when discretion is used to accelerate the vesting of an award that otherwise would have been forfeited, such as the vesting of a nonvested award in connection with an impending termination of employment.

<u>*Proposed Interpretation*</u> – Current practice essentially would be codified with respect to automatic accelerations pursuant to the original terms of an award and discretionary accelerations of an otherwise forfeited award. That is, the former acceleration event would not result in a new measurement date, but the latter would. The proposed interpretation would, however, potentially change current practice with respect to amendments to outstanding awards that provide for the acceleration of vesting upon the occurrence of future events, such as the events identified in the preceding paragraph. In those instances, the modification or amendment of the award would not result in a new measurement date *per se*, but the actual acceleration event itself would create a new measurement date if such event (1) occurs during the vesting period of the award, and (2) results in a more than *de minimis* increase in fair value of the award.

<u>*Practical Application*</u> – Assume, for example, that an outstanding award is amended to provide for the acceleration of vesting upon death, disability, or retirement, and that absent the amendment the nonvested award would be forfeited. The amendment itself would not result in a new measurement date. However, if death, disability, or retirement should occur before the award is normally vested, a new measurement date would result at that future date if the acceleration preserves the award's intrinsic and/or time value. If a new measurement is required, compensation cost would be calculated in accordance with the methodology prescribed for other award modifications discussed below.

<u>Other Modifications and Cash Settlements</u>

<u>*Current Practice*</u> – Two longstanding provisions of Opinion 25 are that (1) the "extension or renewal" of an option term would result in a new measurement date for an otherwise fixed award, and (2) "cash paid to settle a stock option or award" should be the final measure of compensation cost. In practice, differences of opinion have arisen as to whether modifications other than extensions or renewals should result in a new measurement date. Examples of such modifications include the addition of reload or restoration options, option gain deferrals, and limited transferability provisions. In addition, the EITF has issued conflicting guidance over the

years with respect to the appropriate amount of compensation cost to recognize when stock options or awards are modified or settled in cash.[8]

Proposed Interpretation – Modifications to outstanding fixed awards would result in a new measurement date if there is a more than *de minimis* increase in fair value, as determined for stock options using the remaining contractual term rather than expected life. If a new measurement date is required, compensation cost is measured by reference to the modified award's intrinsic value. Specifically, compensation cost would equal the sum of (1) the original intrinsic value (if any) of the award, and (2) the excess of the award's intrinsic value as of the modification date over the original intrinsic value.[9] Compensation cost would be recognized over the remaining vesting period for nonvested awards, and recognized immediately for vested awards. If stock options or awards are instead settled in cash, compensation cost would be equal to the award's original intrinsic value (if any) plus any cash paid in excess of that value (net of any cash paid by the employee).

Practical Application – Award modifications such as reloads, gain deferrals, and transferability provisions should not result in a new measurement date, because such modifications would not affect the award's fair value. If a modification or cash settlement does create a new measurement date, however, the following example illustrates how compensation cost would be calculated for a stock option or restricted stock award:

		Stock Options		Restricted Stock	
		Modification	Cash Settlement	Modification	Cash Settlement
a.	Original intrinsic value of award	$0.00	$0.00	$30.00	$30.00
b.	Intrinsic value at modification/cash settlement	$50.00	$50.00	$50.00	$50.00
c.	Amount of cash paid	N/A	$50.00	N/A	$50.00
d.	Excess of intrinsic value at modification over original intrinsic value (b – a)	$50.00	N/A	$20.00	N/A
e.	Excess of cash paid over original intrinsic value (c – a)	N/A	$50.00	N/A	$20.00
f.	Total compensation cost (a + d + e)	$50.00	$50.00	$50.00	$50.00

N/A = Not applicable

Other Provisions

Share Repurchase Provisions – The presence of puts, calls, and rights of first refusal would not cause an otherwise fixed award to become variable, so long as the repurchase price is based on fair value and the shares are not expected to be repurchased within 6 months of issuance or

8 Refer to EITF Issue No. 87-33, *Stock Compensation Issues Related to Market Decline,* and EITF Issue No. 94-6, *Accounting for the Buyout of Compensatory Stock Options*

9 An exception would apply if stock options are cancelled and replaced with a different grant type, such as restricted stock; in such a case, compensation cost would equal the sum of (1) the original intrinsic value (if any) of the stock option, and (2) the excess of the new award's intrinsic value over the stock option's intrinsic value, both measured as of the modification date

exercise. The repurchase price for private companies (excluding subsidiaries of public companies) may be based on other than fair value, provided that the employee has a "substantial investment" in the repurchased shares.

Business Combinations – A new measurement date would not be required for changes to the exercise price or number of shares of an outstanding stock option in a pooling-of-interests transaction or a nonvested stock option in a purchase business combination, provided that the criteria of EITF Issue No. 90-9 are satisfied, namely (1) the aggregate intrinsic value of the options immediately after the exchange *is no greater than* the aggregate intrinsic value immediately prior to the exchange, and (2) the ratio of exercise price per option to market value per share is *not reduced*.[10]

Effective Date

The proposed interpretation would become effective upon issuance of the final standard, which is expected to be in September of 1999. Importantly, however, the interpretation would be applied prospectively to all transactions (other than stock-for-tax withholding transactions) that occur *subsequent to* December 15, 1998. Affected transactions include grants of new awards, modifications to existing awards, and changes in employment status.

The significance of a prospective application is that any newly measured compensation cost would be recognized only for amounts attributable to vesting periods occurring *after the effective date*. Assume, for example, that $50.00 of additional compensation cost is measured for a stock option that is modified after December 15, 1998 but prior to the effective date. If on the effective date 60 percent of the option's vesting period has elapsed, only the remaining 40 percent of compensation cost ($20.00) would need to be recognized over the remaining vesting period.

As previously mentioned, the provisions with respect to stock-for-tax withholding transactions would apply only to grants made after December 31, 1999. The guidance provided by EITF Issue No. 87-6 Section C, as modified by the EITF on March 24-25, 1999, would continue to apply to all awards granted on or before December 31, 1999.

The deadline for public comment is June 30, 1999.

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General questions about this letter can be addressed to Tom Haines in Chicago (312-332-0910). Specific questions should be addressed to the company's professional accountants. Copies of this letter and other published materials are available on our web site, www.fwcook.com.

[10] EITF Issue No. 90-9, *Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*