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FASB Releases Interpretation 44

Accounting for Certain Transactions Involving Stock Compensation

an Interpretation of APB Opinion No. 25

Exactly one year to the day after issuance of the related Exposure Draft, the Financial Accounting Standards Board (FASB) on March 31 concluded its 3½-year "repairs and maintenance" project on APB Opinion No. 25 (Opinion 25) with the release of FASB Interpretation No. 44, entitled "Accounting for Certain Transactions Involving Stock Compensation" (Interpretation 44).[1] The stated purpose of Interpretation 44 is to "interpret rather than amend" the longstanding provisions of Opinion 25 that provide guidance on how companies should account for stock compensation granted to employees.

While Opinion 25 is relatively simple and straightforward, Interpretation 44 is complex and filled with exceptions and special rules. The interplay between Opinion 25 and Interpretation 44 will require compensation practitioners to exercise an increased level of caution when designing stock compensation programs, especially in regard to design aspects involving the scope of Opinion 25 and certain modifications to outstanding "fixed" stock options or awards. Consequently, the following discussion should be read in conjunction with our detailed summary of Interpretation 44 that can be accessed via our website at www.fwcook.com.

What is Opinion 25?

Opinion 25 is the longstanding accounting standard that provides guidance on how companies should account for stock compensation granted to employees. 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." 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." 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 are referred to as "fixed awards." Examples of fixed awards include time-vesting stock options and restricted stock. 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.

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1 Refer to our letter dated April 27, 1999 for a detailed summary of the Exposure Draft, and our letters dated August 20, 1999, November 18, 1999, and January 24, 2000 for a detailed summary of the FASB's redeliberation process that led to the release of Interpretation 44.

What is Interpretation 44 and When is it Effective?

Interpretation 44 is a new FASB pronouncement intended to provide additional clarification and guidance, within the existing framework of Opinion 25, in several areas of accounting for stock compensation where "questionable application and diversity in practice" have evolved over the years. The Interpretation becomes effective *on July 1, 2000* and, except as noted below, applies to grants of new stock options or awards and changes to existing awards that occur on or after that date. The exception is that once the new rules become effective, Interpretation 44 will apply on a "prospective" basis (1) to stock option "repricings" (including "effective" repricings) and new grants to nonemployees that occur *after December 15, 1998*, and (2) to stock options that are modified to add a "reload" feature *after January 12, 2000*. A prospective application means that compensation cost will not be recognized for amounts attributable to vesting periods or option exercises that occur prior to the July 1 effective date.

What Changes Under Interpretation 44?

The two most significant areas of change involve the Interpretation's additional clarification and guidance in regard to (1) the types of stock compensation that can and cannot be accounted for under Opinion 25, and (2) the types of "modifications" to outstanding stock options or awards that can result in either a "new" measurement date or potentially more punitive variable award accounting. Other areas of changes involve additional guidance and clarification in regard to (1) share "repurchase" features, such as puts, calls, or rights of first refusal, (2) "stock-for-tax" withholding transactions in excess of "minimum statutory" tax rates, and (3) the treatment of nonvested stock options or awards exchanged in "purchase" business combinations.

What Does Not Change Under Interpretation 44?

Although Interpretation 44 provides additional clarification and guidance in several other areas of Opinion 25, the new provisions generally do nothing more than "codify" existing widespread practice. Examples of provisions that provide additional clarification and guidance with little or no change from current practice include (1) permissible provisions in broad-based employee stock purchase plans, (2) adjustments to outstanding awards in connection with “equity restructings” or "pooling-of-interests" business combinations, and (3) miscellaneous issues related to shareholder approval, deferred taxes, and cash bonuses contingent upon option exercise.

When Does Opinion 25 Apply?

