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SEC Issues Accounting Guidance for Stock Option Exercise Rescissions

And Another Accounting Wrinkle for Stock Option Repricings

Recent press reports have been covering an unusual tax-motivated transaction that emerged in the latter half of last year whereby companies and certain employees have agreed to "rescind" the previous exercise of a stock option.[1] In the transaction, employees agree to return to the company shares acquired from an option exercise that occurred earlier in the same taxable year (plus any dividends received on those shares since exercise), and the company agrees to reimburse the employees for the previously remitted exercise price. The company then "reinstates" the previously exercised option according to the option's original terms, i.e., the same number of shares, exercise price, vesting schedule, exercise term, etc. The intent of the transaction is to treat the previous exercise as if it had never occurred for income tax purposes (including the "alternative minimum tax"), so as to eliminate employee tax liabilities incurred earlier in the year when stock prices were high, but which cannot be funded from "option profit shares" because of subsequent stock price declines. A potentially negative consequence of the rescission is that the company loses the income tax benefit (or deduction) it would have otherwise received had the original exercise not been rescinded.[2]

At a recent meeting of the Emerging Issues Task Force (EITF), the Securities and Exchange Commission (SEC) issued a "Staff Announcement" that will result in adverse accounting consequences for companies that participate in stock option rescission transactions.[3] Specifically:

- The forgone tax benefit (if any) must be recognized as additional compensation cost
- The reinstated stock options are subject to "variable award" accounting treatment until such time as it is not possible to further rescind a future exercise of the reinstated options, e.g., until expiration or forfeiture of the reinstated options or the end of the tax year in which the reinstated options are exercised
- The terms of the rescission must be disclosed in the stock option footnotes to the financial statements (regardless of "materiality")

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[1] Refer to "New Corporate Perk: If the Stock Falls, Cancel Repurchases," *The New York Times*, January 23, 2001, and to "S.E.C. Tells Concerns to Disclose Cancellations of Stock Purchases," *The New York Times*, February 1, 2001

[2] In general, the "intrinsic value" of a nonqualified stock option at exercise may be claimed as a deduction on a company's tax return, thus reducing the amount of income taxes payable; this tax benefit may not be applicable to "incentive stock options" (unless disqualified) or to companies in "net operating loss" positions

[3] SEC Staff Announcement Topic No. D-93, "Accounting for the Rescission of the Exercise of Employee Stock Options"

- The initial exercise and subsequent rescission should be separately identified in the statement of changes in stockholders' equity
- The rescinded shares should be included in the calculation of "basic" earnings per share during the period the shares are outstanding
- The cash flow consequences of the rescission may in some instances warrant disclosure in "Management's Discussion and Analysis"

The SEC's rationale for requiring variable award accounting for the reinstated stock options (which apparently runs counter to the advice of the FASB's staff) is that the rescission, in essence, provides the employees with a "put" to the company at a stock price that could be at other than "fair value." Under FASB Interpretation No. 44 and EITF Issue No. 00-23, such a repurchase feature results in variable award accounting until the exercise or expiration of the repurchase feature.[4]

Importantly, the SEC has provided relief from variable award accounting treatment for rescission transactions that occurred prior to January 1, 2001. Companies may account for such rescissions as a new "measurement date" (rather than variable award accounting) provided the employee delivers to the company the *same shares* that were issued upon a previous option exercise. A new measurement date means that companies will generally recognize compensation cost only for the forgone tax benefit at the rescission date, and not for future increases in intrinsic value after that date.

Stock Option Repricings

Separately, we would like to make our readers aware of another accounting wrinkle in the area of stock option repricings. FASB Interpretation No. 44 is clear that a stock option repricing or a cancellation/replacement transaction results in variable award accounting for the modified award. But what happens if employees are *offered* a repricing or cancellation/replacement opportunity, and for whatever reason the employees choose not to participate (e.g., because of an unfavorable "exchange ratio")? We are aware of one public filing where the company discloses that *all* stock options subject to the exchange offer are subject to variable award accounting treatment prospectively, *regardless of whether the offer is accepted by the employees or not.*[5] Apparently, the company's accountants have concluded that the "offer" is what modifies the stock options and results in variable award accounting treatment. The actual *acceptance* of the offer does not appear to be relevant.

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This letter is intended to provide information of interest to compensation professionals about technical developments that may affect compensation design and practice. Questions about specific application to a company should be addressed to the company's accounting staff. General questions may be addressed to Tom Haines at (312) 332-0910. Copies of this letter and other published materials are available on our website, www.fwcook.com.

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4 Refer to our summary of FASB Interpretation No. 44 dated May 1, 2000

5 Amazon.com, Schedule TO, filed January 31, 2001