Financial Reporting Developments

Summary of FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation — An Interpretation of APB Opinion No. 25
# Table of Contents

1 OVERVIEW ........................................................................................................... 1  
1.1 Introduction ........................................................................................................ 1  
1.2 Highlights of the Interpretation ........................................................................ 2  
1.3 Planning for the New Rules .............................................................................. 4  

2 SCOPE OF APB 25 .................................................................................................. 7  
  2.1 Overview ........................................................................................................... 7  
  2.2 Definition of an Employee Under APB 25 ...................................................... 8  
  2.3 Nonemployee Members of the Board of Directors ....................................... 9  
  2.4 Awards Granted Between Companies in a Consolidated Group .................. 10  
  2.5 Awards Granted to an Unconsolidated Entity ............................................... 12  
  2.6 Awards by an Employer Based on Another Company’s Stock ..................... 14  
  2.7 Change in Employee Status .......................................................................... 14  
  2.8 Co-Employment Arrangements .................................................................... 19  

3 MODIFICATIONS TO STOCK OPTIONS OR AWARDS ........................................ 21  
  3.1 Overview .......................................................................................................... 21  
  3.2 Renewal or Extension of Term ........................................................................ 22  
  3.3 Acceleration of Vesting .................................................................................... 26  
  3.4 Modifications to Increase the Number of Shares .......................................... 33  
  3.5 Reload Features .............................................................................................. 34  

4 STOCK OPTION REPRICINGS ........................................................................... 36  
  4.1 Overview .......................................................................................................... 36  
  4.2 Direct or Indirect (“Synthetic”) Repricings ..................................................... 36  
  4.3 Cancellations of Options and Issuances of Replacement Awards ................. 42  

5 SHARE REPURCHASE FEATURES ....................................................................... 47  
  5.1 Overview .......................................................................................................... 47  
  5.2 Public Company Definition ............................................................................ 47  
  5.3 Plans with Puts, Calls, and Rights of First Refusal ......................................... 48  
  5.4 Use of Stock Option Shares to Cover Tax Withholding ................................. 51  

# Table of Contents

6 **OTHER ISSUES** .................................................................53
   6.1 Discretionary Cash Settlements of Earlier Awards ....................53
   6.2 Settlements of Earlier Awards By Granting Stock .....................56
   6.3 Cash Bonus Plans Linked to Stock-Based Plans .......................58
   6.4 Noncompensatory Plans ...............................................59
   6.5 Definition of Grant Date ...............................................60
   6.6 Deferred Income Taxes ................................................62

7 **BUSINESS COMBINATIONS AND EQUITY RESTRUCTURINGS** ...........64
   7.1 Exchange of Stock Options In a Pooling-of-Interests Business Combination ............64
   7.2 Exchange of Stock Options in a Purchase Business Combination ...........65
   7.3 Equity Restructurings ................................................68

8 **EFFECTIVE DATE, TRANSITION PROVISIONS AND TRANSITION DISCLOSURES** ....73
   8.1 Effective Date and Transition Provisions ................................73
   8.2 Transition Disclosures ................................................77

**APPENDIX: STOCK COMPENSATION ACCOUNTING OVERVIEW** ..................79
   APB 25 General Concepts ...............................................79
   Statement 123 General Concepts ........................................82
   Equity Awards to Nonemployees .........................................83
1 Overview

1.1 Introduction

On March 31, 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25. The Interpretation clarifies guidance for certain issues that arose in the application of APB Opinion No. 25, Accounting for Stock Issued to Employees.

The project was added to the FASB’s agenda in August 1996. While the Board was deliberating what became Financial Accounting Standards Board Statement No. 123, Accounting for Stock-Based Compensation, in 1992 through 1995, a variety of practice issues related to the application of APB 25 came to its attention. In general, the Board believed that certain aspects of APB 25 were being applied too liberally, but that these problems would be corrected by its plans to supersede APB 25 with a fair value approach. However, because the Board ultimately decided to permit companies to continue to apply the accounting guidance in APB 25, those practice issues remained.

In addressing the issues, the Board focused on interpreting rather than completely overhauling APB 25. Therefore, the issues were addressed within the APB 25 intrinsic value framework. For this reason, the Interpretation is commonly referred to as the APB 25 “repairs and maintenance” project. It provides accounting guidance on the specific practice issues through a question and answer format, and is not a stand-alone accounting document in that it supplements the existing guidance within APB 25 and, therefore, must be read together with APB 25.

Many of the conclusions reached in the Interpretation will significantly change practice and result in the recognition of compensation expense. Therefore, it is important to understand the impact that the changes will have on existing and future awards as soon as possible. The following section highlights some of the Board’s significant conclusions as well as changes to practice. The Interpretation is generally effective prospectively after July 1, 2000 and, therefore, a number of important planning opportunities exist that companies should consider prior to the Interpretation’s effective date. These are discussed in a later section of the Overview.

The remainder of this booklet explains the Interpretation in greater detail. For each practice issue the booklet describes questions and the diverse accounting practices that may have arisen regarding APB 25’s application. Throughout the booklet, a cross reference to the Interpretation’s specific question is provided. In addition, the Interpretation’s new rules are explained including the Board’s rationale for its decision, and illustrative examples.
Because the Interpretation resolved the practice issues within the framework of APB 25 and requires a general understanding of that standard, the attached Appendix provides an overview of the general concepts of APB 25. It also briefly describes the fair value method of Statement 123 as interpreted by Emerging Issues Task Force 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 because these concepts will have to be applied in situations where APB 25 is not applicable.

1.2 Highlights of the Interpretation
Many of the conclusions reached in the Interpretation will significantly change current practice. Because the Interpretation will be effective beginning July 1, 2000 (refer to discussion below and guidance under Section 8.1, Effective Date and Transition Provisions), it is important to understand the impact of the changes as soon as possible. The following summarizes some of the more significant requirements of the Interpretation and changes to current practice.

• **Definition of an Employee**—The Interpretation addresses when an individual is considered to be an employee for purposes of applying APB 25, and concludes that the common law definition of an employee must be met. Classifying an individual as an employee for payroll tax purposes is not sufficient to apply APB 25. Options granted to individuals who are not common law employees must be accounted for using a fair value method. (Refer to Section 2.2, Definition of an Employee Under APB 25 and Section 2.8, Co-Employment Arrangements for further discussion.)

• **Nonemployee Member of the Board of Directors**—Although nonemployee members of a company’s board of directors do not meet the common law definition of an employee, the Board concluded—solely for practical reasons—that stock options granted to nonemployee directors would be accounted for under APB 25. This is consistent with present practice. To qualify for APB 25 treatment, the options must be granted for services provided as a director and the director must be elected by the shareholders. (Refer to Section 2.3, Nonemployee Members of the Board of Directors for further discussion.)

• **Awards Granted Between Entities**—In the consolidated financial statements, APB 25 applies as long as the recipient of the stock-based award qualifies as a common law employee of any entity within the consolidated group.

Even though subsidiary employees are not directly employees of a parent, the Board made a practical exception to allow APB 25 accounting for parent company stock awards granted to employees of a consolidated subsidiary in that subsidiary’s separate financial statements. However, APB 25 would **not** apply in the subsidiary’s separate financial statements to awards granted by the subsidiary (in its stock) to the employees of the parent or another subsidiary within the consolidated group. In addition, APB 25 would **not** apply to awards granted by a corporate investor to employees of unconsolidated investees. (Refer to Section 2.4, Awards Granted Between Companies in a Consolidated Group and Section 2.5, Awards Granted to an Unconsolidated Entity for further discussion.)

• **Change of an Individual’s Employment Status**—If an option holder changes status (i.e., from an employee to a nonemployee, or vice versa), the accounting basis for the option must be changed to reflect the individual’s new status. For example, if an employee becomes a nonemployee but continues to provide services as a consultant, the accounting for the options must
change from intrinsic to fair value. The amount of compensation expense recognized depends on whether the terms of the option were modified to allow the individual to retain the option following the change in status. (Refer to Section 2.7, Change in Employee Status for further discussion.)

- **Stock Option Repricings**—Once an option has been repriced, it must be accounted for as variable until exercised, forfeited or expires unexercised. This was a controversial conclusion because of the potential income statement volatility resulting from variable accounting treatment. In the Board’s view, reducing the exercise price, either directly or indirectly, indicates that the price was not fixed in the first place and further presumes that, once repriced, an option could be repriced again. In addition, if fixed options are canceled or settled and a replacement award with a lower exercise price is granted either six months before the cancellation or six months after the cancellation, variable accounting would be required for the replacement award. (Refer to Section 4, Stock Option Repricings for further discussion.)

- **Modifications to Extend the Term**—A new measurement of compensation is required for modifications that extend the term of a stock option or award. However, the ultimate recognition of additional compensation expense may differ depending on whether the maximum contractual term has been extended or not. (Refer to Section 3.2, Renewal or Extension of Term for further discussion.)

- **Modifications to Accelerate Vesting**—A new measurement of compensation is required for modifications that accelerate the vesting of a stock option because the modification effectively renews the option. However, recognition of that newly measured compensation, if any, depends on whether the employee ultimately benefits from that acceleration (i.e., the employee gets to keep options that he or she was otherwise not entitled to under the original terms). (Refer to Section 3.3, Acceleration of Vesting for further discussion.)

- **Modification to Add a Reload Feature**—If an option is modified to add a reload feature, variable accounting is required for that option from that date forward. However, a properly structured reload that is part of the original option does not require variable accounting. (Refer to Section 3.5, Reload Features for further discussion.)

- **Plans with Puts, Calls, and Rights of First Refusal**—The Interpretation addresses puts, calls, and rights of first refusal in the context of both public and nonpublic companies. For public companies, the Interpretation liberalizes practice because it allows for puts, calls and rights of first refusal of shares at fair value without the negative consequences of variable accounting, provided that the repurchase of the shares is not expected within six months of option exercise (or within six months of vesting for restricted stock). For nonpublic companies, the Interpretation does not require variable accounting for buybacks at fair value after six months of option exercise or share issuance, or for buybacks at other than fair value (e.g., book value) if the employee has made a substantial investment and has borne the risk and rewards of ownership for at least six months from option exercise or share issuance.

The definition of public company under the Interpretation is somewhat less restrictive than previous practice. Therefore, some companies that were considered public for stock compensation accounting purposes may no longer be and, therefore, can avail themselves of the less restrictive nonpublic stock compensation accounting rules. (Refer to Section 5.3, Plans with Puts, Calls, and Rights of First Refusal for further discussion.)
• Use of Stock Options Shares to Cover Tax Withholding—If shares are repurchased upon exercise of an option in excess of the number necessary to satisfy the employer’s required tax withholding, the Interpretation requires a new measurement date for the entire award. Furthermore, the Interpretation could require variable plan accounting in some situations, if the withholding provisions of the plan are not properly structured. As part of addressing this guidance, the Interpretation clarified that the required tax withholding is the employer’s minimum statutory withholding. (Refer to Section 5.4, Use of Stock Options Shares to Cover Tax Withholding for further discussion.)

• Options Exchanged in a Purchase Business Combination—In a purchase business combination, the fair value of vested options is included in the purchase price. The fair value of partially vested options is included in the purchase price to the extent vested, while the intrinsic value of the unvested portion is allocated to unearned compensation and recognized as compensation expense over the remaining vesting period. (Refer to Section 7.2, Exchange of Stock Options in a Purchase Business Combination for further discussion.)

Effective Date

The Interpretation is applied prospectively to all new awards, modifications to outstanding awards, and changes in employee status after July 1, 2000, with the following exceptions.

The requirements of the Interpretation related to the definition of an employee apply to new awards granted after December 15, 1998, and the requirements related to repricings apply to modifications made after December 15, 1998 that either directly or indirectly reduce the exercise price of an award. The new rules relating to reloads apply to modifications to add a reload feature after January 12, 2000. Although the Interpretation applies to these specific transactions that occur after December 15, 1998 and January 12, 2000, the Board decided that the Interpretation’s accounting should be applied prospectively from July 1, 2000. Consequently, upon the initial application of the Interpretation, no adjustments would be made to financial statements for periods prior to July 1, 2000 nor would the financial statements be restated or otherwise affected.

The effective dates and transition provisions of the new rules are discussed further in Section 8, Effective Date, Transition Provisions and Transition Disclosures.

1.3 Planning for the New Rules

The financial statement impact of the Interpretation will vary depending on the extent to which companies use stock-based awards to compensate their employees and the extent to which companies modify outstanding awards. However, any company that grants stock-based compensation awards will want to carefully analyze the rules in order to avoid unintended negative accounting consequences.

The following are recommendations to consider when analyzing and implementing the new rules:

• Gain a clear understanding of the impact the Interpretation will have on your company. Share this knowledge with all appropriate levels of company management in order to coordinate your efforts and avoid surprises or misunderstandings. This includes coordination between senior management, accounting, tax, human resource, and legal personnel, as well as the board of directors (especially the compensation committee).
• Review current stock compensation recordkeeping systems to determine whether they are sophisticated enough to comply with the new recordkeeping requirements of the Interpretation. This is important because the Interpretation requires that certain modifications (e.g., acceleration of vesting contingent upon a future event) would result in the recognition of compensation expense if the employee ultimately benefits from that modification on a date in the future. Therefore, companies will need to ensure that systems and controls are in place to track (by individual and number of shares) those employees that benefit from certain modifications.

• Analyze stock options or awards made after December 15, 1998 to determine if the following occurred.
  — Grants were made to individuals who are not common law employees but were accounted for as if they were.
  — The exercise price of a stock option or award was reduced, either directly or indirectly.

In these situations, companies must be prepared to apply the Interpretation’s requirements prospectively beginning July 1, 2000. In addition, any reload features added to an option through a modification subsequent to January 12, 2000 would require variable accounting prospectively from July 1, 2000.

• Consider whether the effects of the Interpretation should cause any reconsideration of the company’s stock compensation strategy or plan design. Under the Interpretation, some option arrangements get different (and more favorable) accounting results if specific provisions are included in the terms of the original grant rather than by being added later through a modification. Because the Interpretation’s rules regarding modifications are generally not effective until July 1, 2000, companies may wish to “fix” their existing grants before July 1, 2000 to provide for more favorable accounting. The following are some planning opportunities for companies to consider in existing grants and plans.
  — Companies may wish to clarify that when an option grantee changes status from an employee to a nonemployee (or vice versa) and continues to perform services for the company, the grantee is entitled to retain the options. Because the options are retained according to the original terms, the Interpretation concludes that the change in employee status would be accounted for prospectively as though the awards were newly granted only for the portion attributable to the remaining vesting period. However, if the grantee retains the options based on a new decision the company makes at the time the status changes, the decision generally would result in recognizing more expense because the awards would be accounted for as entirely new grants using the appropriate accounting method (intrinsic value for employees or fair value for nonemployees). In addition, it is important to note that in order to obtain this more favorable accounting treatment, retention of the options cannot be a discretionary decision at the time the status changes. (Refer to Section 2.7, Change in Employee Status for further discussion.)
  — Companies may wish to clarify what particular events (e.g., retirement, death, disability, change in control, involuntary termination) would result in an acceleration of vesting. This is important because if the original terms provide for vesting to be accelerated at the company’s discretion or if the plan is silent, subsequent acceleration of vesting is a modification that
would result in a new measurement date. Therefore, in order to avoid the potential recognition of additional expense, companies need to decide upfront what particular events cause vesting to accelerate versus making a discretionary decision at the time of the future event.

However, companies need to be cautious when making these types of changes. Even under today’s practice, modifying an existing option to provide for acceleration of vesting at a time when future option forfeitures (absent the acceleration) are expected to occur, most likely would result in a new measurement date. For example, if a company modifies its existing option plan to provide for acceleration of vesting upon involuntary termination at a time when the company is presently contemplating involuntary terminations, a new measurement date would be required. For this reason, this particular planning opportunity must be carefully assessed. (Refer to Section 3.3, Acceleration of Vesting for further discussion.)

— Companies may wish to clarify that shares can be repurchased upon option exercise only in amounts necessary to satisfy the required employer’s tax withholding (e.g., the amount defined by IRS guidelines for the employer’s minimum statutory withholding). Secondly, under the Interpretation, if the plan provides the employee discretion to have shares repurchased in excess of the number necessary to satisfy the required tax withholding, variable accounting is required. Therefore, companies may wish to eliminate plan provisions that allow an employee to elect to have shares repurchased in excess of the number necessary to satisfy the required tax withholding. (Refer to Section 5.4, Use of Stock Option Shares to Cover Tax Withholding for further discussion.)
2 Scope of APB 25

2.1 Overview
Companies frequently grant stock options to individuals other than employees. For example, many companies grant stock options to outside directors, consultants or independent contractors in exchange for their services. As its title indicates, APB 25 applies to stock issued to employees. The Board believed, however, that over time, practice had inappropriately extended APB 25’s accounting treatment to awards made to other than employees.

While Financial Accounting Standards Board Statement No. 123, Accounting for Stock-Based Compensation, (Statement 123) and EITF Issue 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, (Issue 96-18) addressed how to account for stock awards granted to nonemployees, the question of what constituted an “employee” had never been formally answered. Therefore, the primary focus of the Board’s deliberations on scope was to determine who qualifies as an “employee” under APB 25. Options granted to individuals who do not qualify as employees under APB 25 must be accounted for using a fair value approach.

As part of defining an employee for APB 25 purposes, the Board discussed the accounting for options granted to a company’s board of directors. The Board also deliberated whether options granted by one entity within a consolidated group to employees of another member of the same consolidated group could be accounted for under APB 25. More specifically, the Board addressed the treatment of awards by a parent company to employees of a subsidiary, awards by an investor to employees of an equity method investee, awards by a subsidiary to employees of its parent company, and awards by a subsidiary to employees of another subsidiary within the same consolidated group. The Board also considered the accounting treatment for awards to individuals in a co-employment arrangement. Finally, the Board also considered how APB 25 should be applied to a stock-based award when an individual, who continues to provide services, changes status to or from an employee. This section discusses each of these issues.
2.2 Definition of an Employee Under APB 25

**Issue**
The Board considered who qualifies as an “employee” under APB 25. (Interpretation—Questions 1(a) and 1(b).)

**Final Interpretation**
The Interpretation concluded that the scope of APB 25 should be limited to individuals who qualify as employees under “common law,” which also currently is the basis for the distinction between employees and nonemployee service providers under the current U.S. Internal Revenue Code. While meeting the U.S. Internal Revenue payroll tax definition is indicative of employee status, it is not determinative. For example, if an individual is classified as an employee for U.S. payroll tax purposes, that in itself does not indicate that the individual is an employee under APB 25 because the individual must also be a common law employee of the company.

APB 25 does not apply to stock compensation granted to either independent contractors, consultants or other service providers who do not qualify as common law employees.

Finally, an individual can provide different services for different employers and qualify as a common law employee for both employers. This may be the case, for example, when an individual works part-time for two different employers. In some circumstances, an individual may qualify as a common law employee of more than one company for the same set of services (such as in a leased employee situation). In the later situation, the Board believes that in substance, only one employer compensates the worker for that set of services. Consequently, the Board decided that only one company should qualify as the employer for purposes of APB 25 for that set of services. (Refer to Section 2.8, Co-Employment Arrangements.)

**Practice Prior to Interpretation**
Most awards to independent contractors have not been accounted for under APB 25, except in certain limited situations, based on facts and circumstances.

**Implications of the Interpretation**
With respect to scope, the Interpretation concluded that the common law definition of employee represents the best available criteria for determining employee status for purposes of applying APB 25. In arriving at this decision, the Board rejected the notion of relying solely on the classification of an employee for payroll tax purposes or creating a new definition of employee for purposes of applying APB 25. The Board concluded that an individual is an employee if the company exercises (or has the right to exercise control) over that individual to establish an employer-employee relationship. That relationship should be determined based on common law as illustrated in case law and IRS Revenue Ruling 87-41. The Board noted that a company also should consistently represent an individual as an employee for all other common law purposes, including U.S. payroll taxes, if applicable.
As indicated earlier, the Board rejected relying only on the classification of an individual as an employee for payroll tax purposes because the definition for payroll tax purposes includes certain service providers who are not common law employees. For example, full-time insurance agents do not qualify as employees under the common law employee definition, even though these agents may qualify as employees for payroll tax purposes and qualify for participation in various company-sponsored benefit plans. In those circumstances, APB 25 would not apply. Awards to such agents will now need to be accounted for at fair value under Statement 123, as interpreted by Issue 96-18. (For further background information on Statement 123 and Issue 96-18 refer to the Appendix.) Because of transition provisions, this applies to grants made after December 15, 1998 that remain unvested at July 1, 2000.

2.3 Nonemployee Members of the Board of Directors

Issue
Companies frequently grant stock options to nonemployee members of a company’s board of directors in exchange for their services. After concluding on the broader issue of who qualifies as an “employee” for APB 25 purposes, the Board deliberated whether options granted to nonemployee directors could be accounted for under APB 25. (Interpretation—Question 2.)

Final Interpretation
Nonemployee members of a company’s board of directors do not meet the common law definition of an employee. However, the Board—solely for practical reasons—concluded that stock options granted to nonemployee directors would be required to be accounted for under APB 25. APB 25 applies if the options are granted for services provided as a director and the nonemployee director is elected by the shareholders, or appointed to a board position that will be filled by shareholder election when the term expires. The Board’s practical exception is not to be extended by analogy and does not apply to awards granted to individuals for advisory or consulting services in a non-elected capacity or to nonemployee directors for services outside their role as a director such as legal advice, investment banking advice, or loan guarantees.

Practice Prior to Interpretation
Practice has treated independent outside directors as employees for purposes of applying APB 25.

Implications of the Interpretation
Initially, the Board determined that stock compensation granted to nonemployee directors was excluded from the scope of APB 25. However, due to overwhelming opposition, the Board decided that stock options granted to nonemployee directors could be accounted for under APB 25. The Interpretation is consistent with current practice in treating independent outside directors as employees for purposes of applying APB 25. However, if a nonemployee director receives stock options for other services (unrelated to his or her services as a director), those stock options would be accounted for using a fair value approach.
Example 1: Stock Options Granted to Nonemployee Directors

Company X has four nonemployee members on its Board of Directors. Members of the Board have several years of business experience and possess specific knowledge and expertise within Company X’s industry. The nonemployee directors are elected by Company X’s shareholders for a three-year term and meet four times a year. The Company grants each nonemployee director 500 stock options for each meeting he or she attends. Company X would account for the stock options under APB 25 because they were granted to elected nonemployee directors for their services as directors.

In addition, one of the nonemployee directors is also an environmental remediation attorney. During the year, Company X is named as a Potentially Responsible Party (“PRP”) at a Superfund site. Internal counsel has limited experience with environmental remediation and confers numerous times with the nonemployee director. Prior to presenting the motion to dismiss the Company as a PRP, the nonemployee director spends approximately 100 hours consulting with internal counsel. Ultimately, Company X is successful and dismissed as a PRP. Company X grants the nonemployee director 7,500 options for his consulting services. Company X would account for the 7,500 stock options under the fair value approach of Statement 123 and Issue 96-18 because the nonemployee director received stock options for services unrelated to his service as a director.

