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Comment letter on Accounting for Certain Transactions involving Stock Compensation: an interpretation of APB Opinion No. 25

American Institute of Certified Public Accountants. Accounting Standards Executive Committee. Stock Compensation Task Force

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June 30, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
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P.O. Box 5116
Norwalk, Connecticut 06856-5116
File Reference No. 195-B

Accounting for Certain Transactions involving Stock Compensation: an interpretation of APB Opinion No. 25

Dear Mr. Lucas:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants and its Stock Compensation Task Force appreciate the opportunity to comment on the FASB's March 31, 1999 Exposure Draft of the proposed Interpretation, *Accounting for Certain Transactions involving Stock Compensation: an interpretation of APB Opinion No. 25* (ED).

AcSEC agrees that a need exists to interpret Opinion 25 to resolve certain long-standing practice issues and narrow diversity in practice. Accordingly, AcSEC supports issuance of a final FASB Interpretation. Our comments on the individual questions and answers in the ED follow.

Scope

Question 1—Does Opinion 25 apply to grantees who are independent contractors or other service providers who are not reported as employees of the grantor for payroll tax purposes?

Response

A plurality of AcSEC believes that the term *employee* should be defined to include any individual who is affiliated with an employer on a long-term basis and who performs essentially the same function as an employee, regardless of whether the individual is designated as an employee for payroll tax purposes. These AcSEC members believe that evolving trends in the workplace—outsourcing, temporary employment, telecommuting, etc.—will render the common law approach obsolete. In addition, these members of AcSEC believe that the common law approach will be difficult to implement in practice. The common law definition is not clear, as demonstrated by some lengthy court cases and by decisions in different Federal Court Circuits that have applied the common law definition differently. Members who have direct experience with the common law definition of *employee* through its application for income tax purposes believe that the common law definition is not clear and that an entity does not know for sure who is an employee for income tax

purposes until the completion of an Internal Revenue Service audit years after the fact. Nevertheless, a significant minority of AcSEC supports the FASB in its proposal to use the common law definition of *employee* as proposed by the ED. They believe this approach will achieve greater consistency in practice than the approach proposed by the plurality. These AcSEC members believe that legal opinions assessing whether an individual (or group of individuals) meets the common law definition of *employee* will be a practical way for preparers and auditors to distinguish employees and nonemployees.

Question 2—Does Opinion 25 apply to stock options or awards granted to independent members of an entity's board of directors?

Response

AcSEC disagrees with the proposed interpretation and believes that Opinion 25 should continue to be applied to stock options or awards granted to a member of the board of directors. AcSEC believes that the FASB should make a practical exception from the definition of employee to allow continued use of Opinion 25 for independent directors. A director ordinarily serves for an extended period and has a unique standing with respect to a company, performing a function that is between that performed by an employee and that performed by an independent contractor. AcSEC believes that continued use of Opinion 25 is a reasonable position, and AcSEC is unaware of any diversity in practice that would warrant this change in guidance. Options to directors existed at the time Opinion 25 was issued, and therefore AcSEC believes that the Accounting Principles Board (APB) could have, but did not, exclude directors.

If the FASB does not change this proposed interpretation, then AcSEC believes the compensation expense for options granted to directors should be measured at grant date in accordance with FASB Statement No. 123, *Accounting for Stock-Based Compensation*, rather than at vesting date as required by 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*, for options that vest based on continued performance. EITF Issue No. 96-18 was intended to apply to outside service providers and vendors, not to individuals who have a relationship with the grantor that is similar to a standard employee relationship. EITF Issue No. 96-18's approach of keeping the measurement date open until vesting is complete is inappropriate where the recipient functions similar to an employee, as does a director. Accordingly, AcSEC recommends that the FASB work with the EITF to revise the scope of EITF Issue No. 96-18 so that it does not apply to awards to independent directors.[1]

Question 3—How does Opinion 25 apply if an individual meets the definition of *employee* under common law for the same set of services provided to more than one unaffiliated entity under a lease or co-employment agreement?

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[1] AcSEC notes, and the FASB should clarify, that EITF Issue No. 96-18 would continue to apply to options granted to directors for services other than service as director, for example, debt guarantees or investment banking services.

