

Stock Compensation

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Stock Compensation

Some Stock Compensation Basics

- For financial reporting purposes — two categories of plans
 - Fixed: Compensation cost does not fluctuate with stock price 
 - Variable: Compensation costs fluctuate with change in stock price 
- Measurement Date — first date on which number of shares and exercise price is known

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Some Stock Compensation Basics

Intrinsic Value — difference between option price and FMV (spread)

Fair Value — what a third party would pay for option considering intrinsic value, volatility, term, and risk free interest rates

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Intrinsic Value (APB 25)



Employees

FV of common stock at measurement date = \$1.00

Exercise price = \$.50

Intrinsic value = \$.50

Fair Value (SFAS 123)



Non Employees

FV of common stock at measurement date = \$1.00

Exercise price = \$.50

FV = \$.75

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Grant Date

- Grant date cannot occur prior to shareholder approval of plan
 - Unless management controls enough votes to approve the plan
- Grant date cannot occur prior to new employee start date
- EITF Issue 00-23, Issue 5 – if shareholder approval voluntarily sought

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EXAMPLE

February 15 – Employee offered 1,000 options at \$12 (stock price = \$12)

March 1 – Employee accepts offer (stock price = \$14)

April 15 – Employee starts work (stock price = \$17)

How much, if any, compensation cost would be recorded for this award?

a. \$0

b. \$2,000

c. \$5,000

d. \$12,000

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Plan or Award Modifications — Key Questions

- When does a new measurement date occur?
- If a new measurement date exists, how should compensation cost be determined?
- Does the modification result in variable plan accounting?

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FASB Interpretation No. 44 (FIN 44)

- Clarifies APB No. 25 with respect to:
 - Repricings
 - Other modifications to awards
 - Definition of an employee
 - Exchanges of stock compensation awards in a business combination
- Effective 7/1/00 with certain provisions effective 12/15/98

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Repricings

- If exercise price is reduced, award shall be accounted for as variable from the date of the modification to the date the award is exercised, forfeited, or expires unexercised
- Repricings may be direct or indirect

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FIN 44 — Examples of Indirect Repricings

- Canceling or settling an existing award and granting replacement at lower exercise price (6-month window)
- Modifying terms of existing award to reduce likelihood of exercise
- Cash bonus upon exercise
- Increasing number of shares under an existing award

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FIN 44 — Examples of Indirect Repricings

- Granting new award with agreement to cancel old one later (6-month window does not apply)
- Allowing exercise with full recourse loan with below market interest rate
- Paragraph 131 — “If it walks like a duck ...”





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FIN 44 — Repricings: Some Ideas

- Cancel “underwater” options with agreement to issue replacement options 6 months and 1 day later at FMV



No compensation charge if new option structured properly



Cannot guarantee or specify strike price of new award



Employee “at risk” for market fluctuation over 6 months



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FIN 44 — Repricings: Some Ideas

- Issue restricted stock in settlement of “underwater” option



Fixes compensation cost at FMV of restricted stock



Cost recognized as restrictions lapse



Personal tax implications



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FIN 44 — Repricings: Some Ideas

- Issue new option that expires 6 months and 1 day after market price recovers to strike price on “underwater” option



Employee gets something “new”



No compensation expense if ...



Company at risk of double dilution for 6 months

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FIN 44 — Accelerated Vesting of Options

- Creates a new measurement date
 - New intrinsic value in excess of original is recognized as an expense
 - For group of employees, expense is calculated using an expected turnover rate
 - Acceleration of vesting upon termination results in immediate compensation charge
-  Acceleration of vesting of “underwater” option does not result in compensation charge

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FIN 44 — Definition of Employee

- Look to IRS Ruling 87-41 (payroll tax purposes)
- Exception to non-employee member of Board of Directors for role as director
- Exception does not extend to advisory board members
- Must track changes in status

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FIN 44 — Definition of Employee

- For consolidated financial statements — intercompany options qualify under APB 25
- For separate financial statements of subsidiary
 - APB 25 applies to parent company stock granted to subsidiary employees
 - FAS 123 applies to subsidiary stock granted to parent or sister company

Grant options to parent company executives from parent company holdings of sub stock rather than directly from sub



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FIN 44 — Business Combinations: Purchase Method

Should an exchange of employee stock options be treated as compensation expense or purchase price?

Vested Options — Fair value of options treated as purchase price

Unvested Options — Fair value of options considered purchase price after allocation of pro-rata intrinsic value to deferred compensation

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FIN 44 — Business Combinations

Pooling-of-Interests

- No compensation expense if:
 - Aggregate intrinsic value of awards does not increase
 - Ratio of exercise price to market value is not reduced
- Other modifications to the terms of outstanding awards would generally preclude pooling

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Other Matters



Use accelerated cost recognition model of AIN 28 for fixed plans (required for variable)

- Recourse vs. non-recourse loans
- Share repurchase features
- Payroll taxes on NQSOs