Example 2: Stock Options Granted to Members of Advisory Boards

Company X has three nonemployee members on its Advisory Board. Members of the Board have several years of business experience and possess specific knowledge and expertise within Company X’s industry. The Advisory Board members are appointed by the Chief Executive Officer for three-year terms and meet once a year for one day. Members receive 250 stock options for each meeting. Company X would account for the 250 stock options using a fair value approach. The exception, described above, applies only to stock options granted to elected nonemployee directors for their services as directors. Therefore, the awards to these Advisory Board members do not meet the criteria for that exception and cannot be accounted for using APB 25.

2.4 Awards Granted Between Companies in a Consolidated Group

Issue

Parent companies often grant stock options to employees of a consolidated subsidiary. Alternatively, a consolidated subsidiary may grant stock options in its stock to employees of the parent company or to the employees of a brother/sister subsidiary within the consolidated group. As discussed earlier, the Board concluded that APB 25 applies only to stock compensation awards granted to individuals who qualify as common law employees of the grantor company. As part of its scope deliberations, the Board discussed whether APB 25 applies to awards granted by a company to the employees of other entities within the same consolidated group. In these situations, the Board addressed the applicability of APB 25 to both the consolidated company financial statements, as well as to the separate financial statements of the parent and subsidiary. (Interpretation—Questions 3 and 4.)
**Final Interpretation**

**Consolidated Financial Statements**—In the consolidated financial statements, the Board concluded that APB 25 applies as long as the recipient of the stock-based award qualifies as a common law employee of any entity within the consolidated group. Therefore, for the consolidated company financial statements, the evaluation of whether the individual is an employee for APB 25 purposes is made at the consolidated group level.

**Separate Financial Statements**—Even though the Board concluded that subsidiary employees are not technically employees of a parent, APB 25 would apply to parent company stock awards granted to employees of a consolidated subsidiary in that subsidiary’s separate financial statements. This conclusion was reached as solely a practical exception, and applies only if APB 25 is the accounting method (rather than Statement 123) applied for stock compensation in the consolidated financial statements. As a basis for this limited exception, the Board acknowledged that some value of a parent company stock award is derived from the subsidiary’s (employer) results of operations. Furthermore, the Board observed that employees are now frequently transferred between a parent company and a subsidiary and may provide services to both companies during the vesting period.

Notwithstanding the practical exception explained above, in the separate financial statements of a subsidiary, the Board decided that APB 25 would not apply to awards granted by that subsidiary (in its stock) to the employees of the parent or of another subsidiary within the consolidated group. For example, APB 25 does not apply to awards granted by subsidiary A to the employees of the parent or to the employees of Subsidiary B in Subsidiary A’s separate financial statements. While the Interpretation does not indicate what accounting model would apply, it appears that the fair value method of Statement 123 as interpreted by Issue 96-18 would be followed because it is the only guidance that presently exists for accounting for nonemployee options.

The following table outlines the Board’s decisions regarding the accounting method for awards granted among companies that are part of a consolidated group in both the company’s consolidated financial statements and the separate financial statements.

<table>
<thead>
<tr>
<th>Award based on stock of:</th>
<th>Accounting Method in the Consolidated Financial Statements</th>
<th>Separate Financial Statements of:</th>
<th>Parent</th>
<th>Subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent to employees of a consolidated subsidiary</td>
<td>APB 25</td>
<td>APB 25</td>
<td>APB 25</td>
<td></td>
</tr>
<tr>
<td>Consolidated subsidiary to employees of parent</td>
<td>APB 25</td>
<td>APB 25 (1)</td>
<td>Fair Value (2)</td>
<td></td>
</tr>
</tbody>
</table>

(1) The Board did not specifically address this issue. However, where separate financial statements of the parent company are prepared, we believe a reasonable basis exists to apply APB 25.

(2) The fair value method of Statement 123 as interpreted by Issue 96-18 would apply.
The Board believes that consolidated subsidiary is a bright line test (i.e., the company is either consolidated or it is not) and that the reasons the company is not consolidated are irrelevant. For example, assume a parent company owns over 50% of an investee but does not consolidate the investee due to participating minority veto rights that preclude consolidation (as discussed in EITF Issue No. 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights). In that situation, the Board concluded that awards granted by the parent company to employees of the investee would not be accounted for under APB 25 because the investee was not consolidated.

Practice Prior to the Interpretation
Generally, present practice supported treating employees of a consolidated subsidiary as employees of the parent company for stock compensation accounting purposes. Likewise, awards granted by a subsidiary to parent company employees generally were accounted for under APB 25 in the separate financial statements of that subsidiary.

Implications of the Interpretation
Certain grants between members of a consolidated group may need to be accounted for at fair value in the separate financial statements of the grantor company. The present model for awards to non-employees is Issue 96-18.

However, the original focus of Issue 96-18 was on options and awards granted to outside service providers, such as outside consultants or vendors. Therefore, questions have arisen regarding whether Issue 96-18 measurement date approach is appropriate for awards granted by a subsidiary to the employees of the parent or another subsidiary within the consolidated group. Under the Issue 96-18 model, the measurement date generally is held open until the vesting date. The rationale for this approach is that an outside service provider does not have an employee relationship with the company, and therefore can more easily sever its relationship with a company. However, the relationship between employees of companies within a consolidated group is different, and is much more like a traditional employee relationship even though the individual may not technically be a “common law” employee. Because of these differences, some have suggested that the EITF re-open Issue 96-18 to address these particular concerns. We understand, however, that the SEC staff voiced objections to the possibility of changing the Issue 96-18 model for awards granted by a subsidiary to a parent or to another subsidiary. Therefore, the provisions of Issue 96-18 will continue to apply.

2.5 Awards Granted to an Unconsolidated Entity

Issue
In some situations, a corporate investor may grant stock options in its stock to employees of an equity method investee or joint venture. The Board discussed whether APB 25 applies to the accounting by a corporate investor for stock compensation that it grants to the employees of an unconsolidated entity—more specifically, are employees of the unconsolidated entity considered employees of the corporate investor. (Interpretation—Question 3.)
**Final Interpretation**

The Board decided that APB 25 does not apply to the accounting by a corporate investor for stock compensation it grants to employees of an investee or joint venture accounted for under the equity method. The reason behind this conclusion is that the award recipients are not common law employees of the corporate investor.

Regarding the grantee company’s accounting (i.e., the investee) for awards granted to its employees in the stock of a corporate investor, the Board also concluded that APB 25 does not apply. In the Interpretation’s basis for conclusions, the Board indicated that the accounting by an investee for costs incurred on its behalf by a corporate investor is an issue beyond the scope of the Interpretation.

As described in Section 2.4, *Awards Granted Between Companies in a Consolidated Group*, the Board believes a bright line consolidation test is to be applied in assessing whether APB 25 applies to awards granted by the parent to the investee.

**Practice Prior to Interpretation**

Practice for awards granted by an investor company to employees of an unconsolidated investee has been mixed and has been heavily dependent on facts and circumstances. In certain circumstances, APB 25 treatment has been considered appropriate.

**Implications of Interpretation**

Prohibiting APB 25 accounting for stock options and other stock-based awards granted to employees of unconsolidated investees by a corporate investor is a significant change for many companies. Although the Interpretation is silent on what accounting the grantor company (corporate investor) should follow, we believe that the fair value method under Statement 123 as interpreted by Issue 96-18 would apply, because it is the only existing guidance regarding awards to nonemployees. Under Issue 96-18, the fair value of the award would be remeasured until the award ultimately vests. As described in Section 2.4, *Awards Granted Between Companies in a Consolidated Group*, many have expressed disagreement with the Issue 96-18 model in other than outside service provider situations. Despite this criticism, the SEC staff has indicated that it would object to changing the Issue 96-18 model for awards granted to employees of unconsolidated entities.

We understand, however, that the EITF will address the grantee’s accounting for costs incurred on its behalf by a corporate investor. EITF Issue 00-12, *Accounting by an Investor for Costs Incurred on Behalf of an Equity Method Investee*, addresses the accounting by an investor for costs incurred on behalf of an investee accounted for under the equity method when no proportionate funding by the other investors occurs and the investor does not receive any increase in the investor’s relative ownership percentage of the investee. Although Issue 00-12 is a much broader issue, its scope includes stock-based compensation granted by an investor to employees of an equity method investee. In addition, the Issue will address the appropriate accounting entries. We believe that the EITF will conclude on this Issue prior to the effective date of the Interpretation.
2.6 Awards by an Employer Based on Another Company’s Stock

**Issue**

In some cases, an employer company may grant awards to its employees that are based on the stock of another company. For example, assume Company A grants stock awards to its employees in the stock of unrelated Company B. The Board discussed whether APB 25 applies to the accounting by Company A under such an arrangement. (Interpretation—Question 4.)

**Final Interpretation**

The Board decided that APB 25 does not apply when an employer grants stock compensation to its employees based on the stock of another company. Furthermore, the Board noted that this accounting issue is beyond the scope of the Interpretation and is addressed, in part, in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Note that options or other awards that a parent would make to its employees in the stock of its consolidated subsidiary would be subject to APB 25 treatment.

**Implications of the Interpretation**

In order to get APB 25 treatment, it is necessary to determine that the recipient of a stock award is an employee of the grantor and that the award is based on the grantor’s own stock.

We questioned the FASB staff on the appropriate accounting treatment for options in a tracking stock granted by a parent company to employees of a consolidated subsidiary. The Interpretation does not directly address tracking stock. The FASB staff believed that in the consolidated company financial statements, APB 25 would apply. Related to the separate financial statements of the subsidiary, the FASB staff believes it would be reasonable to apply APB 25 if the tracking stock related to that subsidiary’s results of operations (but not if it tracked to another subsidiary). The rationale supporting this position is similar to the Interpretation’s exception that allows parent company options granted to subsidiary’s employees to be accounted for under APB 25 in that subsidiary’s separate financial statements.

2.7 Change in Employee Status

**Issue**

Sometimes an employee terminates from a company but continues to provide services as, for example, a consultant. In other circumstances, an outside consultant who was granted stock options may subsequently be hired by a company as an employee. In both of these examples, a change in status to or from an employee has occurred.

A change in status to or from an employee also can arise because of a change in status of the company granting the stock option to or from an employer. For example, assume a company reduces its ownership interest in a consolidated subsidiary (e.g., from 80% to 25%) so that the company now accounts for its investment using the equity method. A change in status occurs in this situation because the individual no longer is considered an employee of the company. The Board considered how APB 25 should be applied to a stock-based award when an individual, who continues to provide services,
changes status to or from an employee. In addition, the Board addressed a change in status from an employee to a nonemployee as a direct result of a spin-off transaction. This issue is discussed separately under Section 7.3, Equity Restructurings. (Interpretation—Questions 5(a) and 5(b).)

**Final Interpretation**

When a change in employment status occurs, the accounting basis for the options must change to reflect the new employment status. Essentially the award is remeasured under either a fair value or intrinsic value method, and accounted for prospectively as discussed below. The accounting also depends, in part, on what the original award agreement provided for (i.e., does the original award provide that the individual keeps the options upon a change in status, or are the awards forfeited).

**Individual Retains Options Under Original Award’s Terms**—When an individual changes status and is allowed to keep the options pursuant to their original terms and no other modification is made (i.e., no change to the life, exercise price or number of shares), a new measurement of compensation is required. However, compensation expense would be recognized prospectively only for the portion attributable to the remaining vesting period. In addition, no adjustment should be made to any compensation expense recognized by the company prior to the change in status unless an award is forfeited (as in the case where an employee terminates prior to the awards vesting) because the individual fails to fulfill an obligation. In this case, prior compensation expense recognized is reversed in the period of forfeiture.

For example, assume that a consultant was granted options that cliff vest five years from the date of grant as long as the consultant continues to provide services. At the end of the second year of vesting, the consultant becomes an employee of the company and continues to provide similar services. Under the original option terms, the change in status (i.e., from nonemployee to employee) does not result in forfeiture of the options. In addition, no other modification is made to the option. At the date of the change in status, a new measurement date under APB 25 is required (assume the option qualifies as a fixed award). At the date of the change in status, the intrinsic value of the options is $100 (e.g., the market value of the stock on the date of change is $400 and the exercise price is $300). Therefore, $60 of newly measured compensation expense ($100 x 3/5) would be recognized as expense over the remaining three year vesting period. Furthermore, the expense previously recognized under the fair value method is not affected.

**Individual Would Have Forfeited Options Under Original Award’s Terms**—When an individual changes status and the terms of the original outstanding stock options are modified to allow the individual to keep the options, or other terms are modified (i.e., to provide for a change to the life, exercise price or number of shares), the modified stock options are accounted for prospectively as an entirely new grant using the appropriate accounting method (intrinsic value for employees or fair value for nonemployees). In this case, because the previous award is forfeited, any prior expense is reversed in full when the status changed and any newly measured compensation expense is fully recognized over the remaining vesting period.

A modification occurs if the original terms of the stock option (or underlying plan) required the option to be forfeited upon the change in status and the terms are then modified to allow continued vesting in the option. In effect, the modification reinstates the outstanding option as a new grant to
the individual immediately after the status change. Similarly, a modification has been made if the terms of an option (or underlying plan) provide the company the ability at its discretion to allow an individual to retain options after a change in status. Considering the above example, if the options had to be modified so that the consultant was able to continue to vest in the options as an employee, the modified options would be accounted for as an entirely new grant. Therefore, the entire intrinsic value of $100 would be recognized as compensation expense over the remaining three year vesting period, rather than only $60 when the options are not modified.

**Practice Prior to Interpretation**

Generally, present practice has been mixed and has been heavily dependent on the facts and circumstances with regard to changes in employee status.

**Planning Idea Prior to July 1, 2000**—As discussed above, the accounting result for a change in status can be more favorable if the terms providing for retention are included in the original grant rather than by being added afterwards as a modification. Companies may wish to clarify in existing grants and in their plans that when an option grantee changes status between an employee and a non-employee (or vice versa) and continues to perform services for the company (such as a consultant), the grantee will retain his options. It is important to note that to obtain the favorable accounting the decision to permit the options to continue cannot be discretionary at the time of the status change.

**Implications of the Interpretation**

Under the Interpretation, changes in employee status would be accounted for as though the awards were newly granted; however, the amount of compensation expense recognized depends on whether or not retention of the option was provided for in the original grant, as illustrated in the following examples.

**Example 1: Change From Employee to Nonemployee — Retention Provided for in Original Grant**

A company grants an employee 10,000 at-the-money options on December 31, 2001 that cliff vest at the end of five years. The company applies APB 25 using the intrinsic value method and no compensation is recognized because the exercise price equals the quoted market price on the grant (measurement) date. At the end of the third year on December 31, 2004, the employee terminates from the company but continues to provide services as a consultant and retains the options pursuant to the option’s original terms (i.e., options are not modified). For 2005 and 2006, expense would be recognized using the fair value method because the individual is now a nonemployee. For purposes of this example, a measurement date as defined in Issue 96-18 does not occur until vesting is complete at December 31, 2006.

The market price of the company’s stock and estimated fair value of each option is:

<table>
<thead>
<tr>
<th>December 31</th>
<th>Stock</th>
<th>Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$33</td>
<td>$17</td>
</tr>
<tr>
<td>2006</td>
<td>40</td>
<td>24</td>
</tr>
</tbody>
</table>
Because the terms of the original grant provided that the individual would retain the options upon a change in employment status (and the options were not otherwise modified), the fair value of the option would be measured on the date of the status change. The company would begin to recognize compensation expense for 40% (2/5) of the fair value over the remaining vesting period of two years. However, it is important to note that because the individual is now a nonemployee, the option would continue to be re-valued at each reporting date in accordance with Issue 96-18 until performance is complete. (Note for purposes of this illustration, remeasurement is shown only at year-end; however, it would be required for each quarterly reporting period starting in the first quarter of 2005). Ultimately, 40% of the option’s fair value on the measurement date (that is, the end of year five) would be recognized as compensation expense as follows.

<table>
<thead>
<tr>
<th>Fair Value Year Ended</th>
<th>A Remaining Vesting Period of Stock Options</th>
<th>B Percentage of Nonemployee After Change in Status</th>
<th>C Nonemployee Expense Service Rendered</th>
<th>D Current Year Previously Recognized</th>
<th>E = (A x B x C)–D Nonemployee Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$170,000</td>
<td>40%</td>
<td>50%</td>
<td>0</td>
<td>$34,000</td>
</tr>
<tr>
<td>2006</td>
<td>240,000</td>
<td>40%</td>
<td>100%</td>
<td>$34,000</td>
<td>62,000</td>
</tr>
</tbody>
</table>

**Example 2: Change From Employee to Nonemployee - New Decision to Allow Retention of Option**

A company grants an employee 10,000 at-the-money options on December 31, 2001 that cliff vest at the end of five years. The company applies APB 25 using the intrinsic value method and no compensation expense is recognized on the grant (measurement) date. On December 31, 2004 (the end of the third year), the employee terminates from the company but continues to provide services as a consultant. The terms of the stock options require the grant to be forfeited upon the change in status; however, the company modified the terms to permit the individual to continue to vest in the options. The company would not have recognized compensation expense for 2002, 2003, and 2004 under APB 25 because the option is fixed. For 2005 and 2006, expense would be recognized under the fair value method because the individual is now a nonemployee. For purposes of this example, a measurement date as defined in Issue 96-18 does not occur until performance is complete at December 31, 2006.

The market price of the company’s stock and estimated fair value of each option is:

<table>
<thead>
<tr>
<th>December 31</th>
<th>Stock</th>
<th>Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$33</td>
<td>$17</td>
</tr>
<tr>
<td>2006</td>
<td>40</td>
<td>24</td>
</tr>
</tbody>
</table>
Because the terms of the grant were modified, the modified stock options are accounted for prospectively as an entirely new grant. The fair value method is used and the option would continue to be re-valued at each reporting date in accordance with Issue 96-18 until the option fully vests as follows. (Note for purposes of this illustration, remeasurement is shown only at year-end; however, it would be required for each quarterly reporting period starting in the first quarter of 2005.)

Because the terms of the grant were modified, the modified stock options are accounted for prospectively as an entirely new grant. The fair value method is used and the option would continue to be re-valued at each reporting date in accordance with Issue 96-18 until the option fully vests as follows. (Note for purposes of this illustration, remeasurement is shown only at year-end; however, it would be required for each quarterly reporting period starting in the first quarter of 2005.)

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D = (A x B)–C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fair Value of Stock Options</td>
<td>Percentage of Nonemployee Service Rendered</td>
<td>Nonemployee Expense Previously Recognized</td>
<td>Current Year Nonemployee Expense</td>
</tr>
<tr>
<td>2005</td>
<td>$170,000</td>
<td>50%</td>
<td>0</td>
<td>$ 85,000</td>
</tr>
<tr>
<td>2006</td>
<td>240,000</td>
<td>100%</td>
<td>$85,000</td>
<td>155,000</td>
</tr>
</tbody>
</table>

Note that the total compensation recognized in this example is $240,000 when a new decision was made to retain the option, as opposed to $96,000 in Example 1, when the retention of the option was provided for in the original grant.

**Example 3: Change From Nonemployee to Employee - Retention Provided for in Original Award**

A company grants an independent contractor 10,000 at-the-money options on December 31, 2001 with an exercise price of $15 per option that cliff vest at the end of five years. Because the individual is a nonemployee, expense would be recognized under the fair value method. Assume a measurement date as defined in Issue 96-18 does not occur until performance is complete, and therefore, the options will continue to be re-valued until the option fully vests on December 31, 2006. On December 31, 2004 (the end of the third year), the independent contractor becomes an employee and continues to provide services. Under the terms of the original options, the individual retains the options, upon a change in status, and the options are not otherwise modified.

Assume that on the date of change in status, the option qualifies as a fixed award under APB 25 and that the company’s stock price is equal to $28 per share. Because the original terms of the grant provided for retention of the award, the intrinsic value would be measured and the company would begin to recognize compensation cost for 40% (2/5) of the intrinsic value over the remaining vesting period of two years. The compensation expense measured under the APB 25 intrinsic value method at the date of the change in status would be equal to $130,000 [($28 - $15) x 10,000 options]. The compensation expense that was recognized during the first three years of the vesting period under the fair value method is not adjusted. Ultimately in this example, 40% of the option’s intrinsic value on the change in status date (that is, the end of year three) would be recognized as compensation expense as follows.
2.8 Co-Employment Arrangements

**Issue**

Under lease or co-employment arrangements, a professional employer organization leases out employees to another company (i.e., the lessee). In many situations, the professional employer organization is the employer of record for payroll tax purposes. Often, the lessee grants stock options to the leased individuals for their services. The Board focused on what conditions must be present that would allow the lessee to grant options to leased employees in a co-employment arrangement and account for them under APB 25. *(Interpretation—Question 1(b).)*

**Final Interpretation**

The Board decided that if a written agreement between the lessor and lessee exists and all of the following conditions are met, an individual can be deemed an employee of the lessee for purposes of applying APB 25.

- The leased individual qualifies as a common law employee of the lessee company, and the lessor is required to remit payroll taxes for the leased individual for the services provided to the lessee. (This means that independent contractors do not meet this exception if they are not common law employees of the company receiving the services.)

- The lessor and lessee agree in writing to all of the following conditions related to the leased individual:
  - The lessee can grant stock options to the individual for the service to the lessee (i.e., both companies could not grant options for the same set of services).
  - The lessee can hire, fire, and control the activities of the individual. (However, this does not preclude the lessor from also having this right.)
  - The lessee has the right to determine the value of the services performed by the individual (including cash compensation levels and the number and value of the options granted).
  - The individual can participate in the lessee’s employee benefit plans, if any, similar to comparable employees of the lessee (e.g., those employees that have an equivalent level of responsibility and compensation).
  - The lessee reimburses the lessor for the individual’s compensation, including all payroll taxes, on or before an agreed upon date.

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>A Intrinsic Value of Stock Options</th>
<th>B Remaining Vesting Period After Change in Status</th>
<th>C Percentage of Employee Service Rendered</th>
<th>D Nonemployee Expense Previously Recognized</th>
<th>E = (A x B x C)–D</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$130,000</td>
<td>40%</td>
<td>50%</td>
<td>0</td>
<td>$26,000</td>
</tr>
<tr>
<td>2006</td>
<td>130,000</td>
<td>40%</td>
<td>100%</td>
<td>$26,000</td>
<td>26,000</td>
</tr>
</tbody>
</table>
If all of the above criteria are met, the lessee’s relationship with the leased individual is essentially the same as its relationship with employees of comparable status. Therefore, if a written agreement between the lessor and lessee exists and all of the above criteria are met, the lessee is the employer for purposes of applying APB 25.

**Practice Prior to Interpretation**

Generally, present practice has been mixed and has been heavily dependent on the facts and circumstances regarding lease or co-employment arrangements.

**Implications of the Interpretation**

The Board concluded that a leased employee may qualify as an employee under common law for more than one company for the same set of services. However, in these situations the Board decided that only one company should qualify as the employer for purposes of applying APB 25. By providing the above guidance, the Board is attempting to establish criteria that would allow the lessee the ability to account for stock options under APB 25 in a lease or co-employment arrangement.

It is not uncommon for leased employees to be granted options by the lessee company. In fact, in some situations the leased employees were originally employees of the lessee until the co-employment arrangement was formed. The Board acknowledged that if certain criteria are met, the lessee should be able to grant options to the leased employee and account for them under APB 25 even though all of the usual employee-employer attributes are not in place (for example, the lessee does not remit payroll taxes to the governmental authorities). However, the Board wanted clear guidelines to restrict the circumstances under which the lessee could grant leased employees options and account for them under APB 25.
3 Modifications to Stock Options or Awards

3.1 Overview
Companies that previously issued stock compensation awards to employees may subsequently decide to modify the terms of those awards in a manner that provides the employee with a greater benefit than he or she currently has in the award.