Response

AcSEC disagrees with proposed interpretation. AcSEC members have differing reasons for this disagreement, depending on their views on the issues raised in Question 1. Those AcSEC members who believe the term *employee* should be defined based on the nature of the services provided would make the lessee the employer, because the individual provides service to the lessee and the lessee directs the individual's duties. Those AcSEC members who believe *employee* should be defined based on the common law definition also disagree with the FASB interpretation of this question for the following two reasons:

a. If both lessor and lessee are employers under common law (dual employment), which is not an unlikely occurrence under the application of the common law guidance, then both should be employers eligible to apply Opinion 25 for accounting purposes.
b. If a single employer presumption is adopted, then the FASB's presumption as to which party is the employer is incorrect. Members supporting this view believe the lessee should be presumed to be the employer, because the individual provides service to the lessee and the lessee directs the actions of the employee.

If the FASB continues to support a single employer presumption, with the lessor as the employer, then it should provide guidance on what factors would overcome the presumption.

Question 4—Does Opinion 25 apply to grants or awards of stock of an entity other than the one for which the employee directly provides services?

Response

AcSEC agrees that the grantor should apply Opinion 25 when the grantee is an employee of a consolidated subsidiary. However, AcSEC suggests that the interpretation should be broadened to recognize current practice of applying Opinion 25 in consolidated financial statements to stock options or awards granted by any member of the consolidated group to any employee of the consolidated group, for example, when the grantee is employed by the grantor's parent company or a sister subsidiary. Employment within a consolidated group often is a matter of convenience. Individual employees may render services to several different companies within the group. Furthermore, grants of shares or options in one consolidated entity to employees of another consolidated entity typically are directed by the parent entity.

AcSEC recommends that options granted to employees of entities excluded from the scope of Opinion 25, such as employees of (i) majority-owned entities not consolidated because of minority owner veto rights, (ii) joint ventures, or (iii) equity method investees, should be excluded from the scope of EITF Issue No. 96-18. AcSEC believes options to such employees should be accounted for in accordance with FASB Statement No. 123 (grant date measurement) rather than EITF Issue No. 96-18 (vesting date measurement), because the relationship between the grantor and the employee of the unconsolidated entity is more akin to the typical employer-employee relationship than it is to the relationships between a company and an independent service provider contemplated by the EITF. Accordingly, AcSEC recommends that the FASB work with the EITF to revise the

scope of EITF Issue No. 96-18 so that it does not apply to awards to employees of nonconsolidated affiliates.

Question 5—Does Opinion 25 apply to transactions that involve stock of a parent company issued to an employee of a consolidated subsidiary for purposes of reporting the separate financial statements of that subsidiary?

Response

AcSEC agrees with the proposed interpretation. However, AcSEC suggests that this interpretation should be broadened. AcSEC believes that Opinion 25 should apply to stock options or awards granted by any member of the consolidated group to any employee of the consolidated group, in the separate financial statements of the employer entity as well as in the consolidated financial statements. Employment within a consolidated group often is a matter of convenience. Individual employees may render services to several different companies within the group. Furthermore, grants of shares or options in one consolidated entity to employees of another consolidated entity typically are directed by the parent entity.

Question 6—How should Opinion 25 be applied to a nonvested stock option or award when the grantee (who continues to provide services) changes status to or from an employee?

Response

The proposed interpretation covers two different sets of transactions—(1) transfers of individual employees from one entity to another or from one status to another and (2) transactions that change the grantor's level of ownership of the grantee's employer. AcSEC believes these two types of transactions are fundamentally different and disagrees with the proposed interpretation as it applies to both types.

For the first type of transaction, AcSEC believes that, if the original terms of an option grant permit an employee to retain unvested options if the employee renders service in another capacity (as an employee of a nonconsolidated entity or as a nonemployee), compensation should not be remeasured if the terms of the option are not changed. If the original option by its terms is forfeited upon termination of employment with the first employer, then a retained option should be accounted for as a new grant. Also, options granted to an employee in contemplation of an imminent change in status should be accounted for as grants to a nonemployee.