In general, Interpretation 44 requires two conditions to exist before Opinion 25 applies to stock compensation. First, the stock compensation must be granted by a company based solely on the stock of the grantor company. Second, the stock compensation must be granted only to "employees" of the grantor company, as defined by "common law" and U.S. payroll tax rules. There are, however, three notable exceptions to the general rule. First, there is a "broad" exception requiring Opinion 25 treatment in consolidated financial statements for all stock compensation granted by any member of a consolidated group to employees of any other member of the consolidated group. Second, there is a "narrow" exception requiring Opinion 25 treatment in the separate financial statements of a consolidated subsidiary for stock compensation granted by the consolidated parent to employees of the consolidated subsidiary. Finally, there is a "practical" exception permitting/requiring Opinion 25 treatment for stock compensation granted to certain "leased" employees and "elected" nonemployee directors (for services as a director).

When Does Opinion 25 Not Apply?

Except as noted above, Opinion 25 does not apply to stock compensation granted to individuals who are not employees of the grantor company, or to stock compensation that is not based on the stock of the grantor company. Thus, Opinion 25 does not apply to stock compensation granted to independent contractors or other nonemployee service providers, or to stock compensation granted to or received from a nonconsolidated company such as a joint venture. Further, Opinion 25 ceases to apply to nonvested stock options or awards held by a service provider who "changes status" from an employee to a nonemployee, unless the change results from a "spinoff" transaction.

What if Opinion 25 Does Not Apply?

Stock options or awards that are excluded from the scope of Opinion 25 are instead accounted for under the "fair value" provisions of 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.

When is a New Measurement Date Required?

A new measurement date means that compensation cost for an otherwise fixed stock option or award must be "remeasured" upon the occurrence of certain events. The amount of newly measured compensation cost is based on the award's intrinsic value as of the new measurement date. Interpretation 44 requires a new measurement date under the following circumstances:

- An otherwise fixed stock option or award is modified to either (1) extend the "maximum contractual" or post-termination exercise period of a stock option, or (2) accelerate or continue the vesting of an award (either unconditionally or upon the occurrence of a specified future event); the use of "discretion" to accelerate or continue vesting is considered a modification
- The company withholds shares in excess of minimum statutory tax rates upon option exercise or award vesting
- A nonemployee service provider with outstanding nonvested stock options or awards changes status to become an employee

Any newly measured compensation cost attributable to an extension of a post-termination exercise period or an acceleration or continuation of vesting is recognized *only if and when* the option term is actually extended or an award vests that would have otherwise been forfeited.

When is Variable Award Accounting Required?

Variable award accounting means that compensation cost is determined at some date later than the date of grant, such as when the stock option or award is vested, exercised, or forfeited, or the award expires. The amount of compensation cost for a variable award is based on the award's intrinsic value as of the final measurement date (or the original intrinsic value of a previously fixed award, if greater). Interpretation 44 requires variable award accounting under the following circumstances:

- An otherwise fixed stock option is modified to either (1) reduce the exercise price of the award through a repricing or a "cancellation and replacement" of the award within a 6-month "look-back look-forward" period, or (2) increase the number of shares underlying the award through the addition of a reload feature
- The company either (1) permits shares to be withheld in excess of minimum statutory tax rates at the election of the employee, or (2) "exhibits a pattern of consistently approving" excess tax withholding transactions
- The company has a share repurchase feature under which either (1) the repurchase price for a stock option is based on other than fair value (such as "book value"), or (2) the shares can be, or are expected to be, repurchased within 6 months of option exercise or share issuance
- An otherwise fixed stock option or award is not correctly adjusted in connection with an equity restructuring (i.e., the intrinsic value is increased or the ratio of exercise price to market price is reduced)
- An otherwise fixed stock option has a "cash bonus" feature whereby (1) the cash bonus is payable solely upon option exercise, and (2) the amount of the bonus is not "fixed and determinable"

Neither a new measurement date nor variable award accounting is 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-tax withholding and stock-for-stock exercise provisions.

What are Stock Option Repricings and Cancellation/Replacement Awards?