Modifications to existing awards are made under a variety of scenarios. In some cases, the company may decide to extend the term of an option from, for example, eight years to 10 years. In other situations, modifications are made at the time of an employee’s termination. For example, an employee’s option agreement may provide that a nonvested option is forfeited at the employee’s termination; however, because of the employee’s excellent service, the company decides to accelerate vesting for the nonvested option when the employee is terminated. Companies also may decide to reprice their options when the stock price falls and the desired motivational effect of the options is lost. In other cases, a company may increase the number of shares previously issued under a stock option or add a reload feature.

The above-mentioned modifications could change the life of the award, the exercise price, or the number of shares to be issued. While APB 25 specifically discusses extension of the option term, it does not provide specific guidance on the accounting consequence of a modification that changes an option’s exercise price or number of shares. Furthermore, while APB 25 requires a new measurement date when an option’s term is extended, it does not provide specific guidance in identifying a renewal or extension. Because of APB 25’s lack of specificity in this area, the Interpretation provides guidance in accounting for the following modifications:

- A modification that renews or extends the term of an award (refer to Section 3.2, Renewal or Extension of Term).
- A modification that accelerates an award’s vesting (refer to Section 3.3, Acceleration of Vesting).
- A modification that reduces the exercise price of an award (refer to Section 4, Stock Option Repricings).
- A modification that increases the number of shares to be issued under an award (refer to Section 3.4, Modifications to Increase the Number of Shares).
- A modification that adds a reload feature to an option (refer to Section 3.5, Reload Features).

The Interpretation identifies modifications that have an accounting consequence within the intrinsic value framework of APB 25 from those that do not. The Board noted that a modification to the term of an option, exercise price, or number of shares would also change the award’s fair value as determined
by an option-pricing model and therefore would have an accounting consequence. On the other hand, the Interpretation provides that modification to a stock option or award that does not affect the life of the award, the exercise price, or the number of shares to be issued has no accounting consequence. By taking this view, the Interpretation resolves questions that arise in practice regarding other types of modifications. For example, we believe that other changes, such as adding a cashless broker arrangement, providing for transferability of the award or adding the ability to have shares withheld for tax purposes would not result in an accounting consequence.

3.2 Renewal or Extension of Term

Issue

The Board deliberated whether modifying an outstanding award to renew or extend its term would result in a new measurement date. (Interpretation—Questions 9 and 10.)

Final Interpretation

Consistent with APB 25, the Board concluded that a new measurement of compensation is required for modifications that either renew or extend the term of a stock option or award. Measurement of compensation is made at the date of modification. However, in some situations the recognition of compensation, if any, depends on whether the maximum contractual term is extended or not, as described below.

Maximum Contractual Term Extended—Modifications to stock options or awards that directly extend the maximum contractual term (often 10 years) of an option result in a new measurement date on the date of modification for all options extended. For example, a company may decide that the term of all options is immediately extended from 10 years to 11 years. A new measurement date would result and compensation expense would be recognized over the remaining vesting period of the award. The amount of compensation is equal to the excess intrinsic value of the award on the date of the modification over the original intrinsic value of the award (often zero).

Modifications that extend the maximum contractual term of the option contingent on future separation from employment (e.g., retirement), result in a new measurement of compensation on the date of the modification for any employee who could benefit from the modification. Any intrinsic value at the date of modification in excess of the award’s intrinsic value at the original measurement date is recognized as compensation expense over the remaining vesting period, or immediately if the award is vested.

For example, assume a stock option’s original terms are that an individual has 90 days upon retirement to exercise his options. The company modifies the plan to give an individual one year to exercise his options upon retirement, and that one year could extend the life of that individual’s options beyond the 10-year maximum term. On the plan modification date, assume the employee will be eligible to retire within the remaining life of the option. In this situation, a new measurement date results because the individual could benefit from the modification.
Maximum Contractual Term Not Extended—Modifications that extend the term of a stock option or award upon separation of employment, but do not extend the maximum contractual term, ultimately result in compensation expense only if the separation event actually occurs and the term of the award is extended. Compensation is measured based on the intrinsic value on the modification date in excess of the award’s original intrinsic value. On the modification date, an estimate of the additional compensation based on the number of employees who might benefit (i.e., the number of options that might actually be extended) is made, and that estimate begins to be amortized over the remaining vesting period. Subsequent to the modification date, this estimate is adjusted in later interim periods as more information becomes available. Ultimately, compensation expense is recognized for individuals who separate employment and have the life of their award extended because of the modification. On the other hand, if the stock option or award vests and is exercised prior to the separation event, additional compensation is not required because the life of the stock option or award has not been extended. Any estimated expense previously recognized would be reversed.

For example, assume a company extends the term of a stock option from 90 days to one year upon retirement, but not beyond the 10-year maximum contractual term. Compensation would be measured based on the intrinsic value on the modification date in excess of the option’s intrinsic value at the original measurement date. The company would make an estimate of the number of people who might benefit (i.e., the number of options that might be extended). Finally, the company would adjust that estimate from the date of the modification forward and the amount of compensation expense ultimately recognized would be only for those individuals who actually retire and the life of the award is extended.

In some situations, a company may be unable to estimate whether employees separate from employment and receive an extension of an award’s term as a result of the modification. Therefore, in this circumstance, no additional compensation expense would be recognized prior to the employee’s separation of employment.

Because the Interpretation requires estimating compensation that could be recognized in the future, companies will have to consider whether disclosure of such estimates is necessary. Disclosure may be necessary if the estimated compensation could be subject to wide variations that could materially affect the financial statements. When assessing whether disclosure is necessary, companies should consider the guidance in SOP 94-6. In general, SOP 94-6 provides that the disclosure of a significant estimate should be made if information known to management indicates that the estimate will change in the near term as a result of future confirming events and the effect of the change would be material. This determination will require judgment. For example, if a company recognizes estimated compensation expense for a modification that accelerates vesting, further disclosure still may be appropriate if the amount recorded may change significantly. In situations when the company is unable to estimate the compensation to be recognized, the company still may need to disclose the possibility that compensation could be required in the future if recognition could materially affect the financial statements.
Practice Prior to Interpretation

Under present practice, when the term of a stock option or award is extended (say from eight years to 10 years), a new measurement date has been explicitly required by APB 25.

For amendments that extend option exercise terms contingent on an employee’s retirement or termination, present practice has required a measurement date on options of all employees who could be affected by the amendment. For example, assume a stock option’s original terms are that upon retirement, an individual would have 60 days to exercise his options. The company modifies the plan to give an individual two years to exercise his options upon retirement. Some employees could benefit from the amendment because they will be eligible to retire within the remaining life of the option and others will not. However, it would be appropriate to exclude younger employees who will not reach early retirement age during the option term, and who therefore could not be affected by a plan amendment that extends the option exercise period following an employee’s normal retirement. Unlike the Interpretation, present practice has not distinguished between modifications that extend the term beyond the maximum contractual term and those that do not.

Implications of the Interpretation

The Interpretation generally is consistent with current practice regarding the extension of a stock option’s term. However, as indicated above, the Interpretation distinguishes between modifications that extend the term beyond the maximum contractual term (contingent upon future separation) and those that do not, while this distinction is not made in present practice. Under the Interpretation, if the extension cannot go beyond the maximum contractual term, a new measurement date arises only if the separation event occurs and the term actually is extended.

In addition, the Interpretation will require a significant amount of additional record keeping beyond what companies are presently required to do. As demonstrated in Example 2 below, the modification could result in compensation expense if the separation event occurs and the life of the award is extended. Therefore, from the option’s date of modification to its exercise date, the company will need to track the number of employees who benefit from the modification and the number of shares received as a result of the modification. Although the company will be required to record interim estimates, ultimately, the company will recognize compensation expense for only those employees who separated (e.g., retired) and the life of the award was actually extended.

Example 1: Extension of Term Beyond the Maximum Contractual Life

On April 1, 2004, employee A and employee B were each granted 1,000 options that vest over four years. The following provides background information related to the grant and the stock option plan:

| Option intrinsic value on April 1, 2004 | $0 |
| Maximum contractual term | 10 years |
| Normal retirement age per plan | 60 years old |
| Exercise period upon retirement | Lesser of 60 days or remaining period of the 10-year life |
On April 1, 2009, the company modified the plan so that upon retirement an individual would have two years to exercise vested options not limited by the original 10 year term. On April 1, 2009, the option’s intrinsic value was $5 per option. As a result of the modification, the maximum contractual term of an option has been extended beyond 10 years for any employee eligible for retirement at 60 within the original 10-year option term.

On the plan modification date, employee A is 30 years old and will not be eligible to retire within the remaining period of the option’s 10-year life. Therefore, employee A cannot benefit from the modification and no compensation is recognized.

However, employee B is 56 years old and will be eligible to retire within the remaining life of the option. Because employee B could benefit from the modification (i.e., receive the extended exercise period beyond the 10-year contractual term), compensation is measured and recognized on the modification date because the options are fully vested.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original intrinsic value of the stock option</td>
<td>$0</td>
</tr>
<tr>
<td>Intrinsic value of the modified award</td>
<td></td>
</tr>
<tr>
<td>Number of options that have been extended based on the modification</td>
<td>1,000</td>
</tr>
<tr>
<td>Option intrinsic value on modification date in excess of original intrinsic value</td>
<td>$5</td>
</tr>
<tr>
<td>Compensation expense</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Regardless of when in the future employee B retires, the company must recognize the $5,000 as compensation expense. In this example, present practice also would have required a new measurement date for this extension of the option term for all options that could be affected by the modification (i.e., employee B).

**Example 2: Extension of Term Not Beyond the Maximum Contractual Life**

A company grants an employee 1,000 options on April 1, 2005. The following provides background information related to the grant and plan:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option intrinsic value on grant date</td>
<td>$0</td>
</tr>
<tr>
<td>Normal retirement age per plan</td>
<td>60 years old</td>
</tr>
<tr>
<td>Exercise period upon retirement</td>
<td>60 days</td>
</tr>
<tr>
<td>Maximum contractual term</td>
<td>10 years</td>
</tr>
</tbody>
</table>

On April 1, 2009, the company modifies the plan such that upon retirement the exercise period will be two years (rather than 60 days), but will not be longer than the maximum contractual term. On the plan modification date, the employee is 57 years old and the options have six years remaining on the maximum contractual term. Because the modification does not extend the maximum contractual term, additional compensation is required only if the employee retires and obtains, as a result of the modification, an exercise period for the options in excess of 60 days provided in the original terms of the option.

The company would need to make interim estimates of the number of awards that will have a term extension as a result of the modification and recognize compensation accordingly. The interim estimate would be adjusted in later periods as more information becomes available in order to true up that estimate from the modification date forward. The company must measure
additional compensation equal to the intrinsic value of the modified options held by the employee at the date of modification in excess of the option’s original intrinsic value. If compensation expense is accrued (i.e., the company estimates that this employee will retire and receive an extension of the award’s life), but the employee exercises the options prior to retirement, rather than upon or subsequent to retirement, the compensation expense previously recorded is reversed.

On the other hand, assume that the company is unable to estimate whether this employee will retire and receive an extension of the award’s life as a result of the modification. No estimate of additional compensation expense would be recognized prior to the employee’s retirement.

3.3 Acceleration of Vesting

Issue

The Board deliberated whether an acceleration of vesting pursuant to an award’s original terms would result in a new measurement date. Furthermore, the Board addressed if modifying an outstanding award to accelerate vesting would have an accounting consequence. (Interpretation—Questions 9 and 10.)

Final Interpretation

In reaching a conclusion on acceleration of vesting, the Board drew a distinction between accelerated vesting provided for in the original terms of the award versus accelerated vesting that was later added by a modification to the original terms, as described below.

Accelerated Vesting Pursuant to the Original Terms—The Board concluded that, as under present practice, if vesting is accelerated in accordance with the original terms of the award, no new measurement date results. For example, the original terms may specify that vesting is accelerated upon retirement, death, disability, or involuntary termination. If one of those events occur, and the vesting is accelerated, no recognition of compensation expense is required (unless expense was being recognized under the original award over its vesting period, then there would be an acceleration of the recognition of that expense). However, if the original terms provide for vesting to be accelerated at the company’s discretion (or on some other discretionary basis), subsequent acceleration of vesting is a modification that would result in a new measurement date.

Modifications That Accelerate Vesting—The Board concluded that if an award is modified to accelerate vesting, a new measurement date results because the modification may allow the employee to vest in an option or award that would have otherwise been forfeited pursuant to the award’s original terms. The Board concluded that a new measurement of compensation was required because the modification introduces the potential for an effective renewal of the award. While measurement of compensation is made at the date of the modification, the recognition of compensation expense, if any, depends on whether the employee ultimately retains an option or award that would have been otherwise forfeited under the option or award’s original vesting terms. Compensation is measured based on the award’s intrinsic value at the date of modification in excess of the award’s original intrinsic value.
The company would begin to recognize compensation over the new expected vesting period based on estimates of the numbers of options that employees will ultimately retain that would have otherwise been forfeited, absent the modification. Such estimates would be based on factors such as historical and expected employee turnover rates and similar statistics. We believe that the estimated compensation would be recognized over the period from the modification date to the date the employee is expected to leave the company (e.g., termination, retires). At the end of each reporting period, the estimate would be adjusted as more information became available. Ultimately, compensation is recognized only for individuals who benefit from the acceleration (i.e., retain awards that otherwise would have been forfeited, absent the acceleration). However, changes in market value after the modification have no impact on the amount of compensation recognized. Interestingly, if the stock’s market price declines after the modification date and the option vests early, expense would be recognized based on the intrinsic value at the modification date even though the option may not be exercised.

In some situations, a company may be unable to estimate the number of options that employees will ultimately retain that would have otherwise been forfeited, absent the modification. Therefore, in this circumstance, no additional compensation expense would be recognized prior to the employee’s termination.

Because the Interpretation requires estimating compensation that could be recognized in the future, companies will have to consider whether disclosure of such estimates is necessary. Disclosure may be necessary if the estimated compensation could be subject to wide variations that could materially affect the financial statements. When assessing whether disclosure is necessary, companies should consider the guidance in Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In general, SOP 94-6 provides that the disclosure of a significant estimate should be made if information known to management indicates that the estimate will change in the near term as a result of future confirming events and the effect of the change would be material. This determination will require judgment. For example, if a company recognizes estimated compensation expense for a modification that accelerates vesting, further disclosure still may be appropriate if the amount recorded may change significantly if management’s estimates prove to be inaccurate. In situations when the company is unable to estimate the compensation to be recognized, the company still may need to disclose the possibility that compensation could be required in the future if recognition could materially affect the financial statements.

To comply with the Interpretation, modified stock options must be tracked from the modification date until the ultimate original vesting date lapses or when no modified options remain outstanding.

Examples of situations where vesting provisions are modified include:

- A company modifies its outstanding options to provide for automatic acceleration of vesting upon retirement. Prior to the modification, the plan indicates that all unvested options that exist at retirement are forfeited. On the date of the modification, the company measures the intrinsic value of the options. The company begins to recognize compensation expense based on the number of employees who are expected to retire before the options’ original vesting period has expired (and therefore will be able to retain options that otherwise would have been forfeited). Ultimately, compensation expense is recognized only for those options that retirees were able to
retain (because of the modification) that they otherwise would have forfeited. Note that this modification would have no effect on options granted to employees where the term of the option expires before the employees reach retirement age.

- To reward employees for excellent performance, a company immediately accelerates the vesting of a stock option grant that would have cliff vested in three more years. Prior to the modification, the plan indicates that if an employee terminated before the options vested, they would be forfeited. At the date of the acceleration, the company measures the intrinsic value of the award. Compensation expense ultimately would be recognized for any employees who terminate within the next three years and were able to retain their options that would have otherwise been forfeited. As in the previous example, interim estimates would be made of those expected to benefit from the modification, and compensation expense accordingly recognized. However, if the company was unable to make such estimates, no additional compensation expense would be recognized until the employees actually terminated. Ultimately, compensation expense would be recognized only for those employees who received a benefit from the acceleration.

**Time Accelerated Restricted Stock Award Plans (TARSAPs)**—The Interpretation does not specifically address or even mention the accounting for TARSAPs. However, some companies establish these types of plans—stock option or award plans with normal vesting restrictions, except that they provide for the possible acceleration of vesting if certain (often performance-related) criteria are met. TARSAPs are required to be carefully structured so that the exercise price generally is the market price, the number of shares under option usually cannot change, the vesting period cannot be for an unduly long period and all options ultimately become exercisable based only on continued employment. That is, it should be “more likely than not” that the award will still ultimately vest if there is no accelerated vesting due to the TARSAP feature.

We do not believe that the Interpretation would change existing practice for a TARSAP. Therefore, if the original terms of the award contain a TARSAP feature and vesting accelerates because the performance target is achieved, no new measurement date results. For example, the original terms of an award specify that options cliff vest in eight years, but are automatically accelerated if earnings per share is increased by 25% anytime before the end of the eight year period. If vesting is accelerated, no recognition of compensation expense is required even if some employees leave before the eighth year and would have lost the options if not for the acceleration feature. This accounting result is consistent with accelerations pursuant to the original terms, as discussed earlier.

However, if a company modifies a stock option to add a TARSAP feature, the modification would result in the acceleration of vesting contingent upon a future event. Therefore, the Board’s model described above under *Modifications That Accelerate Vesting* would be applied. That is, the company would need to assess whether anyone was able to retain options that they otherwise would have forfeited absent the TARSAP acceleration. Similarly, if an option contains a TARSAP, but it is subsequently modified to establish thresholds that are more easily attainable, the modification would have to be assessed under the acceleration of vesting provisions of the Interpretation. For example, assume the original options provide for cliff vesting at the end of 2008, but vesting is accelerated if earnings per share growth exceeds 20% at the end of 2004. In 2002, the earnings per share growth target is reduced to 10%. Because of this modification, the Board’s acceleration of vesting model would be applied, as discussed above.
Practice Prior to Interpretation

Under practice prior to the Interpretation, accelerating the vesting of an award that otherwise did not provide for acceleration required case-by-case consideration based on the facts and circumstances. In general, in a continuing employment situation, acceleration of vesting did not normally result in a new measurement date (although it likely would condense the amortization period for any previously unamortized compensation). However, when such acceleration was related to the employee’s termination, and resulted in the employee receiving an award he or she would have otherwise lost, the substance may have been similar to that of severance pay. In those cases, practice would have required a new measurement date.

If the terms of an entire plan were modified to provide for acceleration of vesting if certain events occurred in the future, the accounting treatment depended on the facts and circumstances. The modification generally would not have resulted in a new measurement date unless it was deemed probable that the event triggering acceleration of the vesting was likely to occur at the time the plan was modified, and that event would have resulted in the individual forfeiting the award, absent the acceleration. For example, if an option was modified to provide for acceleration upon involuntary termination, but no terminations were contemplated at the time of the modification, no new measurement date would be required. Note that this more favorable approach would not be acceptable under the Interpretation.

If a company modified the performance measures of a TARSAP feature after the adoption of the plan by making the thresholds easier to achieve, the accounting treatment depended on the facts and circumstances. Such modifications raised concerns as to whether the employee would have received the options if the performance measures were not modified. Generally, present practice would have required a new measurement date for modifications that enabled an exercise of an option where a lapsing of options otherwise would have occurred.

Planning Idea Prior to July 1, 2000—As discussed above, the accounting result can be more favorable if the terms providing for acceleration are included in the original grant rather than by being added afterwards in a modification. Companies may wish to clarify in their existing grants what particular events (e.g., retirement, death, disability, change in control, involuntary termination) would result in an automatic acceleration of vesting. This is important because if the original terms provide for vesting to be accelerated at the company’s discretion or if the plan is silent, subsequent acceleration of vesting is a modification that would result in a new measurement date. Therefore, in order to avoid the potential recognition of additional expense, companies need to decide upfront what particular events cause vesting to accelerate versus making a discretionary decision at the time of the future event.

However, companies need to be cautious when making these types of changes. Even under today’s practice, modifying an existing option to provide for acceleration of vesting at a time when future option forfeitures (absent the acceleration) are expected to occur, most likely would result in a new measurement date. For example, if a company modifies its existing option plan to provide for acceleration of vesting upon involuntary termination at a time when the company is presently contemplating involuntary terminations, a new measurement date would be required. For this reason, this particular planning opportunity must be carefully assessed.
Implications of the Interpretation

The Interpretation generally is consistent with current practice regarding the treatment of awards for which vesting is discretionarily accelerated at the time the employee terminates. It is harsher than present practice in circumstances where vesting is accelerated in a continuing employment situation because the company must track which employees ultimately benefit. It is also harsher than present practice regarding the addition of an accelerated vesting provision for an event that has yet to occur. As previously explained, practice prior to the Interpretation typically has not recognized a new measurement date when the future event was not contemplated at the time of the modification. The Interpretation will require companies to monitor the number of options the employee ultimately gets to keep even though the original vesting terms were not met.

As the following examples illustrate, the Interpretation will require a significant amount of additional record keeping beyond what companies are presently required to do. As demonstrated in each example below, the modification could result in compensation expense if the employee ultimately gets to keep options that he or she otherwise would have lost, absent the modification. Therefore, from the date of modification until the original vesting terms lapse, the company will need to track the number of employees who benefit (i.e., the number of shares received) from the modification.

Example 1: Modification to Accelerate Vesting Immediately

On September 30, 2001, a company grants 1,000 at-the-money options that cliff vest at the end of five years to each of its 2,000 employees. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. On September 30, 2002, the company modifies the plan to immediately vest the outstanding options. At the modification date, each option has an intrinsic value of $4.

Under the Interpretation, the company is required to estimate the number of employees who might benefit from the modification by getting to keep options that they would have otherwise lost, absent the modification. In this example, an employee would benefit from the modification if he or she terminated after September 30, 2002 (the modification date) but before September 30, 2006 (the original award’s vesting date).

Based on historical employee turnover rates and the company’s projections of future employee separations, the company estimates that 100 employees will terminate employment prior to September 30, 2006. The company estimates the additional compensation as the intrinsic value at the modification date ($4) in excess of the original intrinsic value ($0) for the estimated number of awards that, absent the acceleration, would have expired unvested. Accordingly, $400,000 (100 employees with 1,000 options each, with an incremental intrinsic value of $4) of compensation expense is recognized immediately on the modification date because the awards were immediately vested on that date. Related to disclosure, the company should consider whether the estimate could vary in the near term and have a material effect on the financial statements.

The compensation estimate of $400,000 will require adjustment in future reporting periods based on actual experience. For example, assume one year after modification, the company now estimates that, in total, only 80 employees (versus the previous estimate of 100 employees) will terminate employment prior to September 30, 2006. Therefore, the company would adjust the
previous estimate of compensation downward by $80,000 to $320,000 (80 employees with 1,000 options each, with an incremental intrinsic value of $4) immediately as the awards are fully vested. Up until September 30, 2006, the company would continue to make adjustments to the earlier estimates of compensation, either upward or downward, based on actual experience and as more information becomes available. Ultimately, compensation expense is recognized only for the actual number of options retained that would have otherwise been forfeited.

