



## Alert

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## SEC Staff Views on Accounting Consequences of Prior Stock Option Granting Practices

The SEC staff published its views on the effects on accounting for stock-based awards when registrants may have used inappropriate measurement dates and therefore misstated stock-based compensation cost.<sup>1</sup> The public letter from the SEC's Office of the Chief Accountant focuses primarily on the accounting consequences for periods in which companies applied Opinion 25 and Interpretation 44, but acknowledges that these practices could have consequences for information reported under Statement 123.<sup>2</sup> The letter does not address any non-financial-statement disclosure, legal, or regulatory issues that might arise from past option granting practices.

The letter addresses whether a company incorrectly determined the measurement date of stock-option awards and the potential accounting consequences of having done so. The letter notes that any analysis will heavily depend on the particular facts and circumstances, and cautions that evidence of fraudulent or manipulative conduct would require additional analysis. It presents the staff's views on the accounting consequences under Opinion 25 in the following specific circumstances:

- The option grant is dated prior to the actual award date;
- The company granted options, but some "required granting actions" had not been performed;
- The company is uncertain about the validity of grants;
- The company is uncertain about the individual award recipients;
- The exercise prices were established by reference to a future market price;
- The options were granted before employment began;
- The company's documentation of option granting activities is incomplete or cannot be located;

<sup>1</sup> Letter from Chief Accountant to Committee on Corporate Reporting, Financial Executives International and Center for Public Company Audit Firms, American Institute of Certified Public Accountants, concerning accounting for stock options in the historical financial statements of public companies, September 19, 2006, available at [www.sec.gov](http://www.sec.gov).

<sup>2</sup> APB Opinion No. 25, Accounting for Stock Issued to Employees, October 1972; FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, March 2000, available at [www.fasb.org](http://www.fasb.org); and FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995, available at [www.fasb.org](http://www.fasb.org).

- The timing of the option grants was coordinated with the release of previously non-public information;
- The terms of granted options were changed after the release of new, previously non-public, information; and
- The practices relating to exercise dates have income-tax consequences.

### Option Award's Date Predates the Actual Award Date

Some SEC registrants recently acknowledged by public disclosures that they had dated stock-option awards as of a date that preceded the actual grant date of the award and used that earlier date as the measurement date, inappropriately resulting in no recognition of compensation cost for the awards. The measurement date is essential to accounting for stock-option awards under Opinion 25. The Opinion requires compensation cost to be measured as the difference between the exercise price of an option and the market price of the underlying stock (i.e., "intrinsic value") at the measurement date. No compensation cost is recognized if there is no intrinsic value at the measurement date.

Opinion 25 defines the measurement date as the first date on which the company knows both the number of shares that an individual employee is entitled to receive and the exercise price of the award. This section of the letter addresses the practice referred to as "back-dating." The staff letter points out that "the measurement date cannot occur until the date the terms of the award and its recipient are actually determined."

### Option Grants with Administrative Delays

The staff letter points out that some companies may have determined that a measurement date occurred prior to completing all steps required to grant a stock award. For

example, all required approvals may not have been obtained or documented prior to the measurement date used to account for the award. The staff holds that a measurement date occurs when all actions required to grant the award are final.

The letter uses the term "required granting actions." The term refers to the actions that need to be completed in order to comply with a company's corporate governance provisions, stock option plans, and applicable laws. Required granting actions are not merely administrative, according to the letter, and pending administrative actions may not always preclude a company from reaching a conclusion that a measurement date has been reached. However, if the company operated in a manner that calls into question the finality of the terms of the award prior to completing all of the administrative actions, those questions may indicate that consequential actions were taking place during the period of delay and that the measurement date had not been reached prior to their completion.

The staff letter acknowledges that facts, circumstances, and a pattern of conduct that makes clear that the company considered the terms and recipients of the awards "to be *fixed and unchangeable* at the earlier date" may support a conclusion that a measurement date had been reached prior to completing all granting actions. However, a conclusion that a measurement date occurred before the granting actions were completed must be considered carefully and must be supportable.

### Validity of Prior Grants

Stock-compensation plans may prohibit a company from issuing specific types of awards—for example, in-the-money options.

If option grants may not have complied with the terms of a stock-option plan when granted, the SEC staff will look to the "substantive arrangement that is mutually understood by both the company and its employees." Both the company and the employee might, for instance, have operated on the basis that a stock-option grant was made despite the prohibition in the plan, and that may serve as the basis for a company's determination that the measurement date occurred.

The staff letter describes three situations that could satisfy the case that a substantive arrangement, mutually understood by both the company and its employees, represented the economic substance of past option grants and should serve as the basis for the company's accounting. Those situations are when the company (a) has been honoring awards and settling those awards in stock, (b) intends to honor outstanding awards and it is reasonable to conclude that the company will honor the awards, and (c) intends to settle the outstanding unexercised awards in stock and it is reasonable to conclude that it will be able to do so. Assuming all other conditions for establishing a measurement date were satisfied, circumstances may therefore support accounting for the awards as fixed options under Opinion 25 despite a restrictive condition in the plan.