For the second type of transaction, AcSEC believes that compensation should not be remeasured if the option terms are not changed. If the option terms are changed, then a new measurement of compensation should occur, unless the transaction is within the scope of EITF Issue No. 90-9, *Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*, and that consensus provides that a new measurement date does not occur.

AcSEC believes that EITF Issue No. 90-9 should be retained for transactions within its scope (principally, alterations of options in conjunction with spinoffs). It is unclear what effect, if any,

the proposed interpretation would have on EITF Issue No. 90-9. If the FASB does not accept AcSEC's recommendation to retain EITF Issue No. 90-9, then the final Interpretation should explain the status and applicability of EITF Issue No. 90-9.

Noncompensatory Plans

Question 7—Paragraph 7(d) of Opinion 25 provides as one criterion for determining whether a plan is noncompensatory that "the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others." Does a purchase discount of up to 15 percent meet that criterion?

Response

AcSEC agrees with the proposed interpretation. The FASB proposal is consistent with uniform interpretations in practice.

AcSEC believes the FASB should provide guidance on what constitutes a "reasonable period" of time for exercise of options. Issues are arising in practice as international companies implement stock purchase plans for employees outside the United States.

Question 8—In determining whether a plan is noncompensatory, can the stock price at the date of grant of a stock option be used as the basis for determining whether "the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others" (paragraph 7(d) of Opinion 25)?

Response

AcSEC agrees with the proposed interpretation. The FASB proposal is consistent with uniform interpretations in practice.

Question 9—Can a plan with a *look-back option* qualify as a noncompensatory plan?

Response

AcSEC agrees with the proposed interpretation. The FASB proposal is consistent with uniform interpretations in practice.

New Measurement Date

Question 10—When is a new measurement date required for a modification to the terms of a (fixed) stock option or award other than those terms that are specifically addressed in Opinion 25?

Response

AcSEC believes that clarification needs to be made to the proposed interpretation to this question and believes that the FASB needs to address the following questions:

a. How are changes in fair value measured? AcSEC believes that fair values should be measured using the model in FASB Statement No. 123. However, if the FASB Statement No. 123 model is used, many possible changes in option terms would have no effect on estimated fair value, and the terms that would (exercise price or number of shares) already are dealt with separately in the ED. If the Statement 123 model is used to estimate fair value before and after a change, the FASB should specify what types of changes it has in mind for this general interpretation. For example, would a relaxation of sequential exercise requirements create a more than *de minimis* increase in fair value? If some other model is used to measure fair value, the FASB needs to explain what it is and also explain the rationale for requiring a model different from that adopted in FASB Statement No. 123.
b. Whose perspective is *de minimis* judged from, the employee or the employer? AcSEC believes that it should be the employee. Stated differently, we believe the FASB needs to be clear that significance is measured relative to the value of the option rather than relative to the employer's financial statements.
c. How does the proposed interpretation interact with paragraph 11(d) of Opinion 25? Does a lengthening of the option term always result in a new measurement date, or only if the lengthening results in more than a *de minimis* increase in the option's fair value? For a deep-in-the-money option, even a significant lengthening may cause only a *de minimis* increase in the option's fair value. AcSEC believes the interpretation should not change the longstanding interpretation of paragraph 11(d) that any lengthening (other than those covered by EITF Issue No. 87-6A, *Adjustments Related to Stock Compensation Plans*) triggers a new measurement date.
d. How should a contingent lengthening of term be treated? For example, the employer changes the option expiration from (a) the shorter of 10 years from grant or 90 days after termination of employment to (b) the shorter of 10 years from grant or 12 months after termination of employment. AcSEC believes that such a change currently is treated in practice as a lengthening of term and as a new measurement date.

Question 11—Is a new measurement date required for an acceleration of the vesting date of a stock option or award?