**Example 2: Modification to Accelerate Vesting Immediately**

On September 30, 2001, a company grants two million at-the-money options each to two executives. The options cliff vest at the end of five years. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. On September 30, 2002, the company modifies the plan to immediately vest the outstanding options. At the modification date, each option has an intrinsic value of $20.

Assuming that the company is unable to estimate whether these two employees will benefit from the modification, no additional compensation would be recognized prior to the executives leaving the company. The company should consider disclosing that it modified options to accelerate vesting if certain events occur in the future and that it cannot estimate the amount of compensation that could be recognized in the future.

**Example 3: Modification to Shorten the Vesting Term**

On April 1, 2001, a company grants 1,000 at-the-money options that cliff vest at the end of five years to each of its 2,000 employees. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. Under the option’s original terms, unvested options are forfeited upon separation of employment. On April 1, 2002, the company modifies the plan to change the vesting period from five years to three years. At the modification date, each option has an intrinsic value of $5.

Based on historical employee turnover rates and the company’s projections of future employee separations, the company estimates that 50 employees will terminate employment prior to April 1, 2006 (the date that vesting in the options would have occurred absent the modification). The company calculates the additional compensation as the intrinsic value at the modification date ($5) in excess of the original intrinsic value ($0) for the estimated number of awards that, absent the acceleration, would have expired unvested. Accordingly, $250,000 (50 employees with 1,000 options each, with an incremental intrinsic value of $5) of compensation expense is recognized over the remaining vesting period ($125,000 each during the periods ending April 1, 2003 and April 1, 2004). Related to disclosure, the company should consider whether the estimate could vary in the near term and have a material effect on the financial statements.

The $250,000 estimate will require adjustment in future reporting periods based on actual experience. For example, assume during the year ending April 1, 2005, experience now indicates that an additional 30 employees (or a total of 80 employees) will terminate in the next year (i.e., before the original five-year cliff vesting date). The company recognizes an additional $150,000 (30 employees with 1,000 options each, with an incremental intrinsic value of $5) of compensation expense immediately because the awards are fully vested (i.e., revised cliff vesting date was
April 1, 2004). Up until April 1, 2006, the company continues to make adjustments to its earlier estimates of compensation, either upward or downward, based on actual experience. Ultimately, compensation expense is recognized only for the actual number of options retained that would have otherwise been forfeited.

**Example 4: Modification to Accelerate Vesting Contingent upon Termination**

On July 31, 2001, a company grants 1,000 at-the-money options that cliff vest at the end of four years to each of its 60 middle management employees. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. The original terms provide that unvested options are forfeited upon termination. On July 31, 2002, the company modifies the plan to accelerate vesting upon certain types of termination (i.e., involuntary termination, retirement, or death). At the modification date, each option has an intrinsic value of $3. Compensation is recognized, if termination occurs, vesting accelerates, and all or some of the awards are retained by the employees that otherwise would have been forfeited, absent the acceleration.

At the modification date, based on historical employee turnover rates and the company’s forecast of future employee separations, the company estimates that 25 employees will terminate employment (and be able to exercise the options) prior to the date that vesting in the options would have occurred under the original terms, absent the modification. Accordingly, the company calculates the additional compensation as the intrinsic value at the modification date ($3) in excess of the original intrinsic value ($0) for the estimated number of awards that, absent the acceleration, would have expired unvested. Therefore, $75,000 (25 employees with 1,000 options each, with an incremental intrinsic value of $3) of compensation expense is recognized over the period the employees are expected to provide services prior to termination. In this example, the company estimates that all 25 employees will terminate in the reporting period ending July 31, 2003. Therefore, the company would recognize compensation expense of $75,000 during the reporting period ending July 31, 2003. Related to disclosure, the company should consider whether the estimate could vary in the near term and have a material effect on the financial statements.

The compensation estimate of $75,000 will require adjustment in future reporting periods based on actual experience. Assume on July 31, 2003, one year after modification, the company eliminates all middle management positions. Therefore, on that date, the company will terminate an additional 35 employees (for a total of 60 employees) before the original four-year cliff vesting date. Because the company has terminated all 60 employees, the company recognizes an additional $105,000 (35 employees with 1,000 options each, with an incremental intrinsic value of $3) of compensation, or $180,000 (60 employees with 1,000 options each, with an incremental intrinsic value of $3) in the aggregate. Because $75,000 has been recognized already, an additional $105,000 of compensation expense is recognized immediately.

**Example 5: Modification to Accelerate Vesting Contingent on a Future Event**

On December 31, 2001, a company grants 1,000 at-the-money options that cliff vest at the end of four years to each of its 100 sales and marketing employees. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement)
date. Per the original terms, the unvested options are forfeited upon an employee’s termination. On December 31, 2002, the company modifies the plan to accelerate vesting contingent upon increasing annual fiscal revenues by 25% for any annual period before December 31, 2005. At the modification date, each option has an intrinsic value of $3.

At the modification date, the company measures the additional compensation as the intrinsic value at the modification date ($3) in excess of the original intrinsic value ($0), or $3 per option. The company determines that it is not probable that the 25% revenue increase will be met in the first year after the modification. Because the company does not believe the performance goal will be achieved, no compensation expense is recognized. During the year ended December 31, 2003, the company’s revenues increased by only 11%, and, as a result, the vesting was not accelerated. The circumstances have not changed from the prior year and the company still believes there is only a remote possibility of achieving the goal. Related to disclosure, the company should consider whether the estimate could vary in the near term and have a material effect on the financial statements.

On June 30, 2004, two potential customers each sign contracts to purchase 1.0 million units of the company’s product by year end. The company now believes it is probable that revenue will increase by 25% for the year ending December 31, 2004. Of the 100 sales and marketing employees that the company originally granted options to, only 95 employees remain as of December 31, 2004. Based on historical employee turnover rates and the company’s best forecast of future employee separation, the company estimates that 10 employees (1) will have vesting accelerated based on achieving the performance goal, and (2) will terminate prior to the date the options would have vested under the original terms (December 31, 2005), absent the modification. Accordingly, $30,000 (10 employees with 1,000 options each, with an incremental intrinsic value of $3) of compensation expense is recognized over the period the employees are expected to terminate. In this example, all 10 employees are expected to terminate prior to December 31, 2004; therefore, the $30,000 of compensation expense is recognized in the year ending December 31, 2004. The $30,000 estimate will require adjustment in future periods for actual experience. Ultimately, compensation expense is recognized only for the actual number of options retained that would have otherwise been forfeited.

3.4 Modifications to Increase the Number of Shares

Issue

A company may increase the number of shares previously granted under a stock option. In most cases, increases to the number of shares are made to provide the employee with some economic benefit that is perceived to have been lost since the original grant date. The Board deliberated when variable accounting should be applied when the number of shares previously granted under a stock option award is increased. (Interpretation—Questions 9, 12(a), and 13.) (Note: While an equity restructuring may also modify the number of shares of an outstanding award, the Board addressed that issue separately as discussed in Section 7.3, Equity Restructurings.)
Final Interpretation

The Board concluded that variable accounting is required when an option is modified to increase the number of shares to be issued under a stock option award. The entire option (for the original and additional shares) should be accounted for as variable from the date of modification until the option is exercised, forfeited or expires unexercised. If an option is forfeited (as in the case where an employee terminates prior to the award vesting), prior compensation expense recognized is reversed in the period of forfeiture. However, previously recognized expense is not reversed if the option expires unexercised.

Practice Prior to Interpretation

Under practice prior to the Interpretation, a change to the number of shares previously granted generally has resulted in a new measurement date. A case-by-case consideration based on the facts and circumstances would be necessary to determine whether variable accounting would be required.

Implications of the Interpretation

The Board’s conclusion with respect to an increase in the number of shares previously granted is consistent with its conclusion regarding changes to the exercise price—both changes provide added benefit to the employee and indicate that the option was not fixed at the date of grant and variable accounting should be followed. For example, a modification to increase the number of shares to be issued on the exercise of a stock option (without changing the total exercise price required to be remitted according to the option’s original terms) causes an indirect reduction to the exercise price per share, and variable accounting would be required for the modified award pursuant to the guidance in Section 4.2, Direct or Indirect (“Synthetic”) Repricings.

For example, a company grants an employee 1,000 at-the-money options on December 31, 2001 with an exercise price of $20 per option that cliff vest at the end of four years. The company measures the stock compensation under APB 25 using the intrinsic value method and no compensation expense is recognized on the grant (measurement) date. At the end of the second year on December 31, 2003, the stock price has declined to $10 per share. On that date, the company increases the number of shares previously granted under the stock option from 1,000 to 2,000 shares. That is, for each option the employee will still remit $20 to the company, but will now receive two shares of the company’s stock. As a result of increasing the number of shares, the options are subject to variable accounting from the date of modification to the date the options are exercised, forfeited or expire unexercised. In this example, the modification to increase the number of shares to be issued on the exercise of the stock option causes an indirect reduction to the exercise price per share ($20 to $10 per share) and, therefore, variable accounting is required.

3.5 Reload Features

Issue

A reload feature is used to encourage early exercise of stock options and to promote retention of the shares received upon exercise. Typically, a reload feature provides for 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. For example, if an employee tenders 625 shares to satisfy...
the exercise price for 1,000 options, 625 new options are automatically awarded at the then-current market price. The Board deliberated whether variable accounting should be applied when a reload feature is added to a stock option award. (Interpretation—Questions 9, 12(b), and 13.)

Final Interpretation

The Board concluded that when an option is modified to add a reload feature variable accounting is required from the date of modification until the option is exercised, forfeited or expires unexercised. The rationale behind the Board’s conclusion is that the receipt of the reload is contingent upon the exercise of the original award; therefore, the awards are linked as one. Furthermore, the reload changes the number of shares under option and makes the award variable. In addition, if the reload feature provides for multiple subsequent grants through further reloads, variable accounting would be required for each additional grant that includes the reload feature.

Furthermore, if a stock option award is modified to add any feature that provides for the grant of a new option award if the existing award is exercised, the modified award shall be accounted for as variable regardless of the method used to determine the terms (i.e., exercise price, number of shares, etc.) of the reload grant. For example, assume a company has granted an employee 1,000 options at the then current market price with a five-year cliff vest. Two years after the grant date, the company modifies the options to include a performance feature. The performance is that if the company successfully completes an IPO by the end of year five and the employee exercises the existing award, the company will grant a new award. In this example, the modified award is accounted for as variable.

The Board’s decision is effective for modifications to add a reload feature after January 12, 2000. However, the Board decided to provide an exception for reload features included as part of the original terms of a stock option and not require variable accounting. The Board is providing this exception solely as a practical matter to permit continued accounting for awards with reload features in their original terms under EITF Issue 90-7, Accounting for a Reload Stock Option (Issue 90-7).

Practice Prior to Interpretation

Under present practice, a stock option award containing a reload feature has been viewed as a series of fixed grants and thus accounted for as a fixed award provided that specific criteria have been met. If the shares tendered to satisfy the option exercise price were shares acquired through previous stock compensation arrangements, they must be held for at least six months (i.e., mature shares) to avoid variable accounting treatment. Furthermore, when an option was modified to add a reload feature, there was no additional compensation required to be recognized.

Implications of the Interpretation

The Board’s conclusion represents a significant change to current practice for modifications that add a reload feature to a stock option. However, the Board agreed to not overturn the accounting guidance in Issue 90-7 for reload features included as part of the original terms of an award. This is true even if the plan begins after January 12, 2000. As long as the reload feature is in the original plan, the Interpretation does not require variable accounting. The requirement to use mature shares to satisfy the option exercise price, as described above, remains under the Interpretation. Issue 90-7 applies only to the exact fact pattern as discussed in that Issue.
4 Stock Option Repricings

4.1 Overview
Despite criticism from shareholder activist groups, companies sometimes decide to reprice their options when the stock price falls and the desired motivational effect of the options is lost. Because of the pervasiveness of this practice over the past several years, the Board decided to address the accounting for option repricings, as well as the cancellation of options and the issuance of replacement awards. Thus, if a company decides that rather than simply to reduce the option’s exercise price, it will substitute a new stock compensation award for an old award because that old award has declined in value, the transaction is substantively a repricing.

The overall conclusion that the Board reached is that repricings in any shape or form (including cancellations and reissuances) lead to variable accounting. The next section discusses direct and indirect repricings. Refer to Section 4.3, Cancellations of Options and Issuances of Replacement Awards for special considerations regarding that form of repricing.

4.2 Direct or Indirect (“Synthetic”) Repricings
Issue
The Board deliberated whether changes directly or indirectly (commonly referred to as a “synthetic repricing”) to the exercise price of an option result in variable accounting. In addition, the Board also discussed reductions to the exercise price that are contingent upon the attainment of performance targets. (Interpretation—Questions 9, 11(a), and 13.)

Final Interpretation
The following section of the Interpretation is effective for direct and indirect repricings made after December 15, 1998. The Board chose to use the earlier December 15, 1998 transition date (the date that all of the decisions related to repricings had been made and were available to constituents, rather than July 1, 2000) because it wanted to curtail what it considered to be abusive accounting associated with repricings.

Direct Repricings—The Board concluded that if the exercise price of a stock option award is reduced, the modified stock option award should be accounted for as variable from the date of modification to the date the award is exercised, forfeited or expires unexercised. However, if an option is forfeited (as in the case where an employee terminates prior to the award vesting), prior compensation expense recognized is reversed in the period of forfeiture. On the other hand, previously recognized expense is not reversed if the option expires unexercised.
For example, assume a company decides to reduce the exercise price of an option with an original exercise price of $25 to the then-current stock market price of $10. This is referred to as a direct repricing. The Board believes the decision to require variable accounting for direct repricings is consistent with the basic principle in APB 25 that compensation expense is fixed only when the number of shares and the option price are fixed. The Interpretation concludes that changing the exercise price indicates that the price was not fixed in the first place and further presumes that, once repriced, an option could be repriced again. Because changes to the exercise price can be made for individual options, the Board decided that variable accounting is required only for those individual options that are actually repriced, not for every option granted under a plan.

When an option is repriced at the then-current market price, there is no additional compensation at the modification date. However, in each reporting period after the modification date, additional compensation is adjusted for subsequent increases in intrinsic value (i.e., measured by changes in the quoted market price of the stock). If the market value subsequently declines, previously recognized compensation would be reversed. The additional compensation would be recognized over the remaining vesting period (i.e., from the modification date to the vesting date). After the awards vest, adjustments to additional compensation for changes in intrinsic value are recognized as compensation expense immediately. Ultimately, the final measurement of compensation expense would occur at the date of exercise, forfeiture or expiration. (Refer to Example 1 later in this section.)

In the unusual situation when a stock option is repriced at a discount (i.e., the exercise price is below the then-current stock price), additional compensation may have to be recognized at the modification date. For example, a company has granted 1,000 at-the-money options with an exercise price of $25 per option. The company recognizes stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. Two years later, the stock price declines to $10 per share. On that date, the company reduces the exercise price of the options to $8. Because the exercise price is below the current stock price, additional compensation would have to be recognized over the remaining vesting period, if any, as explained below. Note that if the option was fully vested, the additional compensation would be recognized at the modification date.

In a rather complex methodology, the Board decided that when an option is repriced, compensation is made up of two components: (1) the option’s intrinsic value, if any, at the original measurement date (zero in the above example); and (2) the additional compensation at the modification date subsequently adjusted for increases or decreases in the intrinsic value of the variable option from the date of modification until the option is exercised, forfeited or expires unexercised. The first component is measured at the original award’s measurement date. At the modification date (i.e., the date of the repricing), any unrecognized original intrinsic value would be recognized over the remaining vesting period. In many cases, there is no unrecognized original intrinsic value because the option was granted at-the-money.

The second component, additional compensation, is initially measured at the modification date. Additional compensation would be equal to the intrinsic value of the repriced option (based on its new exercise price) in excess of the lesser of the intrinsic value of the original option (1) at the original measurement date (usually zero) or (2) immediately prior to modification (based on the original exercise price). Under this calculation, when the original award had no intrinsic value and it was
out-of-the-money prior to the repricing, the additional compensation would be equal to the variable option’s intrinsic value on the date of repricing ($2 in the above example). The additional compensation is adjusted for increases or decreases from the date of modification until the award is exercised, forfeited or expires unexercised.

An example of this relatively unusual situation is included in Illustration 3g of Appendix B of the Interpretation.

**Indirect Repricings**—The Board also addressed indirect reductions of the exercise price (often referred to as “a synthetic repricing”), and concluded that indirect repricings also should result in variable accounting. The Board concluded that the exercise price of a stock option has been reduced if the fair value of the revised consideration required to be remitted by the employee upon exercise is less than or potentially less than the fair value of the consideration that was required under the option’s original terms. Therefore, a company may indirectly reduce the exercise price of a stock option without literally revising the stated terms of the option.

Examples of synthetic repricings would be when a company allows an employee to exercise an option with a full recourse note that does not bear a market interest rate, or when a company provides the employee with a cash bonus that vests only if the option is exercised. Through the cash bonus, the company has indirectly reduced the exercise price of the option based on the fair value of the overall consideration that the company will receive upon exercise, even though the stated exercise price of the option award itself is unchanged. The guidance in Section 6.3, Cash Bonus Plans Linked to Stock-Based Plans should be considered in determining when the exercise price of an award has been indirectly reduced by the addition of a cash bonus arrangement.

Determining whether an option has been synthetically repriced will require judgment and an assessment of the particular facts and circumstances. While providing these examples, the Board observed that it was not practical to address every arrangement that would be considered a synthetic repricing.

**Contingent Repricings**—The Board decided that if a company modifies (i.e., this provision is added later) a stock option to provide for a reduction to the exercise price if a specified future event occurs, variable accounting is required regardless of whether the event occurs or the provision expires. Variable accounting continues to be applied all the way up through exercise, forfeiture or expiration similar to any other repricing.

By contrast, if the original terms of a stock option provide for a reduction to the exercise price for a specific future event or condition (or for that matter an increase), variable accounting would be required from the date of grant until the contingency is resolved or the option expires. In other words, in this situation, a measurement date can be reached (and variable accounting cease) prior to the exercise of the option. Note that this is the usual accounting for an award with a variable exercise price. Again, the rationale differentiating the two situations is that an award once modified presumably could be modified again.
Practice Prior to Interpretation

Under present practice, repricing a stock option to the stock’s current market price generally has not resulted in any additional compensation. In EITF Issue No. 87-33, *Stock Compensation Issues Related to Market Decline* (Issue 87-33), the EITF reached a consensus that a repricing to reduce the exercise price of an option requires the use of a new measurement date. However, if the market price has declined and the option is repriced to that lower market price, the use of a new measurement date usually does not result in compensation expense. The consensus does not require the grant to be re-characterized as a variable award.

At the time Issue 87-33 was deliberated, the EITF expressed concern regarding whether multiple repricings would create a variable plan, but did not reach a consensus on this issue. Therefore, under practice prior to the Interpretation, considerable judgment was required to determine at what point multiple repricings could result in a formerly fixed award being recharacterized as variable. This was determined on a case by case basis. In this Interpretation, the Board disagreed with the Issue 87-33 consensus, concluding that a single repricing is sufficient to change the character of an award from fixed to variable.

Implications of the Interpretation

The Interpretation supersedes Issue 87-33. This decision was one of the most controversial requirements of the Interpretation because of the potential income statement volatility resulting from variable accounting treatment for repriced options. The Board believes its decision is consistent with the basic principle in APB 25 that compensation expense is fixed only when the number of shares and the option price are fixed. The Interpretation concludes that changing the exercise price, either directly or indirectly, indicates that the price was not fixed in the first place and further presumes that, once repriced, an option could be repriced again. Accordingly, the exercise price of the repriced option is not deemed fixed until actually exercised, forfeited or expires unexercised.

**Example 1: Stock Option Repricing at the Then-Current Market Price**

A company grants an employee 1,000 at-the-money options on December 31, 2001 with an exercise price of $25 per option that cliff vest at the end of four years and have a maximum life of 10 years. The company measures stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. At the end of the second year on December 31, 2003, the stock price has declined to $10 per share. On that date, the company reduces the exercise price of the options to $10. As a result of reducing the exercise price, the options are subject to variable accounting from the date of modification to the date the options are exercised, are forfeited, or expire unexercised.
The following table illustrates the annual compensation expense for the 1,000 options from the modification date until the options are exercised at the end of seven years.

<table>
<thead>
<tr>
<th>Year Ended December 31,</th>
<th>Stock Market Price</th>
<th>Additional Compensation Per Share (1)</th>
<th>Aggregate Compensation (2)</th>
<th>Percentage Recognized (3)</th>
<th>Previously Recognized Compensation</th>
<th>D=(A x B)–C</th>
<th>E=C+D</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$12</td>
<td>$ 2</td>
<td>$ 2,000</td>
<td>50%</td>
<td>$ 0</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>2005</td>
<td>14</td>
<td>4</td>
<td>4,000</td>
<td>100%</td>
<td>1,000</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>2006</td>
<td>11</td>
<td>1</td>
<td>1,000</td>
<td>100%</td>
<td>4,000</td>
<td>(3,000)</td>
<td>1,000</td>
</tr>
<tr>
<td>2007</td>
<td>13</td>
<td>3</td>
<td>3,000</td>
<td>100%</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
</tr>
<tr>
<td>2008</td>
<td>17</td>
<td>7</td>
<td>7,000</td>
<td>100%</td>
<td>3,000</td>
<td>4,000</td>
<td>7,000</td>
</tr>
</tbody>
</table>

(1) Subsequent to the modification date, additional compensation is adjusted for subsequent changes in intrinsic value (i.e., measured by changes in the quoted market price of the stock). For the year ended December 31, 2004, additional compensation is $2 ($12 stock price less $10 exercise price).

(2) Aggregate compensation is calculated by multiplying 1,000 options by the compensation per share.

(3) The percentage recognized is based on the remaining vesting period. Any original intrinsic value (zero in this example) would have been recognized over the four-year vesting period. After the awards become variable, additional compensation is recognized over the remaining vesting period (i.e., from the date of the modification to the vesting date). For the year ended December 31, 2004, 50% of the additional compensation is recognized because one year of the two year remaining period (i.e., from December 31, 2003 to December 31, 2005) has been satisfied. After the awards vest (i.e., December 31, 2005), the adjustments to additional compensation for changes in intrinsic value are recognized as expense immediately.

**Example 2: Synthetic Repricing - Full Recourse Note With No Interest**

A company grants an employee 1,000 at-the-money options on December 31, 2001 with an exercise price of $25 per option that cliff vest at the end of four years and have a maximum life of 10 years. The company measures the stock compensation under APB 25 using the intrinsic value method and no compensation expense is recognized on the grant (measurement) date. At the end of the third year on December 31, 2004, the stock price has declined to $10 per share. On that date, the company modifies the options to permit exercise upon vesting with a five year full recourse note that bears no interest. The market interest rate for similar risk notes is 10% compounded annually.

The company has changed the fair value of the consideration the employee is required to remit upon exercise of the award. Before the modification, the employee was required to remit a total of $25,000 to exercise the 1,000 options. After the modification, the employee is permitted to exercise the options with a full recourse note with a fair value of only $15,523 (calculated as the present value of a payment of $25,000 in five years, discounted at 10%). Note that any rate below 10% (if deemed to be below the market rate) would have the same impact, that is, variable accounting.
Regardless of the date the employee exercises the award, the company has reduced the exercise price of the stock option because the market interest rate at any future date will exceed the zero interest rate on the full recourse note. As a result, the company would account for the stock option as a variable award from the date of the modification to the date the options are exercised, forfeited or expire unexercised. On the exercise (or forfeiture or expiration) date, the final measurement of compensation equals the difference between the market price of the company’s stock and the fair value of the non-interest bearing note.