### Uncertainty as to Individual Award Recipients

The staff letter addresses the situation in which companies approve pools of option awards before determining the number of options to be granted to each individual. The staff noted that under certain circumstances the award may contain sufficient specificity

to determine the number of options to be allocated to individual employees and thereby satisfy the requirement for a measurement date. For example, an authorization may specify an option allocation based on objective factors, such as employees' levels within an organization, but not name the individual recipients. However, if the pool of awards is approved, but the option allocation is performed by management based on subjective factors, the measurement date would occur only when the allocation process is completed.

#### **Exercise Price Set by Reference to a Future Market Price**

In some situations, companies may have taken actions to protect the employees against declines in the stock price shortly after the granting of options. The staff letter describes a situation where a company awarded options to employees with an exercise price that would be the lowest market price of the company's stock over the next 30 days. In that case, variable accounting would be required until the contingency is resolved—the end of the 30-day period in this example. We believe this also would be the case if a plan is silent but a company's actions demonstrate that the plan operated in this manner. Conversely, according to the letter, if an award is granted with a stated exercise price and the company subsequently adjusts the exercise price at the end of the 30-day period, the award would be considered to have been repriced and variable accounting for that award is required until it is exercised, forfeited, or expires unexercised. We believe this applies when adjustments were made only in isolated circumstances.

#### **Grants Prior to the Commencement of Employment**

The accounting for grants made before an individual began employment depends on whether the individual was previously providing substantive nonemployee service. If so, the awards would be accounted for at fair value in accordance with Statement 123 and EITF 96-18.<sup>3</sup> Once the individual begins service as an employee, the company should treat that as a change in status in accordance with Interpretation 44. If not, a measurement date cannot occur before the employee begins service, as clarified by Interpretation 44.

#### **Incomplete or Missing Documentation**

Companies analyzing stock-option grants from several years ago may have difficulty finding all the documentary evidence needed to support a definitive determination of the measurement date. The SEC staff stated that in this circumstance, the lack of complete documentation "should not necessarily result in a default to variable accounting or to treating the awards as if they had never been granted." The staff emphasized, however, that a company must use "all available relevant information to form a reasonable conclusion as to the most likely option granting actions that occurred."

#### **Timing of Option Grants**

A company may time its grant of options to coordinate with the release of news that is expected to affect the company's stock price. According to the SEC staff, assuming that the measurement date had been properly identified, timing option grants to either avoid or take advantage of the consequences of information to be disclosed to the public

does not change the accounting for those awards. Therefore, companies would determine the intrinsic value of the award on the measurement date using the company's unadjusted stock price at that date.

#### **Change in Option Grants Caused by the Release of New Information**

According to the staff, some companies have changed the terms of previously granted awards in response to newly released information about the company. This situation may occur when a company grants an award, subsequently releases negative information to the public, and then reprices the options in response to the decline in the company's stock price. In accordance with Interpretation 44, the company should apply variable accounting to the repriced award from the date of the repricing until the award is exercised, forfeited, or expires unexercised.

#### **Income-Tax Consequences**

According to the letter, the staff understands "that some companies may have documented option exercises as though such exercises occurred as of a date other than the actual date of exercise, which resulted in a reduction of the amount of income taxes due by the employee, with a corresponding reduction in the income tax benefit received by the company." Use of incorrect exercise dates may affect the amount of tax deductions taken by the company and, as a result, the tax effects reported in additional paid-in capital (through tax deductions in excess of compensation cost recorded for financial-reporting purposes). In some cases, companies may have forgone tax benefits because they mischaracterized the exercise date, resulting in

<sup>3</sup> 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*, available at [www.fasb.org](http://www.fasb.org).



an incorrect tax deduction. The tax benefit forgone and any tax obligations paid on behalf of the employee should be reported as compensation cost. Any tax uncertainties that arose from option-dating practices in periods before the application of Interpretation 48 should be evaluated for compliance with Statements 5 and 109.<sup>4</sup>



Some companies that reassess their previous accounting may find it either in error or unsupported based on evidence currently available. Companies will need to consider the potential materiality of any adjustments, evaluating both quantitative and qualitative factors, to determine the appropriate actions to take. The letter encourages companies to consider consulting with the staff with respect to their individual facts and circumstances. Companies proposing to correct material errors without amending all previous filings are directed by the letter to contact the SEC's Division of Corporation Finance. Additionally, companies should consider the need to consult with legal counsel regarding the potential legal consequences of their previous stock-option granting actions.

The descriptive and summary statements above are not intended to be a substitute for the text of the SEC Office of the Chief Accountant's September 19, 2006 letter on stock-option dating, or any other cited, actual, or potential requirements related to accounting for stock-based compensation and its ramifications. Those companies in the process of restating the accounting for, or looking into their past practices relating to, the granting of stock options should refer to the texts of the applicable documents that set out requirements, consider their specific circumstances, and consult their internal and external accounting and legal advisors.

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<sup>4</sup> FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, June 2006, and FASB Statement Nos. 5, Accounting for Contingencies, March 1975, and 109, Accounting for Income Taxes, February 1992, available at [www.fasb.org](http://www.fasb.org).