Response

AcSEC generally agrees with the approach that a modification to an existing plan that accelerates vesting and prevents an award from being forfeited results in more than a *de minimis* increase in the fair value of the option or award. AcSEC also agrees that accelerated vesting for a continuing employee who is not expected to forfeit does not result in a more than *de minimis* increase in the fair value of the option or award. AcSEC believes that it would be desirable for the final Interpretation to explain that accelerating (shortening) vesting for a continuing employee has no effect on the estimated fair value of an option, because vesting is not one of the six factors

considered in the Black-Scholes or binomial option pricing models (unless accelerated vesting would affect the option term by permitting an employee to exercise an option that would otherwise be cancelled before becoming vested). Further, if accelerating vesting for a continuing employee results in an earlier expected exercise date, the estimated fair value of the option might actually decrease.

However, AcSEC disagrees with the discussion in paragraph 27 regarding vesting that accelerates if a future event occurs. AcSEC believes that the assessment of whether the change results in more than a *de minimis* increase in the fair value of the option or award should be made at the date of the amendment, not at the date the event occurs. Requiring the assessment to be done as of the date the vesting accelerates under the modified terms, as proposed in paragraph 27, will effectively result in a new measurement date for any unvested option or award that is accelerated because of the occurrence of the future event and that is held by an employee whose employment terminates at that time. This provision will result in the grantor recognizing compensation expense even when the circumstances that result in the acceleration were remote possibilities at the date of the modification and hence resulted in no more than a *de minimis* increase in the fair value of the option or award at that date. This requirement is also inconsistent with the approach the Interpretation proposes for other changes (e.g., measuring the impact of the modification on the fair value of the option or award on the date of the change).

Question 12—How should compensation cost be recognized and measured if a new measurement date is required for a modification to the terms or the cancellation and reissuance of a (fixed) stock option or award?

Response

AcSEC agrees with paragraph 29(c), but disagrees with paragraph 29(b). If a new measurement date is required, compensation should be recorded to the extent that the intrinsic value of the new award exceeds the intrinsic value of the original award *on the original measurement date.*

If an employer cancels an option and issues a different type of award, such as restricted stock, then the employer has changed *both* the amount the employee must pay (to zero) and the number of shares the employee is entitled to receive. In effect, the employer has either (a) permitted the employee to pyramid immature shares or (b) turned the option into a share-settled stock appreciation right, either of which requires a new measurement of compensation. Under Opinion 25, two different awards can have identical intrinsic values but very different accounting (for example, a conventional stock option and a stock appreciation right settled in shares). Therefore, a modification may require a new measurement date even though the intrinsic value does not change. AcSEC believes that the transaction discussed in paragraph 29(b) would be treated in practice today as a new measurement date, with compensation expense equal to the intrinsic value of the award at the modification date in excess of compensation expense (if any) previously accrued for the original award. AcSEC recommends deleting paragraph 29(b).

If in spite of these comments the FASB retains paragraph 29(b), then AcSEC recommends that the FASB address the interaction of paragraph 29(b) with Question 14. Is the replacement of a stock

option with restricted stock a repricing (to an exercise price of zero)? If so, does this transaction result in variable accounting? If the FASB believes the transaction is not a repricing, then it should explain why. Also, the FASB should provide further guidance as to what constitutes a "different type of award" pursuant to paragraph 29(b). Because the amount of expense to be recognized under paragraph 29(b) typically would be less than under paragraph 29(c), companies may have an accounting incentive to issue a different type of award rather than modify an existing award. How different does the award need to be?

Question 13—How should compensation cost be recognized and measured if cash is paid to settle an earlier grant of a stock option or award or to repurchase shares shortly after option exercise or issuance?

Response

AcSEC believes the intent of this interpretation is to resolve the inconsistency between EITF Issue Nos. 87-33, *Stock Compensation Issues Related to Market Decline*, and 94-6, *Accounting for the Buyout of Compensatory Stock Options*, by requiring that all of the originally measured compensation be charged to expense at the time of a buyout. AcSEC agrees with that intent. However, AcSEC believes that the answer is worded incorrectly and will fail to achieve the FASB's objective. AcSEC believes the interpretation should be reworded to require total compensation equal to:

a. The originally measured compensation cost of the award (if any).
b. The award's intrinsic value at the buyout date in excess of a.
c. The amount paid for the award in excess of the intrinsic value at the buyout date.