If the company had modified the award to permit exercise with a full recourse note at the 10% market interest rate (at the exercise date), variable accounting would not have been required because the company would not have changed the fair value of the consideration required to be remitted by the employee upon exercise.

**Example 3: Synthetic Repricing - Options Linked to a Cash Bonus**

A company grants an employee 1,000 at-the-money options on December 31, 2001 with an exercise price of $25 per option that cliff vest at the end of four years and have a maximum life of 10 years. The company measures the stock compensation under APB 25 and no compensation expense was recognized on the grant (measurement) date. At the end of the third year on December 31, 2004, the stock price has declined to $15 per share. On that date, the company enters into a cash bonus arrangement for $10,000 (or $10 per option) with the employee that will vest if all or a portion of the 1,000 options granted on December 31, 2001 are exercised.

Because receipt of the cash bonus is contingent upon exercise of the options, the net fair value of the consideration required to be remitted by the employee upon exercise is different than the fair value required to be remitted pursuant to the award’s original terms (i.e., a synthetic repricing). Before the cash bonus arrangement, the employee had to remit a total of $25,000 to exercise the 1,000 options. As a result of the cash bonus arrangement, the employee has to remit only $15,000 ($25,000 stated exercise price less the $10,000 cash bonus that will be paid upon exercise of the 1,000 options). The cash bonus indirectly reduces the stated exercise price of the options from $25 to $15 per option.

The company has indirectly reduced the exercise price of the stock options granted to the employee. The company accounts for the 1,000 options and the cash bonus as a combined variable award from the date the cash bonus arrangement is granted (December 31, 2004) until the date the options are exercised, are forfeited, or expire unexercised. It is important to note that if the original terms of the award provided for a fixed cash bonus then the combined award would have been accounted for as a discount stock option and variable accounting would not have been required. (Refer to Section 6.3, *Cash Bonus Plans Linked to Stock-Based Plans.*)
4.3 Cancellations of Options and Issuances of Replacement Awards

Issue

Companies sometimes decide to cancel an outstanding stock option award because it is out-of-the-money and has lost its desired motivational effect. To motivate the employees, the company may also award new stock options rather than reducing the exercise price of the old option. Questions arise as to whether the cancellation of one option grant and the issuance of another substantively result in a repricing. In effect, the linking of an option cancellation with a new option grant could be viewed as an indirect reduction to the exercise price of the original award. The Board deliberated when the cancellation or settlement of an outstanding option should be linked to the issuance of a new award to require variable accounting for the replacement award. In addition, the Board discussed the concept of “effective” cancellations, and the accounting consequences of agreements to compensate an employee for any market risk after an option is canceled. Cancellations and reissuances are among one of the most confusing areas of the Interpretation. Careful analysis is necessary to avoid unintended negative consequences. (Interpretation—Questions 9, 11(a), 11(b) and 13.)

Final Interpretation

The Interpretation is effective for cancellations and reissuances made after December 15, 1998. As previously mentioned, the Board chose to use the earlier December 15, 1998 transition date (rather than July 1, 2000) because it wanted to curtail what it considered to be abusive accounting associated with repricings.

Note that the model for cancellations and reissuances described below differs in some circumstances if the original award was variable rather than fixed.

Cancellation and Reissuance Model—The Board decided that if an outstanding fixed stock option is canceled (or settled for cash or other consideration), and a replacement award is granted at a lower exercise price, either six months before or six months after the cancellation (settlement), the replacement award is accounted for as variable until the award is exercised, forfeited or expires unexercised. For example, assume a company makes a stock option grant on January 15, 2001. In the subsequent three months, the company’s stock price significantly declines and the company and employees agree to cancel the January 2001 options. The company then grants a new option with a lower exercise price two months later, on May 15, 2001. The Interpretation views the May 15, 2001 grant as a replacement award subject to variable accounting. It is important to note (and as indicated in this example), a replacement award is the grant of another option at a lower exercise price.

When identifying the replacement awards, the Interpretation requires a look back and then a look forward approach. The company should first review the look back period—that is the shorter of (1) six months, or (2) the period from the date of grant of the canceled (or settled) stock option. For example, assume a company has granted an employee 1,000 options on January 1, 2001. On March 31, 2001, the company decides to cancel the options. When identifying if there are replacement awards, the company considers only the period from the date of grant of the canceled award (i.e., January 1, 2001) to the date of cancellation (i.e., March 31, 2001) as the look back period because the original option was outstanding for less than six months. If a replacement award with a lower exercise price is granted before or after six months from the date of cancellation, the replacement award is not subject to variable accounting. If the replacement award is granted within six months, it is subject to variable accounting until the award is exercised, forfeited or expires unexercised.
exercise price than the canceled option is identified in the look back period, variable accounting for the replacement award would begin at the date of cancellation. That is, the replacement award would be accounted for as variable from the cancellation (settlement) date of the original option until the replacement award is exercised, forfeited or expires unexercised. Financial statements prior to the cancellation date would not be restated to reflect variable accounting for the original option in those financial statements.

If a greater number of awards has been canceled than were replaced in the look back period, the company then reviews the look forward period. The look forward period is the period ending six months after the date of cancellation or settlement. If a replacement award with a lower exercise price than the canceled option is identified in the look forward period, variable accounting for the replacement award would begin on the grant date of the replacement award. For example, a company may have canceled 1,000 options in May 2001, and identified 400 replacements in the look back period. That would leave a remaining 600 options for which the company would need to look for replacement awards in the look forward period.

When reviewing the look back and then look forward periods, awards granted at dates closest to the cancellation date are considered first to identify replacement awards. When identifying replacement awards in the look back or look forward period, any options granted with a lower exercise price would be considered “replacement awards,” even if the terms of the replacement awards were significantly different than those of the canceled options, or whether the replacement awards were made as part of a company’s normal pattern of making awards.

If no awards were granted within six months before or after the cancellation there is no variable accounting issue even if the new option is granted six months and one day before or after (however, see exception below for implicit or explicit agreements).

Special Consideration for Cancellation and Reissuance for Variable Awards—The Board decided that the cancellation and reissuance model should be applied to cancellations of variable options only if the options being canceled were accounted for as variable because the options had been previously repriced. However, the Interpretation requires a different approach to identifying replacement awards that would be linked to canceled variable options. Replacement awards would be any awards granted in the look back and look forward periods that have a higher, equivalent or lower exercise price. This is different than when a company identifies replacement awards for canceled fixed stock options (in which case only awards with lower exercise prices are considered replacements). Based on our discussions with the FASB staff, the Board adopted this approach to prevent what it would consider an abusive practice from developing, as illustrated in the following example.

Assume a company reprices 50,000 out-of-the-money fixed stock options by reducing the original exercise price of $25 down to $10, the then-current market price of the company’s stock. In accordance with the Interpretation, the repriced options would then be accounted for as variable. Three months after the repricing, the company has a major product development break-through and its stock price increases to $35. The company wishes to discontinue variable accounting, and concludes that this could be accomplished by canceling the 50,000 options and replacing them with new options with only a nominally higher exercise price (say $10.25). If only awards with a lower
exercise price than the original canceled options were considered replacement awards, the new $10.25 options would not be subject to variable accounting in this example. To prevent this abuse, the Interpretation requires any replacement award (even if it has a higher exercise price) in the look back or look forward period to be considered a replacement award that needs to be combined with a canceled variable option. Therefore, the Interpretation would require the new $10.25 options to be accounted for as variable because they would be deemed replacement awards for the canceled variable option.

Note that this requirement pertains only to options presently accounted for as variable due to a prior repricing. It was not intended to prevent a company from fixing other variable awards such as stock appreciation rights or awards with variable exercise prices. For example, assume a company has issued an employee 1,000 variable stock appreciation rights with a base price of $10 (the award entitles the employee to the increase in value of the company’s stock over $10, payable in shares). When the stock price is $25, the company decides to settle the stock appreciation right by replacing it with 2,500 at-the-money options with an exercise price of $25. As under present practice, all of the expense of the stock appreciation right up to the date of the settlement would need to be recognized. However, because the original award was variable (for reasons other than that it had previously repriced), none of the new 2,500 options are considered replacements, and none would be accounted for as variable.

Effective Cancellations—Besides an outright cancellation, a company may provide for an effective cancellation that also needs to be assessed against the Interpretation’s “cancellation and reissuance” rules. An effective cancellation is any modification to the terms of an option that reduces or eliminates the likelihood of exercise by the employee. For example, an effective cancellation would include reducing the remaining term of an option, increasing the option’s exercise price, or adding an unobtainable performance feature. Based on discussions with the FASB staff, the Board would consider any reduction of an option’s term (e.g., even one day or a nominal increase to the exercise price) to reduce the likelihood of exercise by the employee and thus be an effective cancellation. If an effective cancellation occurs, this triggers the look back-look forward six month rule discussed above.

Agreements Between Employers and Employees—The Interpretation also discusses situations where an option is canceled and, at that time, the company agrees (i.e., any oral or written agreement or implicit promise) to make a replacement option grant sometime in the future. If a company agrees to issue a new stock option more than six months after the date of cancellation at the then-current market price, variable accounting is not required. The Board reasoned that the individual is subject to market risk for a six month period.

On the other hand, variable accounting is required if a company agrees (i.e., any oral or written agreement or implicit promise) to compensate an employee for market price increases of the stock after cancellation (settlement), but prior to the grant of the replacement award. For example, a company cancels stock options with an exercise price of $25 when the market price of the stock is $10. Simultaneously, the company agrees to give employees a bonus equal to any stock price increase above the current $10 market price that might occur prior to the grant of the replacement award. The new grant requires variable accounting regardless of when in the future the grant is made.
Likewise, a company cannot grant an option with an agreement to cancel an existing option in the future, even if the cancellation will occur more than six months from the date of grant. In this case, the employee is not subject to market risk and variable accounting would be required for the replacement award. In the Board’s view, the agreement to cancel (settle) another award at a future date effectively cancels that award at the date the agreement is reached.

**Practice Prior to Interpretation**

In Issue 87-33, the EITF reached a consensus that a repricing to reduce the exercise price of an option, as well as cancellation and reissuance of an option, required the use of a new measurement date. However, if the market price declined and the option was repriced to that lower market price, the use of a new measurement date usually did not result in compensation expense. The consensus did not require the grant to be re-characterized as a variable award. Judgment was required to determine whether multiple repricings would have required variable accounting.

**Implications of Implementation**

The Interpretation supersedes Issue 87-33. The Board believes its decision is consistent with the basic principle in APB 25 that compensation expense is fixed only when the number of shares and the option price are fixed. The Interpretation concludes that changing the exercise price, indirectly through a cancellation and reissuance, indicates that the price was not fixed in the first place and further presumes that, once repriced, an option could be repriced again. Accordingly, the exercise price of the replacement option is not deemed fixed until actually exercised, forfeited or expires unexercised.

In addition, the Interpretation will require a significant amount of additional record keeping beyond what companies are presently required to do. When an option is canceled (settled), companies will need to review the awards made to each individual option holder to determine whether that employee received a replacement award in the look back period. If no replacement awards are identified, the company will need to track whether the employees who had options canceled receive replacement awards in the six month look forward period after the cancellation (settlement) date. Again, a lower price triggers variable accounting for the new grant. The following example illustrates the additional record keeping that will be required under the Interpretation beyond what companies are presently required to do.

**Example 1: Cancellation and Replacement of Stock Options**

A company grants an employee 1,000 at-the-money options on January 1, 2001 with an exercise price of $25 per option that cliff vest at the end of four years. In addition, the company grants two additional options to the same employee: 750 options on September 30, 2001 at $21 per share; and 600 options on February 28, 2002 at $23 per share. The company measures the stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) dates. On January 1, 2002, the market price of the company’s stock is $21 per share. On that date, the company and the employee cancel the 1,000 options previously granted on January 1, 2001.
As a result of the cancellation the company has 1,000 options “at risk” for variable accounting. First, the company reviews the look back period, six months before the cancellation date (the period from January 1, 2002 to July 1, 2001). Since 750 options were granted on September 30, 2001 with a lower exercise price per option than the canceled award, those 750 options are accounted for as variable from January 1, 2002 until the date that those options are exercised, forfeited or expire unexercised. Note that if the exercise price had been higher, the awards would not have been considered replacements.

Because the company canceled 1,000 options and has identified only 750 options as replacement (variable) awards, it must potentially identify an additional 250 options as replacement awards and account for those options as variable. The company then reviews the look forward period, six months from the cancellation date (the period from January 1, 2002 to July 1, 2002). Because 600 options were granted on February 28, 2002 with a lower exercise price per option than the canceled options, 250 of those 600 options are accounted for as a variable from February 28, 2002 until the date those options are exercised, are forfeited, or expire unexercised. The remaining 350 options granted on February 28, 2002 may qualify for fixed accounting, assuming those options meet the requirements for a fixed award under APB 25. (Note: The Interpretation is silent regarding whether the first options exercised are among the 250 variable or the 350 fixed options. We believe it would be reasonable to consider the first options exercised to be among the 250 variable options, thereby eliminating variable accounting once they have been exercised.)

In determining whether variable accounting is required for the replacement awards, the same guidance applies if the 1,000 options had been settled by paying cash equal to the fair value of the 1,000 options, except that the company recognizes compensation equal to the cash paid at the settlement date (refer to Section 6.1, Discretionary Cash Settlements of Earlier Awards). Note that if stock is issued to replace options, different accounting applies (refer to Section 6.2, Settlements of Earlier Awards By Granting Stock).
5 Share Repurchase Features

5.1 Overview
Compensation arrangements may include features that provide for a put by the employee, or provide the company a call or a right of first refusal related to stock previously awarded to the employees (such as stock acquired by the employee through option exercise). Puts, calls, and rights of first refusal are collectively referred to as share repurchase features and are used to satisfy an employee’s liquidity needs. When addressing the accounting ramifications of share repurchase features, the Board considered which share repurchase features should require variable accounting and if that conclusion differs depending on whether the company is public or nonpublic.

A separate issue relates to stock option plans that allow employees to use shares received from the exercise of the option to satisfy the tax withholding requirement. Such arrangements are viewed as a type of share repurchase feature because under such arrangements the company effectively buys back a number of shares received from the employee thereby providing the employee with cash needed to satisfy tax requirements.

Each of these issues is discussed below.

5.2 Public Company Definition

Issue
In most cases, stock compensation accounting is the same for public and nonpublic companies. However, certain differences have developed primarily because a trading market does not exist for a nonpublic company’s stock. The accounting for stock compensation plans that have puts, calls, and rights of first refusal depends on whether the company is public or nonpublic. Therefore, the Board deliberated the definition of a public company for purposes of applying APB 25. (Interpretation—Question 15(a).)

Final Interpretation
The Interpretation considers a company public if its stock is publicly traded (even if thinly traded) or if it is a subsidiary of a public company. In addition, a company is considered public if it makes a filing with a regulatory agency to sell equity securities in a public market. A company with publicly-traded debt, but not publicly-traded equity securities, would not be considered public. The Interpretation’s definition of a public company is consistent with Statement 123.
Practice Prior to the Interpretation

The Interpretation liberalizes the present definition of a public company under APB 25. Under present practice a company with public debt securities has been considered under APB 25 to be public, even if its equity securities have not been publicly traded. In the past, many believed this definition was unnecessarily harsh because the existence of public debt should not affect whether a company’s equity awards are accounted for under the public company stock compensation rules (i.e., the existence of public debt has no bearing on the liquidity of the company’s equity).

5.3 Plans with Puts, Calls, and Rights of First Refusal

Issue

The Board considered whether the existence of features such as puts, calls, and rights of first refusal in stock compensation awards cause an otherwise fixed compensation arrangement to be accounted for as variable. (Interpretation—Questions 15(a) and 15(b).)

Final Interpretation

The Interpretation addresses puts, calls, and rights of first refusal in the context of both public companies and nonpublic companies.

Public Companies—For public companies (as defined in the previous section, Public Company Definition), the Board decided that variable accounting is required for plans with a put, call, or right of first refusal if the shares are expected to be repurchased within six months after option exercise or issuance of those shares. For plans that give the employee a put, the Board decided:

• A put for fair value that is exercisable within six months of option exercise or issuance of the shares would be accounted for as variable.

• A put for a variable premium (that is not fixed and determinable) over the then-current stock price, would be accounted for as variable, even if the put is not exercisable within six months of share issuance. For example, a share repurchase feature that gives the employee the right to sell the shares back to the company for an amount that is 125% of the stock’s market price on the share repurchase date.

• A put for a fixed dollar amount over the stock price does not result in variable accounting as long as the put is not exercisable within six months of share issuance. However, the fixed premium should be recognized as compensation over the vesting period. For example, an employee who can put shares to the company for fair value plus $20 per share.

If a company repurchases shares within six months of issuance or option exercise (but the plan was not accounted for as variable because the repurchase had not been expected by the company) a new measurement date would occur on the date of repurchase. Compensation would be computed in accordance with the guidance in Section 6.1, Discretionary Cash Settlements of Earlier Awards.

If an employee receives shares upon option exercise and bears the risks and rewards of ownership of those shares for at least six months, a subsequent repurchase of those shares by the company would not result in compensation. That repurchase transaction would be accounted for as a treasury stock transaction¾that is, separate from the original stock option or award.
Nonpublic Companies—For nonpublic companies, the Board decided that variable accounting is not required for plans with a put, call, or right of first refusal with the following share repurchase features:

- The stated share repurchase price is equal to the fair value of the shares at the date of repurchase, the employee cannot put the shares to the company within six months of option exercise or share issuance, and the shares are not expected to be repurchased within six months after option exercise or share issuance.

- The stated share repurchase price is other than the fair value of the shares at the date of repurchase (e.g., under a book value plan), the employee makes a substantial investment (as defined below), and bears the risks and rewards normally associated with share ownership for a reasonable period (at least six months).

For nonpublic companies, the Board defined substantial investment to mean that the employee makes an investment (in a form other than services rendered to the company) equal to 100% of the grant date value of the stated share repurchase price. Accordingly, if the award is an option, a substantial investment cannot exist prior to its exercise, and variable accounting would be followed from the date of grant to the date a substantial investment has been made. The basis for this conclusion is that without this level of investment, the award is equivalent to a stock appreciation right.

It is important to note that, consistent with present practice, the Board is not allowing a plan that provides for the buyback of options to be accounted for as a fixed compensation arrangement. This is because a put or call related to an option is in substance a stock appreciation right that requires variable accounting.

Practice Prior to the Interpretation

Prior to the Interpretation, the existence of puts and calls almost always has resulted in variable accounting for a public company, even if the stock was repurchased more than six months after share issuance. Variable accounting was required because the final measurement date was not considered to be known until the stock was repurchased or the repurchase period expired. Some plans may contain a right of first refusal under which the employee must first offer the stock for sale to the company before it may be sold to a third party pursuant to a bona fide offer. Judgment was required to determine the effect of the right of first refusal on the accounting for the plan. The mere existence of the right did not necessarily require variable plan accounting. However, if history or other evidence indicated that the company could be expected to repurchase the stock, or had done so in most cases in the past, the plan may be considered in substance to contain a buyback provision necessitating variable plan accounting. In any event, under a right of first refusal, the company had to wait at least six months before it could repurchase the stock without resulting in the recognition of additional compensation expense.

Buyback features generally are more common among nonpublic companies because of the liquidity needs of employees. In EITF Issue No. 87-23, Book Value Stock Purchase Plans, the EITF reached a consensus that no compensation was recognized for the increase (or decrease) in the value of shares purchased under such a plan during the employment period if the employee made a substantive
investment that would be at risk for a reasonable period of time. The EITF did not define the above phrases, and interpretation and application of the consensus required judgment. A reasonable period of time was generally interpreted to mean at least six months.

Implications of the Interpretation

For public companies, the Interpretation liberalizes current practice because it allows for puts, calls and rights of first refusal at fair value without the negative consequences of variable accounting, provided that the repurchase of the shares is not expected to be within six months of option exercise (or within six months of vesting for restricted stock). The Interpretation does not provide guidance on evaluating whether shares are expected to be repurchased within six months of share issuance or option exercise. The assessment of “expected to be repurchased” will be an important implementation issue.

In evaluating employee put arrangements, it is essential that the employee cannot exercise the put within six months of share issuance. Therefore, a company that gives a put right to an employee must have a mechanism in place to prevent the employee from exercising the put within six months of share issuance. For example, the plan could specifically state that the put is not exercisable within six months of share issuance. Alternatively, the employee could sign a written agreement that waives the put right for the six-month period after share issuance.

Regarding call provisions and rights of first refusal, the assessment of those provisions would focus on the company’s intent. If the plan specifically prohibits the company from exercising its rights under a call or right of first refusal within six months of share issuance, this would provide persuasive evidence. Alternatively, if the plan allows a company to exercise its call or right of first refusal at any time, judgment must be exercised in determining the effect of those share repurchase features on the accounting for the plan. For example, a company’s written representation that it does not intend to exercise its rights under those share repurchase provisions within six months of share issuance would provide evidence to support the company’s intent. Furthermore, if the company has not exhibited a pattern of making such repurchases in the past and absent other evidence indicating that the company can be expected to repurchase the stock within six months of issuance, variable accounting for the plan would not be necessary.

With regard to put arrangements that provide the employee a premium over the current stock price, public companies should structure the premium so that it is fixed and determinable at the date of grant and not exercisable for six months after share issuance to avoid variable accounting.

For nonpublic companies, the Interpretation is consistent with present practice. However, as previously described, the definition of public company under the Interpretation is less restrictive than previous practice. Therefore, some companies that were considered public for stock compensation accounting purposes (for example, because they had public debt) may no longer be and, therefore, can avail themselves of the less restrictive nonpublic stock compensation accounting rules. The Interpretation also clarifies the term substantial investment which previously had been undefined and subject to considerable judgment.
5.4 Use of Stock Option Shares to Cover Tax Withholding

Issue
An employee’s exercise of a nonqualified stock option generates taxable income equal to the fair value of each share received in excess of the exercise price. The IRS requires payment of withholding tax on this taxable income. Some stock option plans allow employees to use shares received from the exercise of the option to satisfy the tax withholding requirement. In effect, the company repurchases a portion of the shares at fair value, and uses the cash on behalf of the employee to satisfy the tax withholding.

EITF Issue No. 87-6, Adjustments Relating to Stock Compensation Plans (Issue 87-6), allows a company to use shares acquired through the option exercise to satisfy the minimum statutory withholding taxes on the option exercise without resulting in compensation expense. During 1999, the EITF re-opened the issue to address the effect of withholding shares for income taxes in an amount exceeding the minimum statutory rate. At its March 24, 1999 meeting, the EITF reached a consensus that compensation expense should be measured based on the number of shares withheld in excess of the statutory minimum withholding amount provided that the amount withheld must actually be paid to the taxing authorities. Plans allowing for this feature were not considered variable. The Interpretation reconsiders the EITF’s conclusion. (Interpretation—Questions 15(c) and 15(d).)

Final Interpretation
The Board disagreed with the EITF’s conclusion and, accordingly, superseded Issue 87-6 regarding tax withholdings.