A stock option repricing occurs when there is either (1) a “direct” reduction to the exercise price of the award, or (2) an “indirect” reduction to the exercise price, such as by providing for a cash bonus that is contingent upon option exercise or a below-market interest loan to facilitate option exercise. A cancellation and replacement occurs when an outstanding stock option is actually or "effectively" cancelled (or “settled” for cash or other consideration) and replaced with a new stock option at a lower exercise price within a period that begins 6 months prior to and ends 6 months after the cancellation date. The Interpretation further provides that (1) an effective cancellation is deemed to occur if a stock option is modified or an agreement is reached to "reduce or eliminate the likelihood” of option exercise, and (2) the 6-month look-back look-forward period cannot be circumnavigated by otherwise agreeing to compensate the employee (in any form) for stock price increases until a new stock option is granted. If a stock option repricing or cancellation and replacement occurs, variable award accounting is required for the remaining life of the repriced or replacement award (except that only a new measurement date is required if the replacement award is in the form of restricted stock).

How is Compensation Cost Measured and Recognized?

If an otherwise fixed stock option or award is (1) cancelled (other than an effective cancellation), (2) modified such that a new measurement date or variable award accounting is required, or (3) settled for cash or other consideration, 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) 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

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."

What Actions Should be Taken or Avoided in Response to Interpretation 44?

<u>Award Vesting</u>

- For many companies, an opportunity exists prior to July 1 to amend (i.e., "modify") the vesting provisions of outstanding "in-the-money" stock options and restricted stock without adverse accounting consequences; this is because, prior to Interpretation 44, most accountants did not consider a change in vesting provisions to result in a new measurement date
- Thus, if a company's professional accountants concur, vesting provisions should be modified prior to July 1 to (1) remove all discretionary authority to either accelerate or continue vesting (no longer permitted), and (2) add explicit language that sets forth the vesting provisions under all contemplated termination events, including changes in status
- If companies wish to retain an element of flexibility in regard to post-termination vesting provisions, the terms of the award could provide that the award (1) becomes fully vested upon termination of employment (other than perhaps voluntary resignations or terminations for cause), remains exercisable or transferable in accordance with the original vesting schedule of the award (other than perhaps terminations due to death or disability), and (3) can be cancelled by the company at any time if the employee acts other than in the best interests of the company
    - ⇒ But be cognizant that the presence of a "noncompete" clause could result in the former employee being deemed to still be "providing services" to the company, in which case compensation cost would need to be measured and recognized under the fair value provisions of Statement 123
- Companies should also keep in mind that vesting provisions can also be amended at any time (even after Interpretation 44 becomes effective) without adverse accounting consequences if, at the time of the modification, the company's stock price has declined in value since grant (i.e., the stock options are "underwater")

Option Exercise Period

- Unlike award vesting modifications, no significant planning opportunity exists prior to July 1 for amendments that extend the maximum contractual or post-termination exercise period of a stock option; this is because current practice in regard to exercise period extensions is virtually identical to the provisions of Interpretation 44
- Similar to award vesting modifications, however, companies should keep in mind that the exercise period of stock options can be extended at any time without adverse accounting consequences if the modified stock options are underwater

Stock Option Repricings and Cancellation/Replacement Awards

- Do not reprice or cancel and replace outstanding stock options; the accounting consequence is variable award accounting
- Be cognizant of "effective cancellations" that could result in an unintended repricing; an effective cancellation is deemed to occur (regardless of "materiality") if an outstanding stock option is modified to (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
- If a repricing is necessary for competitive reasons or otherwise, consider replacing the cancelled stock options with an equivalent fair value of restricted stock; the accounting consequence is a new measurement date with respect to the restricted stock (rather than variable award accounting)
  - ⇒ But be cognizant that any shares cancelled in excess of the number of restricted shares granted can still "taint" other stock options granted during the 6-month look-back look-forward period