For example, assume that the employer initially granted 100 shares of restricted stock with a fair value of $10 per share, or $1,000 total. The employer has amortized $600 of the compensation to expense, and the stock is now worth $2 per share, or $200 total. The employer now settles the restricted stock award by paying the employee $9 per share, or $900 total. The interpretation as drafted would require the employer to record the remaining $400 of the originally measured compensation cost as expense. No additional compensation expense would be recorded for the $900 cash payment, because it is less than the originally measured $1,000 of intrinsic value. AcSEC believes that, in addition to recording the remaining $400, the employer also should charge to expense $700, representing the excess of the cash payment over the intrinsic value at the buyout date.

Variable Awards

Question 14—Does a change to the exercise price or number of shares to be issued under a stock option grant that originally qualified as a fixed award create a variable award?

Response

AcSEC agrees with the proposed interpretation, but believes that the FASB needs to provide additional implementation guidance. AcSEC believes that EITF Issue No. 87-33 has been extended

in practice beyond the specific limited circumstance for which it was issued, and that the FASB's proposed answer is appropriate in the Opinion 25 framework.

AcSEC recommends that the FASB clarify the interaction of this interpretation with EITF Issue No. 90-9. If a company adjusts option exercise prices in conjunction with a spinoff, and fails to meet the three tests in the consensus on EITF Issue No. 90-9, is the result a one-time new measurement of compensation or a variable award? AcSEC believes that the result should be a one-time new measurement date, not a repricing leading to variable accounting, unless the facts and circumstances indicate that the adjustment of the exercise price or number of shares includes an adjustment that is unrelated to the spinoff transaction.

AcSEC believes the proposed interpretation should also address the following questions:

- If an employer reprices options and independently, at a later date, spins off a subsidiary, does the spun off entity inherit variable accounting for options held by employees of the spun off entity?

- When is a transaction considered a cancellation and reissuance?
  a. If the new option has terms significantly different from the cancelled award? (For example, the new award has different vesting terms or an acceleration feature.)
  b. If the employer cancels existing options in, say, January and then makes new grants in April, where the employer has a history of granting options in April every year and the current grants are similar in size to prior annual grants?
  c. If the employer cancels an option and represents to the employee that it will grant new options six months and one day later?
  d. If the employer grants new options with a lower exercise price and subsequently cancels the old options with higher exercise prices?
  e. If the employer cancels stock options and grants restricted stock (see the comments on Question 12)?
  f. If the employer quadruples the exercise price on existing options and simultaneously grants new options with an exercise price equal to the current, lower market price? The existing options whose exercise price was increased are variable awards prospectively, but what about the new options? Would the issuance of these new options be considered an effective repricing?

Question 15—Is variable-award accounting required for a stock option or award with a share repurchase feature (for example, a put, a call, or right of first refusal)?

<u>Response</u>

AcSEC agrees with the proposed interpretation with respect to puts, calls, and rights of first refusal. Where the plan does not specify when shares can or will be repurchased, AcSEC believes that the accounting should differ depending on which party has the right to require repurchase under the plan. If the employee has the right to require the employer to repurchase the shares (a put), then a

plan that is silent would effectively permit repurchase within six months. This type of plan should be considered variable. Conversely, if the employer has the right to repurchase shares (a call or right of first refusal), then AcSEC believes that the expected repurchase date, and the employer's accounting, should be based on the substantive plan demonstrated by the employer's actions.

AcSEC agrees with the proposed interpretation with respect to tax withholdings, but has the following specific comments.

a. Paragraph 41 provides that a plan that permits withholding of shares in excess of the minimum number required for tax withholding establishes an expectation that additional shares will be withheld and requires that the plan be accounted for as a variable plan. AcSEC believes that the accounting should be based on what the employer actually does, rather than what the plan permits. Thus, whether the plan specifically permits excess withholding or is silent, AcSEC believes that the accounting should be based on the substantive plan as demonstrated by the employer's actions. This is similar to existing practice for plans that permit stock option pyramiding. Variable plan accounting is not required because of the mere existence of such a provision, but instead is governed by past practice and the substantive terms of the plan.

b. Many plans limit the maximum number of shares withheld to the tax liability computed at the employee's marginal income tax rate. If the employee's marginal income tax rate is 40%, then not more than 40% of the shares would ever be withheld, no matter how high the employer's stock price rises. In those cases, AcSEC believes that variable accounting should be required only to the extent of the maximum number of shares that could be withheld, not the entire grant.

c. Some employers permit employees to tender already-owned mature shares to cover withholding taxes in excess of the minimum (similar to the phantom pyramiding discussed in EITF Issue No. 87-6D). AcSEC believes that variable accounting should not be required if the excess withholding is covered by mature shares that the employee tenders.