The Board concluded that if a stock option plan contains a provision that permits participants to have shares withheld in excess of those necessary to satisfy the required tax withholding (referred to as excess shares), the accounting depends on whether the excess tax withholding is at the election of the employee or the employer. The Interpretation provides the following.

• If the election to withhold excess shares is at the discretion of the employee, variable accounting would be required for the award from the date of grant until it is exercised, forfeited or expires unexercised.

• If the terms of an award or plan are silent with respect to tax withholding or if the election to permit excess share withholding is at the discretion of the employer, variable accounting would not be required. However, in either circumstance, if the employer exhibits a pattern of consistently approving repurchases of excess shares, variable accounting would be required from the date of grant for all awards granted under the plan.

The Board also clarified that the required tax withholding is the employer’s minimum statutory withholding based on the minimum statutory withholding rates for federal and state tax purposes, including payroll taxes, that are applicable to such supplemental taxable income. Amounts withheld in excess of that amount do not represent the employer’s required tax withholding for purposes of APB 25.

If shares are repurchased upon exercise of an option in excess of the number necessary to satisfy the employer’s required tax withholding, a new measurement date would be required for the entire award (i.e., the entire intrinsic value would be recognized as expense on the date of exercise).
Practice Prior to the Interpretation

Prior to the EITF deliberations in 1999, practice did not require compensation expense to be recorded for the shares used to meet the required tax withholding requirements. However, this treatment was limited to the number of shares with a fair value equal to the dollar amount of only the required tax withholding. Therefore, compensation expense would be recognized if shares were withheld in excess of the tax withholding requirement. While practice was diverse regarding how to measure the amount of expense, a new measurement date for the entire award generally was not considered necessary. The EITF reopened the issue in order to bring consistency to practice in this area.

Planning Idea Prior to July 1, 2000—Companies may wish to clarify that shares can be repurchased upon option exercise only in amounts necessary to satisfy the required employer’s tax withholding (e.g., the amount defined by IRS guidelines for the employer’s minimum statutory withholding). Secondly, under the Interpretation, if the plan provides the employee discretion to have shares repurchased in excess of the number necessary to satisfy the required tax withholding, variable accounting is required. Therefore, companies may wish to eliminate plan provisions that allow an employee to elect to have shares repurchased in excess of the number necessary to satisfy the required tax withholding.

Implications of the Interpretation

The Board’s conclusions represent a significant change in practice because a new measurement date for the entire award is required resulting in greater compensation expense. Under the March 1999 EITF consensus, a new measurement date was required only for excess shares withheld. Under the Interpretation, variable plan accounting could be required in some situations while current practice would not require variable plan accounting. The following example illustrates the different accounting results for withholding excess shares under the March 1999 EITF consensus and the Interpretation:

**Example 1: Withholding Excess Shares**

Company A’s stock option plan is silent with respect to tax withholdings. An employee exercises an option for 1,000 shares with an exercise price of $5 when the market price of the common stock is $10, resulting in taxable income of $5,000 [1,000 shares times ($10 - $5)]. The assumed employer’s minimum tax withholding rate is 28%, but the employee elects to have enough shares withheld to satisfy his tax liability based on an estimated marginal tax rate of 40%. As a result, Company A retains 200 shares ($5,000 times 40%, divided by $10 per share). However, only 140 shares ($5,000 times 28%, divided by $10 per share) need be withheld to satisfy the employer’s required tax withholdings. Under the EITF consensus (superseded by the Interpretation), Company A would have recorded compensation expense equal to the number of excess shares, times the excess of their fair value over the exercise price of the options, or $300 [60 shares times ($10 - $5)]. Under the Interpretation, a new measurement date would be required for the entire award. Therefore, Company A must record compensation expense equal to the number of shares for the entire award times their current intrinsic value, or $5,000 [1,000 shares times ($10 - $5)].

Although the stock option plan is silent with respect to excess tax withholdings, if the employer exhibited a pattern of consistently approving excess withholdings, variable accounting would be applicable to all awards under the plan.
6 Other Issues

6.1 Discretionary Cash Settlements of Earlier Awards

Issue
Employers sometimes decide to repurchase stock acquired by an employee under a stock compensation award, even though the terms of the award do not specifically provide for a buyback (that is, no put or call arrangement exists). APB 25 states that cash paid to settle an earlier award of stock (or to settle a grant of options) to an employee should measure compensation cost if the stock is reacquired “shortly after issuance.” In practice, a period of six months is used as a reasonable time period whereby the employee must bear the full risks and rewards of the stock before the company can repurchase it without resulting in the recognition of additional compensation expense, and the Interpretation reaffirms this. If cash is paid to settle an outstanding option or to buy back shares within six months of option exercise or share issuance, the Interpretation addresses how to measure compensation expense. (Interpretation—Question 14.)

Final Interpretation
The Interpretation provides guidance on the measurement of total compensation cost when cash is paid to settle an outstanding stock option, an earlier award of stock or to repurchase shares after exercise of an option within six months. Total compensation cost would be equal to: (1) the intrinsic value, if any, of the option or award at the original measurement date and (2) the amount of cash paid (reduced by any amount paid by the employee to acquire those shares) to the extent that the cash paid exceeds the lesser of intrinsic value of the option or award (a) at the original measurement date or (b) immediately prior to the cash settlement.

Practice Prior to Interpretation
Under present practice, when cash was paid to settle an earlier award of stock or to repurchase shares shortly after exercise of an option, compensation expense generally has been measured as the original intrinsic value of the option or award (if any) plus any cash paid to repurchase the shares (reduced by any amount paid by the employee to acquire those shares) in excess of the original intrinsic value of the option or award.

Under present practice, accounting for the cash settlement of a fixed option has depended on whether the option included a discount at the date of grant (and therefore resulted in compensation expense). For typical options with no discount, the amount of cash paid to settle the option measures compensation expense. The buyback of discount options (which are rare) was governed by EITF Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options (Issue 94-6). Issue 94-6
generally required that the total amount of compensation expense recognized for those repurchased discount options be the sum of: (1) the compensation cost amortized to the buyout date; (2) the options’ intrinsic value (if any) at the buyout date in excess of the compensation cost amortized to the buyout date; and (3) the amount (if any) paid for the options in excess of their intrinsic value at the buyout date.

Implications of the Interpretation
For typical fixed options with no discount, the measurement of compensation expense should be the same under the Interpretation and present practice. However, for discount options, the Interpretation supersedes the Issue 94-6 consensus and is a change to current practice. In many circumstances, the Interpretation will require recognition of more compensation expense than current practice, because the Interpretation recognizes the entire original intrinsic value as compensation expense (including the unamortized portion), while Issue 94-6 did not.

Example 1: Purchase of Shares Within Six Months of Share Issuance Upon Option Exercise
A company grants 1,000 stock options to an employee with a $10 exercise price that is equal to the stock’s market price on January 1, 2001. On February 15, 2002, the employee exercised the 1,000 stock options by paying cash of $10,000 (1,000 options x $10 exercise price) and received 1,000 shares of the company’s stock. On July 31, 2002, the employee sells the shares back to the company for $12 per share, the then-current market price.

Because the company bought back the shares within six months of option exercise, under both the Interpretation and current practice total compensation cost would be equal to $2 per option ($2,000 in the aggregate). This amount is equal to (a) the entire original intrinsic value of the option ($0) plus (b) the amount of cash paid (reduced by any amount paid by the employee to acquire those shares) [$12 - $10] in excess of the lesser of the award’s current intrinsic value ($2) or original intrinsic value ($0). Under the Interpretation, if the buy back of the shares occurred six months and one day after the option exercise or later, no compensation expense would be recognized.

Example 2: Buyout of “At-The-Money” Options
A company grants 1,000 stock options to employees with a $10 exercise price that is equal to the stock’s market price on January 1, 2003. On December 31, 2004, the company’s stock price has dropped to $6 per share and the company decides to settle the 1,000 options by paying cash of $2 per option.

Under the Interpretation, total compensation cost would be equal to $2 per option ($2,000 in the aggregate), which is the entire original intrinsic value of the option ($0) plus the amount of cash paid in excess of the option’s current intrinsic value ($2 - $0). On the buyout date, because the original intrinsic value was zero, the additional compensation related to the cash settlement is recognized as compensation expense ($2 per option or $2,000 in the aggregate).
Example 3: Buyout of Discount Stock Options

A company grants 1,000 options to purchase shares of its stock at an exercise price of $15 per share with a five year cliff vesting period. On the grant date, the market price of the stock was $25. Compensation expense recognized on the $10 original discount through year three is $6 per option \[\left\{\frac{($25 - $15)}{5 \text{ years}}\right\} \times 3 \text{ years}\}. On the buyout date (end of year three), the market price of the stock is $16, and the amount paid for the buyout of options is $2 per option. The intrinsic value at the buyout date is $1 per option.

Under present practice (Issue 94-6), total compensation cost would be equal to $7 per option ($7,000 in the aggregate). The total compensation would be the sum of: (a) the $6 of compensation cost amortized to the buyout date; (b) nothing related to the option’s intrinsic value at the buyout date in excess of the compensation cost amortized to the buyout date (because the $1 intrinsic value at the buyout date is less than the $6 of compensation expense recognized to date); and (c) the $1 excess amount paid per option over and above the option’s intrinsic value at the buyout date ($2 - $1).

Under the Interpretation, total compensation cost would be equal to $11 per option ($11,000 in the aggregate), which is the entire original intrinsic value of the option ($10) plus the amount of cash paid in excess of the option’s current intrinsic value ($1). On the buyout date, the remaining unamortized compensation cost of $4 of the originally measured intrinsic value per option and the $1 additional compensation cost related to the buyout is recognized as compensation expense ($5 per option or $5,000 in the aggregate). (Note that $6,000 of compensation had already been recognized up through the buyout date, resulting in a total of $11,000).

Note that if in any of the above examples, the company granted options in the “look back” period prior to the settlement, or subsequently grants options after the date of settlement, the company would need to consider the cancellation and reissuance rules. Refer to Section 4, Stock Option Repricings for guidance.

Example 4: Buyout of Restricted Stock

A company grants 1,000 shares of restricted stock with a fair value of $10 per share with a five year vesting period. On the buyout date (end of year three), the fair value of the restricted stock is $2 per share. The company has recognized $6 per share (aggregate of $6,000) of compensation expense through year three. The company settles the restricted stock award by paying the employee $9 per share in order to provide the employees with some economic benefit as a result of providing services during the period.

Under the Interpretation, total compensation cost would be equal to $17 per share ($17,000 in the aggregate). The total compensation cost would be equal to: (a) the $10 per share originally measured compensation cost and (b) the $7 excess amount paid per share over the restricted stock’s current intrinsic value ($9 - $2). On the buyout date, the remaining unamortized compensation cost of the originally measured intrinsic value of $4 per share of restricted stock and the $7 per share additional compensation cost related to the buyout is recognized as compensation expense ($11 per share or $11,000 in the aggregate) on the date of settlement.
Under current practice, total compensation cost would be equal to only $13 per share (comprised of $6 of compensation expense through year three and $7 related to the excess amount paid over the restricted stock’s current intrinsic value).

### 6.2 Settlements of Earlier Awards By Granting Stock

#### Issue

Companies may decide a new stock compensation award should be substituted for an old award because that old award has declined in value and lost its desired motivational effect. For example, an out-of-the-money stock option is canceled and replaced with a new restricted stock award. The Board addressed the accounting consequence of canceling (or settling) an option by granting a new stock award. *(Interpretation—Questions 9, 11(b), potentially 11(a), and 13.)*

#### Final Interpretation

The Board concluded that if a company cancels (or settles) a stock option and replaces that award with stock, a new measurement date would be required. For example, assume a company cancels a stock option for 250 shares and issues the employee 100 shares of restricted stock. A new measurement date is required for the restricted stock. Total compensation would be measured as the sum of the following:

- The award’s (options) intrinsic value, if any, at the original measurement date
- The modified award’s (restricted stock) intrinsic value that exceeds the lesser of the intrinsic value of the original award (1) at the original measurement date or (2) immediately prior to the modification

If a new measurement date is required, the remaining unamortized original intrinsic value (if any) plus any additional compensation (based on the above calculation), would be recognized over the remaining vesting period. However, if the modified award is fully vested at the settlement date, any additional compensation would be recognized immediately.

When options are canceled and replacement stock awards granted, the Board decided that because the original option’s exercise price would effectively be reduced to zero and future reductions to the exercise price of the replacement stock would not be possible, variable accounting would not be required. However, the number of shares underlying the canceled fixed stock option in excess of the number of shares of replacement awards would be subject to the guidance under Section 4.3, *Cancellations of Options and Issuances of Replacement Awards*. In other words, if additional options are granted within the succeeding six months, or had been granted within the prior six months, the replacement and cancellation guidance under Section 4.3, *Cancellations of Options and Issuances of Replacement Awards* would have to be applied.

#### Practice Prior to the Interpretation

Under present practice, the cancellation of an option and issuance of a stock award has required a new measurement date. However, variable accounting was not required for any excess shares of a stock option that is canceled over the number of shares of the restricted stock award.
Implications of the Interpretation

The Interpretation is consistent with current practice as to the measurement of compensation due to the replacement award. However, the Interpretation represents a significant change to practice regarding its requirement to consider canceled options “at risk” for variable accounting.

Example 1: Replacement of “At-The-Money” Options with Restricted Stock

A company grants an employee 1,000 at-the-money options on December 31, 2001 with an exercise price of $25 per option that vest at the end of five years. The company measures the stock compensation under APB 25 and no compensation expense is recognized on the grant (measurement) date. At the end of the third year on December 31, 2004, when the stock price is $10 per share, the company settles the 1,000 outstanding out-of-the-money options by issuing 40 shares of restricted stock to the employee that have an aggregate fair value of $400. The stock will vest pursuant to the original vesting terms of the options.

A new measurement date results for the settlement of the 1,000 options. Under the Interpretation, total compensation cost would be equal to $10 per share ($400 in the aggregate), which is the entire intrinsic value of the original award ($0) plus the amount of the stock’s value in excess of the option’s original intrinsic value ($10 - $0). The total remaining compensation cost ($10 per share or $400) is recognized during 2005 and 2006, the two remaining years of the vesting period.

It is important to note that the 40 shares of restricted stock would not be subject to variable accounting because the exercise price of the original option has effectively been reduced to zero; therefore, future reductions to the exercise price of the replacement restricted stock award are not possible.

However, the company must determine the number of options “at risk” for variable accounting. The number of options “at risk” for variable accounting would be 960 (1,000 options settled less the 40 shares of restricted stock issued). To identify whether the settled awards should be combined with replacement awards, first the company reviews the look back period—in this example the six month period prior to the settlement date (i.e., July 1, 2003 to December 31, 2004). Assuming no replacement awards were granted during the look back period, the company then reviews the look forward period, the six-month period subsequent to December 31, 2004. In April 2005, assume the company grants 200 options with an exercise price of $20 to this employee as part of its normal annual stock option grants. Those 200 options would be considered replacement awards that have to be accounted for as variable.

Example 2: Replacement of Discount Stock Option with Restricted Stock

A company grants stock options to employees on January 1, 2003 with an exercise price of $10 per share and a five-year vesting period. On the grant date, the market price of the stock was $25. Compensation expense recognized through year three is $9 per option {[$(25 - 10) / 5 years] x 3 years}. On January 1, 2006 (end of year three), the market price of the stock is $12, and the company issues one share of restricted stock for each outstanding option.
A new measurement of compensation is required and results in additional compensation cost of $10 per option [$12 per share of the restricted stock less $2 intrinsic value per option (that is, the lesser of the original intrinsic value ($15) or the current value of the original option immediately prior to the modification ($12 - $10) or $2]. The stock is restricted and subject to the remaining vesting period of the options.

On January 1, 2006, the remaining unrecognized compensation cost for the originally measured intrinsic value is $6 per option. The total compensation cost remaining to be recognized on a per option basis is $16, determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional compensation cost</td>
<td>$10</td>
</tr>
<tr>
<td>Unrecognized compensation cost for the original intrinsic value</td>
<td>6</td>
</tr>
<tr>
<td>Total remaining compensation cost to be recognized</td>
<td>$16</td>
</tr>
</tbody>
</table>

That amount is recognized during 2006 and 2007, the two remaining years of vesting.

### 6.3 Cash Bonus Plans Linked to Stock-Based Plans

#### Issue

Companies sometimes grant cash bonuses that are clearly linked to stock option exercise. The most common is a cash bonus that is paid to satisfy the employee’s tax liability arising from the stock option exercise. Another example is a cash bonus that, if earned, must be used to satisfy the exercise price of outstanding stock options. In other situations, it is less clear whether a cash bonus is linked to an option exercise. The Board deliberated under what circumstances a cash bonus should be linked to an option and, if linked, whether the bonus requires variable accounting for the stock option (that is, the stock option in essence has a variable option price). *(Interpretation—Question 20.)*

#### Final Interpretation

The Board concluded that if the payment of the cash bonus is contingent upon *exercise* of the option and the amount of the bonus is not fixed, the award should be accounted for as a combined variable award. However, if the amount of the cash bonus is fixed and contingent upon exercise of the option, the option should be accounted for as a discount stock option. The Board concluded that a fixed or variable cash bonus that is contingent upon the *vesting* of the option would be accounted for separately from the option, and would not result in an otherwise fixed option being accounted for as a variable award (i.e., only the bonus would be expensed).

#### Practice Prior to Interpretation

Current practice has assessed the substance of cash bonuses to determine whether they are linked to the stock-based compensation award. However, guidance in this area has been limited. In Issue 87-6 the EITF reached a consensus that certain “tax offset cash bonuses” payable when an underlying related option is exercised required not only expensing the bonuses, but also variable accounting for the options (that is, “combined” accounting). In practice, this same unfavorable accounting result may be necessary when tax offset cash bonuses were attached to other forms of stock awards, for example to shares of restricted stock.
This EITF consensus was extended by analogy to other arrangements. In some cases, other cash payments have been linked to options, with the same variable accounting consequences. Under current practice, cash bonuses and stock option grants required careful case-by-case consideration based on the facts and circumstances to determine whether variable accounting was appropriate.

Implications of the Interpretation

By identifying specific criteria to evaluate whether a cash bonus is linked to a stock option, the Board attempted to bring consistency to a subjective area. Companies will still need to exercise care when awarding cash bonuses and granting stock options. If the bonus is contingent on option exercise, it must be determined whether the bonus is a fixed amount or whether it may vary. If the amount of the bonus is fixed and payment is contingent upon exercise of the option, a compensation charge would result for the granting of a discount stock option (i.e., the bonus would be viewed as reducing the stated exercise price).

For example, assume a company grants an option with a $10 exercise price when the market price of the stock is $10. The company also grants a cash bonus of $2 that is contingent upon exercise of the option. In substance, the company has granted a discount stock option (exercise price of $8 on stock with a market value of $10). Therefore, $2 of compensation expense for each option granted would be recognized over the vesting period of the option. However, if the amount of the bonus is not fixed and payment is contingent upon the exercise of the option (e.g., 40% of the then intrinsic value to cover income taxes for the employee), the Interpretation would require variable accounting for the combined (that is, “linked”) option and cash bonus.

6.4 Noncompensatory Plans

Issue

Employee stock purchase plans generally provide a broad group of employees the right to acquire employer stock through payroll deductions. A typical plan (that qualifies under Section 423 of the Internal Revenue Code—"Section 423 Plan") allows employees to buy the employer’s stock at a discount from the market price at the date of grant over a period of time (for example, two years). These types of plans that meet certain criteria in APB 25 are not compensatory. The Board considered what amount of discount is reasonable to offer employees as part of an employee stock purchase plan.

Some Section 423 Plans also have a look-back option feature. A look-back option sets the purchase price at the lesser of the stock’s market price on the grant date or its market price on the exercise (or purchase) date. The Board also considered whether a look-back option would require an employee stock purchase plan to be accounted for as a compensatory plan. (Interpretation—Questions 6, 7, and 8.)

Final Interpretation and Practice Prior to Interpretation

During its deliberations, the Board observed that APB 25 provides as an example of a noncompensatory plan, a plan that qualifies under Section 423. Therefore, in order to keep changes to APB 25 to a minimum, the Board decided to carry that concept forward in the Interpretation. As a result, the Board’s decisions on this issue were influenced by the requirements of Section 423.
The Board concluded that a purchase discount of up to 15% would be permissible in order to account for a plan as noncompensatory provided that all the other provisions of APB 25 regarding noncompensatory plans were satisfied. The Board reached this conclusion solely on the basis that a discount of up to 15% is allowed under Section 423. In fact, when deliberating Statement 123, the Board concluded that 15% was too large of a discount to account for a plan as noncompensatory under that standard. The decision to permit a discount of up to 15% under APB 25 was the Board’s practical concession to the reference to Section 423 in APB 25, and to long standing practice in this area.

Regarding look-back options, Section 423 also permits a qualified employee stock purchase plan to contain a look-back option. Consequently, for solely practical reasons, the Board concluded that a plan with a look-back option should qualify as a noncompensatory plan even if the effect of the look back feature results in a greater than 15% discount. Notwithstanding this conclusion, the Board expressed the view that it believed look-back options really were compensatory, but chose not to change long standing practice.

### 6.5 Definition of Grant Date

**Issue**

Options and other awards under stock-based compensation plans periodically are granted subject to the approval of shareholders. Such approval may be required by state law, regulator or stock exchange provisions, tax code, or corporate by-laws, or it may be requested by corporate management. If awards granted under a plan are subject to shareholder approval, an accounting question arises as to the date on which a grant actually occurs. Although APB 25 did not clarify the grant date for awards subject to shareholder approval, Statement 123’s definition of the grant date included the concept of shareholder approval. The SEC staff has informally stated that the grant date guidance of Statement 123 also should be applied to awards accounted for under APB 25. The Board deliberated whether APB 25 should be interpreted to capture the Statement 123 grant date definition. **(Interpretation—Question 18.)**

**Final Interpretation**

The Board decided to extend its Statement 123 grant date definition to cover awards accounted for under APB 25. Therefore, the Interpretation provides that awards made under a grant that is subject to shareholder approval should not be deemed granted, and therefore, no measurement date can occur, until that approval is obtained. However, if management and the members of the board of directors control sufficient votes to approve the plan, a grant date and a measurement date may be deemed to occur prior to shareholder approval because such approval is essentially a formality. Furthermore, the Board clarified that a probability assessment that the shareholders will approve the plan is not sufficient to make approval essentially a formality. Consequently, in most cases, required shareholder approval must be obtained in order to conclude that a grant date, and therefore, a measurement date for an award has occurred under APB 25.
Practice Prior to Interpretation

This Board decision is consistent with Statement 123 and is generally consistent with how the SEC staff already views the grant date under APB 25. Therefore, practice has evolved that grants subject to shareholder approval (that is, not essentially a formality) would not be deemed granted until the required shareholder approval is obtained.

The SEC staff tightened the Statement 123 “grant date” definition even further by indicating that the only situation in which it would consider shareholder approval a formality is the Statement 123 example (that is, when management and the members of the board of directors control enough votes to approve the award). In addition, shares held by outsiders (for example, a single shareholder owning a large block of stock) can be included only if an irrevocable proxy is obtained. In all other cases, the SEC staff believes the stock price to use in measuring compensation expense for a fixed plan under APB 25 is the price on the date the shareholders approve the award. If the stock price on that date is greater than the exercise price, this would result in the recognition of compensation expense.

