



SEC Staff Publishes Guidance On Accounting For Option Awards

On September 19, 2006, the staff of the Securities and Exchange Commission's Office of Chief Accountant (the "Staff") publicly released a letter to the accounting community intended to advise issuers who, in light of the ongoing scrutiny of stock option award practices, may be examining their past practices related to stock option grants. (See www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm.) As is customary, the Staff pointed out that its guidance in this letter has not been approved by the Securities and Exchange Commission ("SEC").

The letter provides guidance on accounting for outstanding option awards made pursuant to Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). The guidance addresses accounting issues and is not directed at disclosures outside financial statements or legal or regulatory questions. Although APB 25 has been superseded by Financial Accounting Standards Board Statement No. 123 (Revised), "Share-Based Payment" ("FASB 123R"), which became effective for calendar-year public companies for their first quarterly period beginning in 2006, APB 25's principles may remain applicable, in most cases, to options granted before the effectiveness of FASB 123R.

A central introductory focus of the letter is the importance of identifying the correct "measurement date" in order to appropriately account for the compensation cost to the issuer of option awards made to the issuer's employees. In this regard, the Staff made the following points:

- Under APB 25, the compensation cost of an option award should be calculated as the difference between the exercise price of the option and the market price of the underlying stock at the "measurement date."
- The "measurement date" is the first date on which both of the following "key terms" are determined "with finality": (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Thus, the measurement date may differ from the deemed grant date under the related option plan documents.

SEPTEMBER 2006

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- Dating the underlying option award documents “as of” a date prior to the date on which the key terms are determined “with finality” does not affect the appropriate measurement date.
- Whether the key terms of an option award have been determined “with finality” generally depends on whether (under the organizational documents of the issuer, the option plan documents, and applicable law) the issuer has taken all required granting actions for making the grant.
 - If the issuer’s particular facts, circumstances, and pattern of conduct make clear that it considered the terms and recipients of the awards to be fixed and unchangeable at a date prior to the completion of all required granting actions, it may be appropriate to conclude that the key terms (and, therefore, the measurement date) occurred prior to the completion of those actions.
 - There must be consistency to the issuer’s practices and patterns of conduct. The Staff cautions that if an issuer retracts awards or changes their terms (or engages in other conduct as if the terms of its awards were not final) prior to the

completion of one or more required granting actions, then the measurement date for all of its awards, including those awards that were not changed, ought to be delayed until the completion of the required granting actions.

The Staff highlighted the following five situations that could raise thorny issues for issuers in determining an appropriate measurement date:

1. *Invalidity of Prior Awards.* Even where the validity of past option awards is in doubt (e.g., because a shareholder-approved option plan only permitted at-the-money awards, but the issuer authorized an in-the-money award), the Staff believes it is nonetheless appropriate to account for the awards using a measurement date on the date that the key terms were determined “with finality”; provided that (1) the issuer and the affected employees honor and comply with the terms of the options and (2) all other conditions for the establishment of a measurement date have been satisfied.
 - The Staff does not believe that legal analysis or advice (including a legal opinion) regarding the validity of the option award is necessarily required in order to reach these accounting conclusions.

2. *Uncertainty Regarding Award Recipients.* The measurement date of option awards cannot be determined before allocations to individual recipients, or at least to categories of recipients (e.g., all employees of certain levels within the issuer’s organization), have been determined.

- If an award-date list of recipients and their awards was subsequently revised, the issuer should conclude that either (1) the list that was prepared on the award approval date did not constitute a grant, in which case the measurement date for the entire award would be delayed until a final list has been determined, or (2) the list that was prepared on the award approval date constituted a grant, in which case any subsequent changes could constitute a modification (such as a repricing) or cancellation.
 - If the issuer determines that a repricing occurred, variable accounting should be applied to the option award from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

3. Option Price Set by Formula.

Generally, if the terms of the option award set the award's exercise price based on the occurrence of a specified future event or condition, then (1) variable accounting would be required from the award approval date until that uncertainty is resolved and (2) a measurement date would occur (and variable accounting would cease) on the date the contingency is resolved.

4. Awards Before Employment Date.

The Staff confirmed that the measurement date for an award cannot occur before the award recipient commences employment for the issuer. Accordingly, the measurement date for awards made prior to employment would generally be the date of the commencement of the award recipient's employment.

- The Staff pointed out that where options were awarded to individuals who rendered services to the company prior to the commencement of employment, the provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation," and 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," instead of APB 25, should be applied.

- 5. Unavailable or Unreliable Award Documents.** The Staff does not believe that the unavailability or unreliability of award documentation, which could cause uncertainty regarding when the key terms were determined "with finality," should necessarily result in a "default" to variable accounting or to treating the awards as if they had never been awarded. Instead, the Staff urges an issuer facing such circumstances to "*use all available relevant information* to form a reasonable conclusion as to the most likely option granting actions that occurred and the dates on which such actions occurred in determining what to account for." (Emphasis in original.)

The Staff also addressed practices adopted by issuers to manage the impact of compensation cost associated with option awards. The Staff noted, for example, that some public company issuers may have chosen to make option grants in coordination with the public release of information; in particular, so as to grant options before the release of positive material nonpublic information (that would increase its stock price) or after the release of adverse

material nonpublic information (that would lower its stock price). In these circumstances, absent fraud or other misconduct, the Staff believes that the compensation cost should be computed on the measurement date by reference to the freely traded, unadjusted quoted price of the stock in an established market. This aspect of the Staff's guidance was phrased broadly, and it remains to be seen how it will be applied in practice to particular facts and circumstances.

The Staff reached more distinct conclusions with respect to certain other practices aimed at managing option award compensation costs. In contrast to timing awards to match disclosures, if the issuer instead modified the terms of existing option awards following the public release of material information, the Staff would conclude that the issuer effected an option repricing. In that event, the issuer should apply variable accounting to the option award from the date of such modification until the date the award is exercised, is forfeited, or expires unexercised.

Similarly, if the date that an option is exercised is documented "as of" a date other than the actual date of exercise, then the Staff believes that (1) the issuer should record the excess tax benefit it otherwise would have been entitled to receive on the actual exercise date as an addition to paid-in capital and (2) any benefit

forgone by the issuer because of the mischaracterized exercise date, and any other tax obligations of the employee paid by the issuer, should be recorded as compensation cost.

The Staff concluded with an indication that it is continuing to consider these issues and that further informal guidance may be forthcoming.

The Staff's guidance follows closely on the release of the SEC's executive compensation disclosure rules. We expect that many public company issuers will choose to revisit their option grant practices as part of preparing the required disclosures. The Staff's new guidance should be kept in mind while undertaking that analysis.

This advisory should not be construed as providing legal advice. If you have any questions, please feel free to contact your Arnold & Porter attorney or call:

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