Business Combinations

Question 16—Does an exchange of (fixed) stock options in a pooling of interests require a new measurement date?

<u>Response</u>

AcSEC agrees with paragraph 43 of the proposed interpretation but disagrees with paragraph 44. AcSEC believes the changes covered by paragraph 44 and specified in paragraph 71 are alterations of equity interests that preclude accounting for the business combination as a pooling of interests. AcSEC recommends that paragraphs 44 and 71 be rewritten to refer only to technical amendments that conform the administrative details of the combining company's options to the issuing company's options (for example, changes in notice requirements, form of acceptable consideration, employer loan provisions, etc.).

Question 17—Should an exchange of stock options in a purchase business combination be accounted for under Opinion 25 or included as part of the consideration paid for the acquiree under

APB Opinion No. 16, *Business Combinations*? If any part of the exchange is accounted for under Opinion 25, when is a new measurement date required for the exchange of a (fixed) stock option?

Response

AcSEC agrees with the proposed interpretation as it pertains to vested options. However, AcSEC disagrees with the proposed interpretation with respect to accounting for the exchange of nonvested options. AcSEC believes that nonvested options issued in exchange for options of the target company should be measured at fair value. The fair value of the nonvested options issued in exchange should be recorded as purchase cost unless the terms of the nonvested options are altered to increase their intrinsic value. If they are so altered, then an amount equal to the increase in intrinsic value should be recorded as compensation cost over the employee service period, and the remainder of the fair value should be recorded as purchase cost.

AcSEC believes that an acquiring company that issues nonvested options to replace nonvested options of the target company has issued more consideration than if it had not replaced the nonvested options of the target company. The FASB's approach fails to give accounting recognition to a potentially significant component of consideration. Although nonvested options are still subject to risk of forfeiture, they represent an equity interest and are treated for accounting purposes as earned over their vesting period.

AcSEC disagrees with the FASB's proposal that the acquirer record compensation cost equal to the unamortized compensation recorded by the target company. Purchase accounting is a fresh start approach. All accounting deferrals of the target company are eliminated. AcSEC sees no basis to single out deferred compensation on equity plans as the lone deferred charge of a target company to be recorded by the acquiring company.

AcSEC notes that the result of the FASB approach is paradoxical. The closer an option is to being vested, the less cost the acquiring company will record. But if the option is vested, the acquiring company will record the full fair value of the option as purchase cost.

AcSEC also believes that the approach proposed by the FASB is unclear and potentially creates opportunities for abuse:

a. Employees holding vested options of the target company could accept nonvested options in exchange. Some believe that under the proposed interpretation the acquiring company would record neither the purchase cost that otherwise would have been recorded if the acquiring company had issued replacement vested options nor compensation cost (because the target company would have no unamortized compensation from vested options). That result also is inconsistent with the consensus in EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*, which indicates that contingent payments to individuals should be recorded either as purchase cost or as compensation. Nonrecognition is not an acceptable alternative in EITF Issue No. 95-8.

b. A target company may grant at-the-money nonvested options shortly before initiation of a business combination. The premium offered by the acquiring company might result in those options being in the money at the measurement date for the purchase business combination. If the acquiring company grants identical replacement nonvested options, then it would record neither purchase cost nor compensation cost.

c. An acquiring company would like to issue vested options in exchange for nonvested options of the target company. If they do so, the fair value of the vested options would be included in purchase cost. If the acquiring company instead issues nonvested options in exchange for nonvested options of the target company, then the acquiring company need only reflect the unamortized deferred compensation of the target company. If the acquiring company then accelerates vesting shortly after consummation of the merger, they would accelerate the amortization of the deferred compensation and record a one-time charge to compensation expense.

