August 23, 2001

Potentially Negative Accounting Changes For Stock Options with a Reload Feature

The purpose of this letter is to alert our readers to recent accounting developments that, if enacted, would lead to unfavorable "variable award" accounting treatment for *all* stock options that contain a "reload" feature.

Background

A reload is a stock option enhancement which allows an employee to exercise a valuable stock option before the end of its term, using already-owned "mature" shares in a "stock-for-stock" exercise, without giving up the benefit of future stock price appreciation on the full number of shares covered by the original option. Upon exercise of the original stock option, the employee receives a new stock option which is commonly referred to as a reload or "restoration" stock option. In a typical reload design, the new stock option is for the same number of shares tendered to exercise the original stock option, has an exercise price equal to the market value of the stock on the date of the reload exercise, and has an exercise period equal to the remaining term of the original stock option. Some companies also provide a reload for the number of shares withheld or tendered to pay taxes due upon the option exercise (commonly referred to as a "tax" reload). The typical stock-for-stock reload is designed to ensure that the company ultimately issues the same number of shares and receives the same aggregate exercise price as if the original option did not contain a reload feature (tax reloads, however, do result in the issuance of more shares by the company). The prevalence of reload stock options has increased significantly over the last decade, with about one in five of the largest U.S. companies using stock-for-stock reloads today (and about half of those companies also using tax reloads).

Historically, the presence of a reload provision has not tainted the favorable "fixed award" accounting treatment of the underlying stock option provided the requirements of Emerging Issues Task Force (EITF) Issue No. 90-7 were satisfied, namely (1) the reload feature provided for the automatic grant of a new stock option with an exercise price equal to the market price on the reload grant date, and (2) the shares tendered in the reload stock-for-stock exercise were mature (that is, owned for at least 6 months prior to exercise). The EITF's rationale for permitting fixed award accounting treatment was that a reload was nothing more than "a series of fixed grants" that should be accounted for as a fixed award provided the foregoing requirements were met. In practice, the above guidance was applied not only to traditional stock-for-stock reloads but also to tax reloads, regardless of whether the reload feature was pursuant to the original terms of underlying stock option or subsequently added through a modification of the original award.

FASB Interpretation No. 44

The longstanding fixed award accounting guidance for reloads was modified last year when the Financial Accounting Standards Board (FASB) concluded in Interpretation No. 44 (FIN 44) that variable award accounting would be required for outstanding stock options that are *amended* after grant to add a reload feature. Variable award accounting would apply from the date of modification until the date the original option was exercised, forfeited, or expired, and would also apply to any subsequent reload grant itself, if it too were subject to a reload feature. The FASB's rationale was that a reload feature was not a series of fixed grants, but rather a "combined award" with the receipt of the new award (the reload) contingent upon the exercise of the original award. The combined award "introduces variability" to the number of shares and exercise price of the underlying award, and thus variable award accounting would be required.

Importantly, the FASB in FIN 44 reluctantly decided to preserve fixed award accounting treatment for stock options with a reload feature if the provision was pursuant to the *original terms* of the award *and* the "limited fact pattern" in EITF Issue No. 90-7 was followed (that is, "a reload feature that provides for the automatic grant of a new option at the then-current market price in exchange for each previously owned share tendered by an employee in a stock-for-stock exercise"). The FASB stated in FIN 44 that it believes the same combined award/variable award accounting treatment that applies to reloads added through a modification should also apply to reloads pursuant to the original terms of an award. But because this fact pattern was not adequately addressed in the FIN 44 deliberation process and because fixed award accounting "has been consistently applied in practice," the FASB "decided not to overturn at this time" the fixed award accounting treatment permitted by EITF Issue No. 90-7 for reloads pursuant to the original terms of an award.

Recent Developments

At the prodding of the Securities and Exchange Commission (SEC), the EITF is in the midst of an extensive deliberation of over 65 practice issues and questions on the accounting for stock compensation. The project is referred to as EITF Issue No. 00-23, and two issues on the project agenda are targeted directly at reload stock options. The first issue is a direct attack on the fixed award accounting treatment still afforded reloads that are pursuant to the original terms of an award. That is, the EITF must decide whether the accounting guidance in EITF Issue No. 90-7 is still appropriate or *whether it should be overturned*. The second issue is a direct attack on tax reloads (presuming, of course, that fixed award accounting is not eliminated by the first issue). That is, the EITF must decide whether tax reloads are consistent with the limited fact pattern of EITF Issue No. 90-7, and thus whether variable award accounting should apply.

Given the FASB's stated belief that all stock options with a reload feature should be subject to variable award accounting and the SEC's interest in seeing this issue resolved, ***it is reasonable to assume that the EITF will conclude that EITF Issue No. 90-7 should be overturned and variable award accounting should be required for all reload stock options***. This negative outcome would encourage companies to abandon reload stock options as they are designed today, and would eliminate a stock option enhancement that has been acknowledged by many leading companies as an effective means for increasing stock ownership and thereby aligning employee interests with stockholders.

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The FASB and EITF are organizations well known for the openness and fairness of their deliberation process. Thus, companies that are interested in preserving fixed award accounting treatment for reload stock options pursuant to EITF Issue No. 90-7 should express their views to the FASB, EITF, and their professional accountants before the EITF takes up the issue.*

If you have general questions regarding the recent accounting developments affecting reload stock options, please feel free to contact any of our offices. Specific questions are most appropriately directed to the company's professional accountants.

* The EITF does not release its findings in proposed form for public comment. Its findings are final once released, assuming no objection from the SEC for publicly traded companies.