Reload Stock Options

- Do not amend outstanding stock options after July 1 to add a reload feature; the accounting consequence is variable award accounting
- Outstanding stock options can technically still be amended prior to July 1 to add a reload feature without variable award accounting (even though the amendment occurs after the January 12, 2000 "retroactive application date"), provided (1) the modified stock option is exercised prior to July 1, and (2) the reload stock option does not itself have a reload feature
- Interpretation 44 does not require variable accounting for an otherwise fixed stock option if the reload feature is pursuant to the *original terms* of the award; however, companies should verify that stock options with a reload feature granted after July 1 are in strict compliance with the provisions of EITF Issue No. 90-7, i.e., (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" (i.e., owned for at least 6 months)

Stock-for-Tax Withholding

- Do not withhold shares in excess of minimum statutory tax rates upon option exercise or award vesting; the accounting consequence is a new measurement date for stock options granted on or after July 1, and compensation cost equal to the amount of excess withholding for stock options granted prior to that date

- If a company does withhold in excess of minimum statutory tax rates, make sure that the excess withholding transaction is not (1) at the volition of the employee, or (2) pursuant to a pattern of consistently approving excess withholding transactions; the accounting consequence is variable award accounting

Grants to Nonemployees and Change in Status

- Be cognizant that stock options or awards granted to nonemployees are not accounted for under Opinion 25; this includes grants made to or received from any nonconsolidated company after December 15, 1998 (except as noted above)
- If an employee changes status to a nonemployee (other than via a spinoff or by becoming a nonemployee director), the terms of the award should provide that the award becomes fully vested at the date of change (but remains exercisable/transferable in accordance with the original vesting schedule of the award); there is no accounting consequence if the award is fully vested and not otherwise modified coincident with the change
- If a nonemployee changes status to an employee, the terms of the award should provide that the award is forfeited at the date of change; immediately prior to the date of change, however, the company should modify the award to continue the award in accordance with the award's original vesting and exercise period provisions (the accounting consequence is a lower compensation cost)

Other Considerations

- Do not (1) grant stock options with a variable cash bonus feature that is payable solely upon option exercise, or (2) adjust outstanding stock options or awards in an equity restructuring in a manner inconsistent with the provisions of Integration 44; the accounting consequence is variable award accounting
- In business combinations (i.e., "changes-in-control"), consider providing for the accelerated vesting of nonvested stock options or awards *only if* (1) the outstanding awards are not equitably assumed by the surviving company, or (2) the awards are equitably assumed but the employee is involuntarily terminated within a reasonable time period following the change-in-control, e.g., within 2 years

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

Application of Opinion 25

Opinion 25 Applies	Opinion 25 Does Not Apply
• Grants to employees, certain leased employees, and elected nonemployee directors (for services as a director)	• Grants to independent contractors, nonelected nonemployee directors (such as members of an “advisory board”), and other nonemployee service providers
• In consolidated financial statements, to all grants made within the consolidated group	• In consolidated financial statements, to grants made to or received from a nonconsolidated company
• In separate financial statements of a consolidated subsidiary, to grants received from the consolidated parent	• In separate financial statements, to grants made to or received from any other company (other than grants received from a consolidated parent)
• Grants to a service provider who changes status to an employee • Grants to a service provider who changes status to a nonemployee as a result of a spinoff (provided certain requirements are met)	• Grants to a service provider who changes status to a nonemployee

Accounting Consequences Under Opinion 25

	Potential Accounting Consequence Under Opinion 25		
Type of Transaction	New Measurement Date	Variable Award Accounting	No Accounting Consequence*
• Change in status to employee			
• Change in status as a result of a spinoff			
• Modification to extend option exercise period			
• Modification to accelerate or continue vesting			
• Modification to change exercise or purchase price (e.g., a repricing)			
• Modification to change number of shares (e.g., add a reload feature)			
• Modification to change shares and/or price in an equity restructuring			
• Stock option with share repurchase feature based on other than fair value (e.g., "book value")			
• Awards can be/expected to be repurchased by grantor company within 6 months			
• Shares withheld in excess of minimum statutory tax rate			
• Shares withheld in excess of minimum tax rate at volition of employee or consistently by grantor company			
• Stock option with variable cash bonus payable solely upon exercise			

* Provided certain requirements are met