In addition, AcSEC notes that the accounting set forth in Example 6 does not reflect the proposed interpretation of Question 17 and is inconsistent with the example published on the FASB web site in December 1998.

AcSEC recommends that the FASB expand this question and answer to address another stock compensation issue that arises in purchase accounting. Assume that a parent company makes a cash tender offer for all of the outstanding minority interest in a majority-owned subsidiary. The parent company also pays cash for all of the outstanding options issued by the subsidiary to employees. Is the cash paid to the employees a cash settlement of options to be charged to compensation expense in accordance with Opinion 25 or purchase consideration to be accounted for in accordance with Opinion 16? The existing literature is not clear, and AcSEC believes that diversity in practice may exist.

Other Issues

Grant Date

Question 18—If a plan is subject to shareholder approval, should the grant date ever be deemed to occur prior to obtaining that approval?

<u>Response</u>

AcSEC agrees with the proposed interpretation but provides the following comments and implementation issues:

a. The FASB should provide a bright line test for this interpretation. Are there any other examples of situations that make shareholder approval a formality? Can the directors obtain irrevocable proxies from shareholders that would, combined with their own holdings, representing a majority? If there are no other examples, the words "for example" should be deleted.

b. Do management and the directors need to have a majority of the votes based on voting shares outstanding, or just a majority of the votes likely to be cast at the shareholders' meeting (based on the February 23, 1999 Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*)?

c. What happens if management and the directors have a majority of the votes at the time the options are granted, but lose that majority before the shareholders' meeting?

Deferred Tax Assets

Question 19—Should the carrying amount of a deferred tax asset recognized for a temporary difference related to a stock-based award accounted for under Opinion 25 be adjusted for a subsequent decline in the stock price?

Response

AcSEC agrees with the proposed interpretation.

Cash Bonus Plan Linked to a Stock-Based Plan

Question 20—Should a cash bonus associated with the grant of a stock option or award be accounted for as a combined variable award?

Response

If the cash bonus is contingent on the exercise of the option, then AcSEC agrees that the bonus and the option should be viewed as a single award for accounting purposes. However, that single award is not necessarily a variable plan. For example, assume that an employer grants 100 options with an exercise price of $10 per share and also grants a cash bonus of $400 contingent only on exercise of the options. In substance, the employer has granted 100 options with an exercise price of $6 per share. The cash bonus would be included in measuring compensation on the award, but the bonus does not make the award variable. By contrast, if the amount of the cash bonus might vary, then the single award would be a variable plan.

If the cash bonus is contingent on the vesting of the option, then AcSEC sees no reason to link the accounting for the bonus and the option. Once the cash bonus vests, the employee can use the cash however he or she wishes and need not ever exercise the option. In some instances, the option might vest but expire unexercised.

Effective Date

Response

AcSEC disagrees with the proposed effective dates and recommends that the Interpretation be effective only for options or awards granted or modified after the issuance of the final Interpretation. AcSEC believes that there are many areas where the proposed Interpretation is unclear, subject to varying interpretations, or inconsistent with past practice. The FASB has put preparers and auditors in the awkward position of trying to determine the accounting for transactions since December 15, 1998, under proposed interpretations that often are not clear and that may or may not be adopted in final form. The FASB generally makes Interpretations effective upon issuance, and AcSEC sees no compelling reason to make the transition partially retroactive here.

Some Board members have observed that retroactive application is appropriate because the FASB is merely interpreting existing standards, rather than changing them. However, in several instances (for example, questions 2 and 14), the FASB is proposing an interpretation that varies from past practice. Thus, regardless of the label "interpretation," these are substantively changes to Opinion 25 as it has been understood and applied in practice. AcSEC believes that the issues in this proposed Interpretation do not justify this unusual transition approach.

Representatives of AcSEC would be pleased to discuss these comments with the Board or its representatives.

Sincerely,

David B. Kaplan
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Accounting Standards
Executive Committee

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Stock Compensation Task Force