

Stock Compensation

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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





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





Intrinsic Value (APB 25)







Employees

Non Employees

FV of common stock at measurement date

= \$1.00

FV of common stock at measurement

date

= \$1.00

Exercise price = \$.50

Exercise price

= \$.50

Intrinsic value = \$.50

FV

\$.75



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





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





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?





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





Repricings

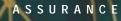
- If exercise price is reduced, award shall be accounted for as variable from the date of the modification to the date the award is exercised, forfeited, or expires unexercised
- Repricings may be direct or indirect





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





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 …"









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







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







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





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





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 <u>not</u> extend to advisory board members
- Must track changes in status





FIN 44 — Definition of Employee

- For <u>consolidated</u> financial statements intercompany options qualify under APB 25
- For <u>separate</u> 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



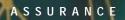


FIN 44 — Business Combinations: Purchase Method

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

Vested Options — <u>Fair value</u> 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





Stock Compensation

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





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