In summary, the Interpretation is consistent with present practice and simply formalizes the SEC staff’s position.

Example 1: Defining the Grant Date

A company’s board of director meeting was held on December 15, 2001. On this date, the board of directors approved a new stock option plan and granted 50,000 options under the plan to employees. The Board established the exercise price of the options at $25 per share, the-then current market price, with a three year vesting period. However, the plan and the awards made under the grant were subject to shareholder approval. In addition, management and the members of the board of directors did not control sufficient votes to approve the plan and the awards. Because the plan and the awards are subject to shareholder approval, and approval is not essentially a formality, shareholder approval must be obtained in order to conclude that a grant date, and therefore, a measurement date has occurred under APB 25.

On May 15, 2002, the shareholders approved the plan and the 50,000 option grant at the company’s Annual Shareholder’s Meeting. On this date, the then-current market price of the company’s stock is $40 per share. The company will recognize compensation expense of $15 ($40 market price less $25 exercise price) per option, or $750,000 in the aggregate, over the three year vesting period. In this situation, the awards are treated similar to a discount stock option and no accounting recognition is required until May 15, 2002.
6.6 Deferred Income Taxes

Issue
The tax effects of stock-based awards generally are recognized for financial reporting purposes only if such awards are structured to result in deductions on the company’s income tax return. For example, a company generally receives a tax deduction for a nonqualified (nonstatutory) stock option in an amount equal to the market price of the stock on the date of exercise in excess of the exercise price (that is, the intrinsic value). Similarly, a company generally receives a tax deduction equal to the market value of restricted stock on the date the restrictions lapse, less any amounts paid by the employee. For these tax deductible stock-based awards, compensation expense (if any) is recognized in the financial statements in different amounts and in different periods than when the actual tax deduction is taken. Therefore, if stock compensation expense is recognized, deferred tax assets are also recognized. After recognizing a deferred tax asset, the accounting question is how to evaluate the future realizability of the deferred tax asset and whether a valuation allowance is necessary. It is important to note that this issue does not affect companies that have fixed plans where no compensation expense is recognized. (Interpretation—Question 19.)

Final Interpretation
The Board decided that the recognition of deferred tax assets should be based on compensation expense recognized for financial reporting purposes, not on the expected future tax deduction. In other words, the carrying amount of the deferred tax asset should not be adjusted for a subsequent decline in stock price, even though such a decline would result in a smaller tax deduction for the company.

The Board concluded that a valuation allowance to reduce the carrying value of those deferred tax assets should be established only if the company expects that future taxable income will be insufficient to recover the deferred tax assets in the periods in which the tax deduction will be recognized for tax purposes. This decision is consistent with the approach under Statement 123.

Practice Prior to Interpretation
Under present practice, we believe some companies considered the effects of subsequent stock price changes in determining whether a valuation allowance was needed for the deferred tax asset.

Implications of the Interpretation
At least for some companies, the Interpretation differs from present practice under APB 25 in accounting for deferred tax assets arising from stock compensation arrangements. The following example illustrates this difference:

Example 1: Deferred Income Taxes
During September 2000, a company grants a discount option having an intrinsic value of $10 per option on the grant date (stock price is $25 and exercise price is $15). The company would recognize a deferred tax asset at the same time the expense is recognized over the vesting period of the option based on the $10 intrinsic value. Under present practice, during future reporting periods, some companies considered the effects of subsequent stock price declines in determining whether
a valuation allowance is needed for that deferred tax asset. For example, if the intrinsic value subsequently dropped to $2 per option, the company would record a valuation allowance related to the deferred tax asset. The valuation allowance is recognized because the current stock price would support only a $2 per option deduction, while the deferred tax asset recognized is based on a $10 per option deduction.

Under the Interpretation, no valuation allowance would be recorded because of the stock price decline. Rather, a valuation allowance would be recognized only if the company expected that future taxable income will be insufficient to recover the deferred tax asset. At the time the option is exercised, the Interpretation requires the deferred tax asset to be adjusted through income based on the actual deduction the company ultimately realizes, up to $10. The tax benefit of any deduction above $10 (e.g., if the market value is $40 at date of exercise), is recognized in additional paid-in capital. If the option expires unexercised (e.g., the market value goes below $15), the deferred tax asset is written off on that date and not before either to expense, or to the extent available, against additional paid-in capital credits from earlier option exercises under same or similar plans.
7 Business Combinations and Equity Restructurings

7.1 Exchange of Stock Options In a Pooling-of-Interests Business Combination

Issue
Under the common-stock-for-common-stock condition for pooling-of-interests accounting under APB Opinion No. 16, Business Combinations (APB 16), the issuing company must issue common stock “for substantially all of the voting common stock interest of another enterprise.” Stock options are “essentially residual equity interests,” and, therefore, stock options in the target company must be exchanged for an equivalent equity interest in the combined company. Generally, the target company options are exchanged for equivalent options in the issuing company based on the exchange ratio. The Board deliberated whether a new measurement date is triggered when employee stock options are exchanged in a pooling-of-interests transaction. (Interpretation—Question 16.)

Final Interpretation
The Board decided that no new measurement date should be required for changes to the exercise price or to the number of shares of a (fixed) stock option resulting from an exchange of stock options in a pooling provided both of the following criteria are met:

- The aggregate intrinsic value of the options immediately after the exchange is not greater than the aggregate intrinsic value of the options immediately before the exchange.

- The ratio of the exercise price per option to the market value per share is not reduced.

If those criteria are not met, a new measurement date is required.

It should be pointed out that significantly changing the other terms of an option in a pooling transaction would most likely represent a “change-in-equity interests” that would violate the strict APB 16 pooling conditions. Therefore, it is unlikely that a modification to the other terms could ever occur and the business combination still be accounted for as a pooling.

Practice Prior to Interpretation
Generally, when options are exchanged in a pooling transaction, the number of options and the exercise price have been adjusted to reflect the exchange ratio. All of the other terms of the option remain unchanged; otherwise a change in equity interests would result and the pooling conditions would be violated. Therefore, under present practice, no compensation expense would be recognized under APB 25 as a result of an exchange of stock options in a pooling transaction.
Implications of the Interpretation

The Interpretation is consistent with present practice as to the treatment of options in a pooling as illustrated below:

Example 1: Pooling-of-Interests Business Combination

Company A (issuing company) and Company B (target company) enter into a business combination to be accounted for as a pooling. At the consummation date, Company A and Company B common stock have fair values of $20 per share and $10 per share, respectively. Assume each company has the exact same number of shares outstanding (therefore, Company A is worth exactly twice what Company B is worth). To effect the combination, Company A will exchange one share of Company A stock for two shares of Company B stock.

Company B employees own 1,000 stock options that fully vest upon the change in control. The options were issued “at-the-money” and, under APB 25, Company B appropriately recognized no compensation expense. The options have an exercise price of $6 per share. Therefore, prior to the exchange, the Company B options have an aggregate intrinsic value of $4,000 [1,000 options times $4 ($10 - $6)].

Assuming that none of the Company B options were exercised, the Company B options would be exchanged for options in the combined Company A. Generally, each Company B option would be exchanged for an option in Company A, adjusted for the exchange ratio. In this example, Company B employees would receive 500 stock options with an exercise price of $12 to purchase Company A stock. In the aggregate, the employees could exercise the options for an aggregate exercise price of $6,000 (500 options times $12 per share) and receive 500 Company A shares worth $10,000 (500 shares times $20 per share). In effect, the Company B employees have maintained the same $4,000 aggregate intrinsic value they had before the exchange.

Consistent with the requirements of pooling accounting, the options in Company B and Company A have substantially identical terms. Also, the aggregate intrinsic value of the options in Company A is the same as the aggregate intrinsic value of the options in Company B. In addition, the ratio of exercise price per option to the market value per share has not been reduced (that is, the ratio is still 60%). As such, no additional compensation expense would be recognized presently under APB 25 or under the Interpretation. The above accounting is the same whether the options are vested or unvested.

7.2 Exchange of Stock Options in a Purchase Business Combination

Issue

Frequently in purchase business combinations, stock options held by employees of the target company are exchanged for options of the acquiring company. The options held by employees may be vested or unvested. If the acquiring company exchanges its options for the vested and unvested outstanding options held by employees of the target company, a question arises as to what portion, if any, of the value exchanged should be purchase price versus compensation. The Board deliberated whether a new measurement date is triggered when vested or unvested stock options are exchanged in a purchase business combination. (Interpretation—Question 17.)
Final Interpretation

The Board concluded the following related to vested and unvested options granted by the acquiring company in a purchase business combination.

**Vested options**—The Board decided that options granted by the acquiring company in exchange for outstanding vested options (or options that vest upon change in control) of the target company should be considered part of the purchase transaction and accounted for under APB 16. Accordingly, the fair value of the new (acquiring company) options (not the intrinsic value) should be included as part of the purchase price to acquire the target company.

**Unvested options**—The Board decided that unvested options granted by the acquiring company in exchange for outstanding unvested options held by employees of the target company should be considered part of the purchase price and accounted for under APB 16 (i.e., at fair value). However, to the extent that service is required after the consummation date in order to vest in the replacement awards (i.e., the acquiring company’s options), a portion of the unvested options’ intrinsic value should be allocated to unearned compensation cost and amortized over the remaining vesting period. The amount of the compensation cost to be recognized as unearned compensation cost is based on the portion of the intrinsic value at the consummation date related to the employee’s future service. To determine the amount of unearned compensation cost, the aggregate intrinsic value of the replacement options at the consummation date is multiplied by the ratio of the remaining service period to the total service period (the service period prior to the consummation date plus the remaining service period required to vest in the award). The amount of unearned compensation cost is deducted from the fair value of the awards in determining the allocation of the purchase price under APB 16.

Practice Prior to Interpretation

**Vested options**—Under present practice, if the acquiring company issued vested options in exchange for the outstanding vested options of the target company employees, the value of the acquiring company’s vested options has been treated as purchase price. However, due in part to practical considerations, there has been diversity in practice regarding whether the acquiring company measures the option exchange at intrinsic value or fair value. Under the intrinsic value approach, the amount of the option’s intrinsic value was treated as purchase price. Under the fair value approach, the fair value of vested options issued by the acquiring company is treated as purchase price.

**Unvested options**—When an acquiring company issues unvested options in exchange for unvested options of the target company employees, the predominant practice has been for the acquiring company to include the value of the unvested options exchanged in the purchase price, although some acquiring companies may recognize the value of unvested options as compensation cost over the employee’s remaining service period. Similar to vested options, practice has been mixed as to whether the company measures the unvested option exchange at intrinsic value or fair value.
Implications of the Interpretation

**Vested options**—The Interpretation is consistent with present practice in that the value of options granted by the acquiring company in exchange for outstanding vested options of the target company should be considered part of the purchase price, but it eliminates diversity in practice regarding how to measure the value of the vested options.

**Unvested options**—The Interpretation’s treatment of unvested options in a purchase business combination eliminates diversity in present practice. Under the Interpretation, the value of the options granted by the acquiring company in exchange for outstanding unvested options of the target company is considered part of the purchase price. However, to the extent that employee service is required subsequent to the acquisition in order for the employee to vest in the replacement awards, a portion of the intrinsic value of those stock options should be recognized as unearned compensation cost and amortized to expense over the remaining vesting period. The Interpretation also resolves how to measure the value of unvested options in a purchase business combination.

**Example 1: Purchase Business Combination**

Company X (acquiring company) acquires Company Y (target company) in a purchase business combination that occurs on July 1, 2006. Prior to the exchange, assume an employee of Company Y holds 5,000 options granted on June 30, 2002 that provide for cliff vesting five years later on June 30, 2007. Therefore, 80% of the service towards vesting has been rendered on the consummation date of the purchase business combination.

Company X issued 10,000 options with a fair value of $100,000 in exchange for the options held by the employee. The Company X options vest according to the vesting schedule of the previous Company Y options (cliff vest on June 30, 2007). The intrinsic value of the Company X options issued is $4 per option (or $40,000 in the aggregate) on the date of exchange.

The $100,000 fair value of the Company X options issued in the exchange is part of the purchase price paid for Company Y. However, $8,000 is recognized as unearned compensation and is deducted from the purchase price of Company Y that is allocated to the other assets acquired. The unearned compensation of $8,000 is determined by taking the total intrinsic value of Company X options issued of $40,000 ($4 intrinsic value per option times 10,000 options) multiplied by the fraction (1/5) that represents the remaining vesting period over the total vesting period. The unearned compensation of $8,000 would be shown as a reduction from equity on the balance sheet and would have to be expensed over the remaining vesting period of one year. The remaining $92,000 would be part of the purchase price allocated to the other assets of Company Y that were acquired.
7.3 Equity Restructurings

Issue

Stock option grants may contain antidilution provisions that explain how the exercise price and number of shares will be adjusted at the time of an equity restructuring. In other situations, the plan may be silent, but the company may still make adjustments to the options at the time of the restructuring. An equity restructuring transaction is a nonreciprocal exchange between a company and its shareholders, such as a stock dividend, spin-off, stock split, rights offering, or recapitalization through a special, large non-recurring dividend. As a result of the equity restructuring, the stock’s market price per share decreases. Typically, at the time of an equity restructuring, the exercise price is reduced, and the number of shares under option is increased to offset the dilution created by the transaction. The Board deliberated whether an accounting consequence occurs for changes to the exercise price or the number of shares as a direct result of an equity restructuring.

In addition, the Board addressed a change in status from an employee to a nonemployee as a direct result of a spin-off transaction. (Interpretation—Questions 5(c) and 11(c).)

Final Interpretation

The Board concluded that no accounting consequence results from changes to the exercise price or the number of shares of an option in an equity restructuring, as long as both of the following criteria are met.

• The award’s aggregate intrinsic value immediately after the modification is not greater than the award’s aggregate intrinsic value immediately before the modification.

• The ratio of the exercise price per share to the market value per share is not reduced. (Note that in situations where the ratio has been reduced, variable accounting is required for options of both the spinnor and the spun-off company as illustrated in Example 2.)

In the Board’s view, modifications satisfying the two criteria above merely restore the option holder’s economic position as measured under the intrinsic value method. If either of the above criteria are not met, the Board concluded that variable accounting would be necessary because the exercise price of the option has been reduced (either directly or indirectly). This guidance also applies regardless of whether the terms of the stock option provide for adjustments as part of an equity restructuring. Ordinary cash dividends or distributions should not be considered an equity restructuring for the purposes of applying this guidance.

If the criteria above are met, but the terms of the original award are modified to either accelerate the vesting or extend the life, the accounting guidance for acceleration of vesting or term extension would apply. (Refer to Section 3.2, Renewal or Extension of Term and Section 3.3, Acceleration of Vesting.) The Board also noted that cash or other consideration provided to restore the employee’s economic position as a result of an equity restructuring should be recognized as compensation.

Change-in-Status in a Spin-off—In some spin-off transactions, an employee in Company A that held options in Company A becomes an employee of spun-off Company B, but retains the options in Company A. Therefore, from Company A’s perspective the individual option holder’s status technically
has changed from that of an employee to a nonemployee. The Board, however, provided an exception for changes in employee status resulting from spin-off transactions and concluded that a change from the intrinsic value to the fair value method for stock options or awards previously granted to the individual as an employee was not required. This exception applies only to changes in status occurring as a result of a spin-off transaction (i.e., a pro rata distribution to owners of an enterprise of shares of a subsidiary such that the enterprise no longer consolidates the former subsidiary) and only to stock options or awards that were granted and outstanding at the date of the transaction. Awards granted by the company to a nonemployee after the spin-off are accounted for under the fair value method.

Practice Prior to Interpretation

Adjustments to the exercise price or the number of shares of an option resulting from an equity restructuring did not result in a new measurement date provided that the provisions of EITF Issue 90-9, Changes To Fixed Employee Stock Option Plans as a Result of Equity Restructuring, were met. Under Issue 90-9, no new measurement date occurred provided that: (1) the aggregate intrinsic value of the options did not increase; (2) the ratio of the exercise price to the stock price is not reduced; and (3) the vesting and term of the option remain the same. If the Issue 90-9 criteria were not met, a new measurement date resulted.

Implications of the Interpretation

The Interpretation uses the same criteria as the first two criteria of Issue 90-9. If those two criteria are met, there is no accounting consequence under the Interpretation or Issue 90-9. If the criteria are not met, a new measurement date results under Issue 90-9. However, in a significant change to practice under the Interpretation, not only does a new measurement date result if the criteria are not met, but variable accounting would be required. Under Issue 90-9, if the vesting or term of the option are changed, a new measurement date results. Under the Interpretation, a change to the term or vesting provisions would require application of the guidance discussed under Section 3.2, Renewal or Extension of Term and Section 3.3, Acceleration of Vesting. Because the Board incorporated most of the provisions of Issue 90-9 into the Interpretation, as discussed above, Issue 90-9 is superseded.

Example 1: Stapled Options in a Spin-off

Company X grants an employee 1,000 at-the-money options with an exercise price of $8 per share. Company X measures the stock compensation under APB 25 and no compensation expense is recognized because the exercise price equals the quoted market price on the grant (measurement) date. The market price of Company X’s stock is $24 per share on January 1, 2001. On that same date, Company X spins off Company Y. Shareholders receive one share of Company Y for each share of Company X held. In addition, the employee retains the options previously held in Company X and receives one option in Company Y for each option of Company X held. The options cannot be separately exercised. There is no change in the exercise price for an option in Company X, but the employee is now entitled to one share of Company X and one share of Company Y when the option is exercised. No other modifications are made to the terms of the stock options. The market price of Company X and Company Y stock immediately after the spin-off is $20 and $4 per share, respectively.
Because the two criteria are met, there is no accounting consequence of the modifications to the options as a result of an equity restructuring. Note that even though the employee of Company X now has an option in Company Y, he or she is not accounted for as a nonemployee option holder by Company Y because of the Interpretation’s exception related to change in employee status as a result of a spin-off.

**Example 2: NonStapled Options in a Spin-off**

Company X grants an employee 1,000 at-the-money options with an exercise price of $8 per share. Company X measures the stock compensation under APB 25 and no compensation expense is recognized because the exercise price equals the quoted market price on the grant (measurement) date. The market price of Company X’s stock is $24 per share on January 1, 2001. On that same date, Company X spins off Company Y. Shareholders receive one share of Company Y for each share of Company X held. In addition, the employee retains options previously held in Company X and receives one option in Company Y for each option of Company X held. The options can be separately exercised. The exercise prices of Company X and Company Y options are set at $6 and $2, respectively. No other modifications are made to the terms of the stock options.

The market price of Company X and Company Y stock immediately after the spin-off is $20 and $4 per share, respectively.

![Table](https://example.com/Table.png)
Because the ratio of exercise price per option to the market price per share is reduced for Company X (.33 versus .30), variable accounting for both the Company X and Company Y options is required as a result of the modifications to the options. If the ratio for both Company X and Company Y options had been maintained (exercise price of $6.67 and $1.33 for Company X and Company Y options, respectively), no accounting consequence would have resulted because the two criteria would have been met. As described in the previous example, there would be no accounting consequence because of the Interpretation’s exception related to change in employee status as part of a spin-off.

Example 3: Reduction in the Exercise Price in an Equity Restructuring

Company X grants an employee 1,000 at-the-money options with an exercise price of $8 per share. Company X measures the stock compensation under APB 25 and no compensation expense is recognized because the exercise price equals the quoted market price on the grant (measurement) date. The market price of Company X’s stock is $24 per share on January 1, 2001. On that same date, Company X spins off Company Y. The employee remains an employee of Company X. The exercise price for Company X options is reduced by $4 per option, an amount equal to the decline in market price per share of Company X as a result of the spin-off of Company Y.

<table>
<thead>
<tr>
<th></th>
<th>Market Price</th>
<th>Exercise Price</th>
<th>Number of Options</th>
<th>Aggregate Intrinsic Value</th>
<th>Ratio (Exercise/Market)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Before:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company X</td>
<td>$24</td>
<td>$8</td>
<td>1,000</td>
<td>$16,000</td>
<td>.33</td>
</tr>
<tr>
<td><strong>After:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company X</td>
<td>$20</td>
<td>$4</td>
<td>1,000</td>
<td>$16,000</td>
<td>.20</td>
</tr>
<tr>
<td><strong>Evaluation:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Criterion A:</td>
<td>Aggregate Intrinsic Value</td>
<td>Same</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Criterion B:</td>
<td>Ratio (Exercise/Market)</td>
<td>Reduced</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Variable accounting results from the modifications to the options because the second criterion is not met. If the exercise price for Company X options had been reduced by $1.33 to $6.67 per option so that the ratio of exercise price per share to market price per share was the same before and after the modification to the stock options and the number of shares increased by 200 shares so that the aggregate intrinsic value of the modified awards equaled $16,000, there would have been no accounting consequence.
Example 4: Exchange of Options in an Equity Restructuring

Company X grants an employee 1,000 at-the-money options with an exercise price of $8 per share. Company X measures the stock compensation under APB 25 and no compensation expense is recognized because the exercise price equals the quoted market price on the grant (measurement) date. The market price of Company X’s stock is $24 per share on January 1, 2001. On that same date, Company X spins off Company Y. Employees who previously worked for Company X and now work for Company Y are allowed to exchange options held in Company X for options in Company Y and maintain the same aggregate intrinsic value. The market price of Company Y shares immediately after the spin-off is $4 per share. The employees are given 6,000 options (1,000 x $24 ÷ $4) in Company Y at an exercise price of $1.33 (rounded) per share ($8 x $4 ÷ $24).

<table>
<thead>
<tr>
<th>Before:</th>
<th>Market Price</th>
<th>Exercise Price</th>
<th>Number of Options</th>
<th>Aggregate Intrinsic Value</th>
<th>Ratio (Exercise/Market)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company X</td>
<td>$24</td>
<td>$8</td>
<td>1,000</td>
<td>$16,000</td>
<td>.33</td>
</tr>
<tr>
<td>Company Y</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>After:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company X</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Company Y</td>
<td>$ 4</td>
<td>$1.33</td>
<td>6,000</td>
<td>$16,000</td>
<td>.33</td>
</tr>
</tbody>
</table>

Evaluation:
- Criterion A: Aggregate Intrinsic Value
- Criterion B: Ratio (Exercise/Market): Company X

There is no accounting consequence as a result of the modifications because the two criteria are met. As described in Example 1, there would be no accounting consequence because of the Interpretation’s exception related to change in employee status as part of a spin-off.
8 Effective Date, Transition Provisions and Transition Disclosures

8.1 Effective Date and Transition Provisions

The Interpretation is effective July 1, 2000 (regardless of a company’s fiscal year) and, except as discussed below, should be applied prospectively to:

• new awards
• exchanges of awards in a business combination
• modifications to outstanding awards
• changes in employee status that occur on or after that date

Therefore, it applies to grants of options after July 1, 2000 even though the plan was adopted years ago.

Because the Board believes that the Interpretation only clarifies an existing standard, it retained the effective date it originally proposed for direct or indirect repricings made after December 15, 1998. Stock option repricings on December 15, 1998 or earlier are not affected. In addition, stock option repricings after December 15, 1998 are not affected if the repriced stock options are exercised before July 1, 2000. Refer to Section 4, Stock Option Repricings for further discussion of this guidance.

The Interpretation’s definition of an employee applies to new awards granted after December 15, 1998. Refer to Section 2.2, Definition of an Employee Under APB 25 and Section 2.8, Co-Employment Arrangements for further discussion.

Finally, the Board also decided that a third effective date should be established for modifications made after January 12, 2000 (the date of the Board’s meeting deciding this issue) to add a reload feature to stock options or awards. Refer to Section 3.5, Reload Features for further discussion.

Although the Interpretation would apply to certain events that occur after December 15, 1998 and January 12, 2000, the Board decided that the Interpretation should be applied prospectively from July 1, 2000. Consequently, upon the initial application of the Interpretation, no adjustments would be made to financial statements for periods prior to July 1, 2000. Additional compensation expense measured upon initial application of the Interpretation that is attributable to periods prior to July 1, 2000 (e.g., for repricings) should not be recognized.

As discussed earlier, the Interpretation provides an exception that allows stock options granted to a company’s outside directors to be accounted for under APB 25. In the unlikely situation where a company previously accounted for grants to outside directors as awards to nonemployees, the change to APB 25 accounting should be reported as a cumulative effect of a change in accounting principle.
The following examples illustrate how the Interpretation would apply to a stock option repricing (made after December 15, 1998), a modification to add a reload feature (made after January 12, 2000), to a stock option award (made after December 15, 1998) to an individual who does not qualify as an employee under the Interpretation, and to a change in employee status.

**Example 1: Stock Option Repricing — Fully Vested**
A company granted 10,000 options to its employees on July 1, 1998 when the stock price was $20 per share. The options have a one year vesting period. The exercise price was set equal to $20 per share, and no compensation expense was recognized. Due to a market decline, the company repriced its options on December 20, 1998, and reduced the exercise price to the then market price of $8 per share. Under the Interpretation, no compensation expense would be recognized on the date of the repricing, but the options would be accounted for as a variable stock award from July 1, 2000 until the award is exercised, forfeited or expires unexercised.

**Stock Price Rises By July 1, 2000**
On July 1, 2000, the market price of the company’s stock has risen to $14 per share. No compensation expense for the $6 intrinsic value ($14 - $8) would be recognized upon adoption of the Interpretation. However, stock price increases above the stock’s measurement value subsequent to July 1, 2000 would be recognized as compensation expense. Therefore, the company must determine the stock’s measurement value on July 1, 2000 to use for purposes of applying variable accounting in the future and recognizing compensation expense. The stock’s measurement value is the greater of the market price on July 1, 2000 or the repriced exercise price. In this example, the stock’s measurement value is the market price on July 1, 2000 of $14, which is greater than the repriced option’s exercise price of $8.

Assume the stock price rises to $18 per share on September 30, 2000, $4 ($18 - $14) of compensation expense would be recognized for each option or $40,000 in the aggregate because all 10,000 options are still outstanding and are fully vested. Variable accounting for the repriced options would continue until the date of exercise, forfeiture or expiration. Furthermore, no credit (reversal of compensation expense) would be recognized for a subsequent decrease in the stock price below $14 (i.e., the stock’s measurement value on July 1, 2000). However, if the stock price declined to $16 on December 31, 2000, $20,000 would be credited to compensation expense.

**Stock Price Falls By July 1, 2000**
On the other hand, assume instead that on July 1, 2000 the market price of the company’s stock was $5 per share. No compensation expense (or income) is recognized upon adoption of the Interpretation. As previously described, for purposes of measuring future compensation expense, the stock’s measurement value is the greater of the market price on July 1, 2000 or the repriced option’s exercise price. In this example, the stock’s measurement value is the repriced option’s exercise price of $8, which is greater than the stock’s market price on July 1, 2000 of $5. (Note that if $5 was used, compensation expense in excess of the option’s intrinsic value would be recognized—a counterintuitive result.)
Assume the stock price rises to $10 per share on September 30, 2000, $2 ($10 - $8) of compensation expense would be recognized for each option, or $20,000 in the aggregate because all 10,000 options are still outstanding and are fully vested. Variable accounting for the repriced options would continue until the date of exercise, forfeiture or expiration. Furthermore, no credit (reversal of compensation expense) would be recognized for subsequent decreases in the stock price below $8 (i.e., the stock’s measurement value on July 1, 2000).

**Example 2: Stock Option Repricing — Not Fully Vested**

A company granted 10,000 options to its employees on July 1, 1998 when the stock price was $20 per share. The exercise price was set equal to $20 per share, and no compensation expense was recognized. The options have a three year cliff vesting requirement and two years of service have been rendered as of July 1, 2000. Due to a market decline, the company repriced its options on December 20, 1998, and reduced the exercise price to $8 per share, the then market price of the stock.

**Stock Price Rises By July 1, 2000**

On July 1, 2000, the market price of the company’s stock has risen to $14 per share. Under the Interpretation, the portion of the award’s intrinsic value measured at July 1, 2000 that is attributable to the remaining vesting period or $2 (i.e., the July 1, 2000 intrinsic value of $6 times 1/3) is recognized over the remaining vesting period which will result in $20,000 of compensation expense. In this example, the $20,000 of compensation would be recognized over the remaining one year vesting period, or $5,000 per quarter.

In addition, variable accounting for the repriced options would continue until the date of exercise, forfeiture or expiration. As previously described, for purposes of measuring future compensation expense, the stock’s measurement value is the greater of the market price on July 1, 2000 or the repriced option’s exercise price. In this example, the stock’s measurement value is the market price on July 1, 2000 of $14, which is greater than the repriced option’s exercise price of $8.

On September 30, 2000, assume the stock price rises to $18 per share, and therefore, $4 ($18 - $14) of compensation for each option or $40,000 in the aggregate would be measured. The amount of compensation recognized as expense would be based on the percentage of the vesting period satisfied as compared to the total vesting period. In this example, 75% of the total vesting period has been satisfied as of September 30, 2000, (which is 27 months representing the period July 1, 1998 to September 30, 2000 divided by the total vesting period of 36 months). Assuming all 10,000 options are unexercised at September 30, 2000, compensation of $30,000 would be recognized for the quarter ($40,000 x 75%). Therefore, total compensation expense related to these repriced options would be $35,000 ($30,000 + $5,000) for the quarter ended September 30, 2000.

**Stock Price Falls By July 1, 2000**

On the other hand, assume instead that on July 1, 2000, the market price of the company’s stock was $5 per share causing the options to be out-of-the-money. Therefore, no compensation expense (or income) is recognized upon adoption of the Interpretation.
Nevertheless, variable accounting for the repriced options would be required from July 1, 2000 until the date of exercise, forfeiture or expiration. As previously described, for purposes of measuring future compensation expense, the stock’s measurement value is the greater of the market price on July 1, 2000 or the repriced option’s exercise price. In this example, the stock’s measurement value is the repriced option’s exercise price of $8, which is greater than the stock’s market price on July 1, 2000 of $5.

Until the options are fully vested, the amount of compensation recognized as expense would be based on the percentage of the vesting period satisfied as compared to the total vesting period calculated in the manner illustrated above.

**Example 3: Award of Stock Options to Individuals Who Do Not Qualify As Employees Under the Interpretation**

On December 28, 1998, a company grants options to independent contractors. The options have an exercise price of $9 per share when the market price of the company’s stock is also $9 per share. The options cliff vest at the end of five years. Assume no compensation expense had been recognized from the date the options were granted up until July 1, 2000 under the company’s current practice.

Because the option was granted after December 15, 1998, it is covered by the Interpretation. Under the Interpretation, the options are not within the scope of APB 25 because they were granted to individuals who do not qualify as employees under common law. As such, the options are accounted for prospectively from the effective date of the Interpretation as a grant to nonemployee service providers using the fair value method.

On July 1, 2000, assume the fair value of the award is now $5 per option (based on option pricing model assumptions as of July 1, 2000). The option is now about 18/60, or 30% vested. While no compensation expense would be recognized upon adoption of the Interpretation, compensation would start to be recognized from that point forward up until the option is vested. The first 18/60 (or $1.50) of the option’s fair value would be excluded from the measured value of the option because that portion of the option vested before the Interpretation became effective. At July 1, 2000, the company would begin to recognize the remaining $3.50 of option value over the remaining 42-month vesting period. However, in accordance with Issue 96-18 because there is no economic disincentive not to perform, the option would continue to be re-valued at each reporting date and compensation expense accordingly adjusted up (or down), excluding the 30% portion, until the vesting date. Ultimately, the company would recognize compensation expense for 42/60 of the option’s final fair value on the vesting date (that is, December 28, 2003).

**Example 4: Change in Status**

Changes in status before July 1, 2000 do not have an accounting consequence as illustrated in the following two examples.

On October 15, 1998, a company grants options to an individual who qualifies as an employee under the common law definition (as discussed in Question 1(b) of the Interpretation). On April 30, 2000, the individual is transferred and becomes an employee of an unconsolidated joint venture of the company. After the change in status, the individual no longer qualifies as an
employee under the Interpretation (as discussed in Question 1(b)). Because the Interpretation only covers changes in status that occur after July 1, 2000, the accounting for this change in status is not covered by the Interpretation. Therefore, the company continues to apply APB 25 to the accounting for the outstanding award.

As a separate example, assume that a company grants options to a consolidated subsidiary employee and the company then reduces its ownership interest in the consolidated subsidiary from 80% to 25% prior to July 1, 2000, then the change in status would not have to be recognized because it happened prior to July 1, 2000. It is important to note that any new grants made to the individual would be considered grants to a non-employee.

8.2 Transition Disclosures

As mentioned above, certain of the Interpretation’s provisions apply to transactions that occur after December 15, 1998 and January 12, 2000. If a company has had transactions of those types during that period and not applied the accounting required by the Interpretation, the company will need to change its accounting prospectively beginning July 1, 2000. As a result, for companies in this situation, disclosure of the accounting change would be necessary in financial statements issued for periods ending after July 1, 2000.

To illustrate a stock option repricing disclosure, assume a company granted 10,000 options to its employees on July 1, 1998 when the stock price was $20 per share. The options have a two year vesting period. The exercise price was set equal to $20 per share, and no compensation expense was recognized for the fixed options. Due to a market decline, the company repriced its options on December 20, 1998, and reduced the exercise price to $8 per share, the then-current market price of the stock. The company expects that all 10,000 options will be outstanding on July 1, 2000. An illustrative footnote disclosure in a company’s annual report for a reporting period ending after July 1, 2000 follows.

Example 1: Footnote Disclosure—Adoption of the Interpretation as of the Effective Date

In March 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25. The Interpretation, which has been adopted prospectively as of July 1, 2000, requires that stock options that have been modified to reduce the exercise price be accounted for as variable. The Company repriced 10,000 stock options on December 20, 1998, and reduced the exercise price to $8 per share, the then-current market price of the stock. Under the Interpretation, the options are accounted for as variable from July 1, 2000 until the options are exercised, forfeited or expire unexercised. Prior to the adoption of the Interpretation, the Company accounted for these repriced stock options as fixed. Because the market price of the company’s stock increased since July 1, 2000, the effect of adopting the Interpretation was to decrease net income for the year ended December 31, 2000 by $X or $Y per share.

For a calendar year company, in the 10-Q for the quarter ended September 30, 2000, the last sentence would be revised to read:
Because the market price of the company’s stock increased since July 1, 2000, the effect of adopting the Interpretation was to decrease net income for the quarter ended September 30, 2000 by $X or $Y per share.

In addition, there are SAB 74 disclosure implications for these types of situations as discussed below.

In addition, disclosure regarding an accounting change may also be appropriate for transactions occurring after July 1, 2000 that result in compensation charges under the Interpretation if the company had similar transactions that resulted in no charges under its prior accounting that was followed. For example, a company repriced options in July 1999 which were then exercised prior to July 1, 2000. In July 2000, the company then repriced another grant of options. Disclosure of the fact that there is a charge in 2000 and none in 1999 as a consequence of applying the Interpretation (i.e., an accounting change) would be necessary if the effect is material.

**SAB 74 Disclosures**

Public companies are required to disclose the expected financial statement effects, if known, of adopting a new accounting standard in accordance with Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*. For companies where the adoption of the Interpretation may have a material impact on earnings compared to their existing accounting policy, companies will be required to address this in their financial statements. Thus, companies would be expected to include SAB 74 disclosures in its quarterly or annual financial statements for periods prior to July 1, 2000.

To illustrate a SAB 74 footnote disclosure, assume a company granted 10,000 options to its employees on July 1, 1998 when the stock price was $20 per share. The options have a two year vesting period. The exercise price was set equal to $20 per share, and no compensation expense was recognized for the fixed options. Due to a market decline, the company repriced its options on December 20, 1998, and reduced the exercise price to $8 per share, the then-current market price of the stock. The company expects that all 10,000 options will be outstanding on July 1, 2000.

**Example 2: Footnote Disclosure Prior to Adoption of the Interpretation**

In March 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25*. The company is required to adopt the Interpretation on July 1, 2000. The Interpretation requires that stock options that have been modified to reduce the exercise price be accounted for as variable. The company has repriced stock options on December 20, 1998 and in accordance with generally accepted accounting principles accounts for the repriced stock options as fixed. As a result of adopting the Interpretation, the company will be required to apply variable accounting to these options and if the market price of the Company’s stock increases it will recognize additional compensation expense that it otherwise would not have incurred. However, the impact cannot be determined as it is dependent on the change in the market price of the stock from July 1, 2000 until the stock options are exercised, forfeited or expire unexercised.
Appendix: Stock Compensation Accounting Overview

The Interpretation provides guidance related to certain accounting issues in applying APB 25; therefore, it must be read in conjunction with the requirements of APB 25 in order to be fully understood. The Interpretation’s accounting guidance was developed within the intrinsic value framework of APB 25. This Appendix provides an overview of the general concepts of APB 25.

In certain situations, the Interpretation concludes that the transaction is not under APB 25 and instead, the fair value method of Statement 123 would apply as interpreted by Issue 96-18. Therefore, the Appendix also provides a brief overview of the Statement 123 and Issue 96-18.

APB 25 General Concepts

APB 25 was issued in 1972 and applies to stock compensation granted by an employer company to employees. When applying APB 25, compensation is measured based on “intrinsic value” (i.e., the excess of the market price of the stock over the exercise price on the measurement date). Under the intrinsic value method, compensation is determined on the measurement date, that is, the first date on which both the number of shares the employee is entitled to receive, and the exercise price, if any, are known. Compensation, if any, is generally recognized over the equity award’s vesting period. Compensation expense associated with awards that are immediately vested or attributable to past services is recognized when granted.

Measurement Date

The measurement date is the first date on which both (1) the number of shares that an individual employee is entitled to receive and (2) the stock option or purchase price (i.e., the exercise price), if any, are known. It is important to note that the measurement date is not changed from the grant or award date if the number of shares is reduced solely by the employee terminating employment. Therefore, for many arrangements, both the number of shares and the exercise price are known at the date of grant. When the measurement date occurs on the date of grant, the plan is a fixed plan because the compensation cost, if any, is determinable on that date, (i.e., “fixed”) and not subsequently adjusted.

However, when either the number of shares or exercise price or both are not known or depend on events after the date of grant, these arrangements are commonly referred to as variable plans. For example, the number of options that the employee ultimately receives may depend on the attainment of financial performance targets, such as earnings per share or sales. The accounting for variable plans generally requires that estimates of compensation expense be recorded and updated each accounting period until the measurement date. The final compensation expense is not determinable until both the number of shares and the per share price are known.
Fixed Plans

The defining characteristic of a fixed plan is that the terms (i.e., number of shares and exercise price) are fixed. In other words, at the date of grant or award both the number of shares of stock that may be acquired by or awarded to an employee and the cash, if any, to be paid by the employee are both known. The measurement date is the grant date for fixed stock options because the number of shares and price per share are known and “fixed” at that date. Compensation is measured by the difference between the quoted market price of the stock at the grant date and the price, if any, to be paid by an employee. When a fixed stock option is granted at a price equal to the quoted market price of the stock on the grant date (the typical situation), no compensation is recognized. In some cases, the exercise price of a stock option is set at a discount from the stock’s market price (i.e., a discount option), which results in compensation expense for the aggregate discount. Fixed compensation expense is typically recognized on a straight line basis over the service period.

Even though an award was accounted for as fixed on the grant date, a subsequent modification to the award could result in a new measurement date (e.g., the option’s term is extended from 10 years to 12 years).

Variable Plans

The characteristic that identifies variable plans is that either the number of shares of stock that may be acquired by or awarded to an employee or the price to be paid by the employee, or both are not determinable until after the grant date. The indeterminate factors usually depend on events that are not known or determinable at the grant date. When variable plan awards are granted, compensation is measured as the amount by which the quoted market price of the company’s stock exceeds the amount, if any, to be paid by an employee at the measurement date. However, with a variable plan, the measurement date is not the grant date. Therefore, changes (either increases or decreases but not below the exercise price) in the quoted market price of the stock between the grant date and the measurement date result in a change in the measure of compensation for the right or award.

With a variable plan, estimates of compensation expense are recorded before the measurement date based on the quoted market price of the stock at intervening dates. The estimated compensation may fluctuate because of changes in quoted market price of the stock. Therefore, the accounting for a variable plan requires the recomputation of estimated compensation expense until the measurement date. FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (“FIN 28”) discusses how to account for and measure compensation associated with variable plan awards. Compensation is recognized as expense over the period the employee performs related services.

A careful analysis of the specific terms of each individual award and stock compensation plan is necessary under APB 25 to determine whether it is variable or fixed. However, as a general rule, any features of a plan that could result in the exercise price or number of shares changing, either directly or indirectly, are indicators that the plan is variable.
Following are some of the more common provisions that can lead to the ultimate measurement date occurring subsequent to the grant date (i.e., the plan is either variable or a new measurement date results):

- An exercise price that changes based on time or performance-related criteria.
- A variable number of shares being issued upon option exercise, such as a greater number of shares if performance goals are met.
- Stock price targets whereby the award vests only if the stock price reaches certain levels.
- Cash bonuses paid at or around the time the award is exercised, such as “tax offset cash bonuses.”
- Certain stock repurchase arrangements with a public company such as “puts,” “calls” or similar arrangements. These arrangements effectively turn the award into a cash plan. Likewise, a repurchase of shares within six months of exercise also would result in delaying the measurement date.
- “Pyramiding” of shares/use of “immature” shares (held less than six months) to exercise options.
- Nonrecourse employer stock loans which do not meet certain specified criteria or for which there are “forgiveness” provisions.
- Extension of the length of the option period beyond that included in the original plan agreement, such as upon retirement or termination.
- Grants are subject to shareholder approval, but shareholder approval is uncertain.
- Shares used to settle withholdings taxes exceeding the minimum statutory withholding requirements.
- Accelerating vesting provisions to give an employee an award he or she otherwise would have lost.
- An award that pays an employee (in either cash or shares) the excess of the stock’s market price over a stated price on a given date (e.g., stock appreciation right).

Because of the complex and subjective judgments often required in accounting for stock compensation arrangements, and the negative consequences of unintentionally establishing a variable plan, new plans or amendments to existing plans (including provisions that affect stock option arrangements that are included in employment agreements) should be considered carefully prior to their implementation.
Statement 123 General Concepts

Companies have a choice whether to apply APB 25 or Statement 123 for accounting purposes in its financial statements. Companies electing to apply APB 25 (the vast majority) are required to provide disclosures in their footnotes of what net income and earnings per share would have been if the fair value provisions of Statement 123 had been applied.

Statement 123 establishes accounting and reporting standards for all stock-based compensation plans, including restricted stock, stock appreciation rights (payable in either cash or stock), and other stock-based plans. Statement 123 also encompasses the issuance of equity awards to nonemployee suppliers of goods and services, such as vendors and independent contractors.

Companies that decide to adopt the Statement 123 fair value method for accounting purposes will recognize compensation expense for virtually all equity awards based on their fair value on the date of grant. The fair value of options granted by public companies is estimated using complex option pricing models (e.g., the Black-Scholes or binomial models). Nonpublic companies are permitted to use a simpler method known as the “minimum value” method. Statement 123 requires that compensation expense related to equity instruments be recognized over the period in which the employees render the services associated with the award, which is presumed to be the vesting period. Compensation expense associated with awards that are immediately vested or attributable to past services is recognized when granted.

For example, a company grants 10,000 options to an employee with an exercise price of $10 per share (the then market price of the stock) that cliff vest at the end of year five. The company accounts for stock-based compensation under Statement 123’s fair value method. By using an option pricing model (which requires the input of several subjective input assumptions), the company estimates that the fair value of each option on the date of grant is $3. The option pricing model. The company would recognize $30,000 (10,000 options x $3 fair value) of compensation expense over the five year vesting period. Thus, $6,000 of compensation expense would be recognized in each of the next five years with a corresponding credit to equity (i.e., additional paid-in capital). Under APB 25, no compensation expense would have been recognized.

The detailed requirements of Statement 123 are contained in our Financial Reporting Developments booklet, Accounting and Disclosure of Stock-Based Compensation, (SCORE Retrieval File No. BB0517). We have also developed a software program, EY/Options 2.05, that can be used to estimate the value of most stock-based awards (SCORE Retrieval File No. BB0555).
Equity Awards to Nonemployees

As mentioned earlier, Statement 123 applies its fair value method to the issuance of equity awards not only to employees (where it is optional), but also to nonemployees (where applying Statement 123 is required) such as vendors, consultants, and independent contractors (i.e., these awards cannot be measured using the APB 25 intrinsic value approach). Under Statement 123, the fair value of equity awards to employees generally is measured at the date of grant. Statement 123, however, does not specify the measurement date to be used for awards to nonemployees. Therefore, the EITF addressed the measurement date issue and recognition approach for transactions in which equity instruments are issued to nonemployees in exchange for the receipt of goods or services provided by the nonemployee.

In 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 (Issue 96-18), the EITF reached a consensus that requires that the fair value of the equity instruments issued to a nonemployee be measured on the earlier of (1) the performance commitment date or (2) the date the services required under the arrangement have been completed. In other words, in order for the issuer of the equity instruments to “freeze” the measurement of the fair value of the equity instruments at the grant date, the transaction must contain either a performance commitment, or performance must already have occurred. Therefore, under many arrangements, unless properly structured, the measurement date to determine fair value may not be the date of grant.

For example, a company grants 10,000 options with an exercise price of $10 per share, its current market price to an engineering consultant. Because the individual is an independent contractor, the individual does not qualify as a common law employee. The options cliff vest at the end of year five and have a ten year life. The only penalty for nonperformance is that unvested options are canceled. Under Issue 96-18, the company would remeasure the fair value of the options until the options ultimately vest. Thus, expense ultimately recognized is based on the fair value of the options on the date the options vest, not on the date of grant. In a rising stock market, using the later date would result in a significantly higher expense. Assume the stock’s price has risen to $25 at the end of year five and the fair value of each option is $17 as of that date. At the end of year five, the company would have had to recognize aggregate compensation expense of $170,000 (10,000 options x $17 fair value) related to the award.

In summary, Issue 96-18 requires that companies continue to measure (and remeasure at each reporting date) an award’s fair value until performance is complete (that is, until the vesting date is reached) unless the option holder has an economic disincentive not to perform the service (for example, a termination penalty). The consensus is very complicated, fact-intensive, and often is difficult to apply. The EITF Abstract contains numerous examples and guidance regarding less common arrangements. In addition, the detailed requirements of Issue 96-18 are contained in our Accounting Release, 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 Service, (SCORE Retrieval File No. BB4115).