

August 28, 1998

**FASB PROPOSES CHARGE TO  
EARNINGS FOR REPRICED STOCK OPTIONS**

The Financial Accounting Standards Board (FASB) met on August 12 to continue its deliberations on the project to issue a comprehensive interpretation of APB Opinion 25, Accounting for Stock Issued to Employees. It reached two preliminary decisions:

1. Outstanding stock options which are either repriced or cancelled and reissued at a lower option price will be treated thereafter as a variable grant.
2. Employee stock purchase or option plans with a “look-back” feature that complies with Internal Revenue Code (IRC) §423 will remain noncompensatory.

**Stock Option Repricings**

One of the major open issues that the FASB is grappling with as part of its Opinion 25 interpretation project is how to account for modifications to the terms of an outstanding and otherwise fixed grant which add value to the grant but which were not provided for in the original grant agreement. The FASB regards a repricing of an underwater stock option as such a plan modification.

Under Opinion 25, a grant is treated as a fixed grant once the number of shares to be issued and the option price (if any) are known and fixed. Thereafter, changes in market value do not affect earnings unless the terms of the grant are modified. If the number of shares to be issued and/or the option price are *not* known at the time of grant, then the grant is treated as a variable grant, with changes in market value affecting earnings until the terms become fixed or the option is exercised.

In approaching this issue, the FASB considered four alternatives, as described in the minutes of the meeting:

1. Option repricing does not create a variable plan.
2. Any option repricing creates a variable plan.
- 3a. More than one option repricing (that occurs during the option term) creates a variable plan.
- 3b. Variable-plan accounting should be required on the third option repricing (that occurs during the option term).

The FASB reached a preliminary decision at its meeting on August 12 that an option which had been repriced would be treated thereafter as a variable grant. This means that subsequent increases in market value between the new exercise price and the fair market value at exercise of the option would be charged to earnings, just like a stock appreciation right (SAR). The FASB views the repricing of an option as a change in terms which creates uncertainty as to the future exercise price of the option, i.e., it could be repriced again. Therefore, the exercise price of a repriced option is not determinable until exercise.

The FASB recognized that the repricing of an underwater option can occur in one of two ways: (1) amendment of the original grant to reduce the option price (and possibly make other changes such as to reduce the number of shares or extend vesting), or (2) to cancel the original grant and substitute a new grant within a six-month period at a lower option price. Both types of repricings would be treated prospectively as a variable grant from the date of modification or regrant.

Once the FASB decided that repricing led to variable plan accounting for that grant (alternative 2 above), it considered several other plan-related issues:

1. Should all grants under plans that do not *expressly prohibit* repricing be accounted for as variable grants?
2. If a repricing occurs under a plan, should all grants under that plan be deemed variable because the *potential* for repricing exists?

Fortunately, the FASB rejected both these alternatives, thereby limiting variable accounting to the actual grant or grants that had been repriced.

Current accounting practice supports repricings because there is no P&L cost to the company, even though there is a cost to the shareholders in greater EPS dilution because the company is selling stock at a lower price. We are certainly no fan of repricings and consider them an indefensible practice which undercuts shareholders' and the public's support for stock options as an incentive device for aligning employees' interests with those of shareholders. A change in accounting practice which treats the repriced options as a variable grant would be a major negative for any company considering a repricing. Therefore, we support this change.

### Look-back Options

The FASB reached a preliminary decision earlier in the Opinion 25 project that employee stock options with a "look-back" feature are always compensatory\*. The Board had seen a conflict between the four criteria in Opinion 25 for noncompensatory options and the statement, also in Opinion 25, that an option which meets the requirements of IRC §423 is an example of a noncompensatory plan. IRC §423 plans can have a look-back feature, namely that the purchase or exercise price is the *lower* of 85% of market value at grant of the option or purchase of the stock. To the FASB, such a grant was obviously compensatory because the final purchase price at exercise has the potential of being lower than what would be regarded as a "reasonable"

---

\* See our letter of June 9, 1998.

discount at grant. Therefore, the FASB resolved the conflict in favor of the four criteria, thereby saying that grants with a look-back feature henceforth would be compensatory and require variable accounting.

On August 12, however, the FASB decided to reverse this position and make no change in present accounting practice for employee stock purchase plans which meet the noncompensatory criteria of Opinion 25. A reason discussed is that the Board is pledged to interpret Opinion 25, not rewrite it. Thus, since Opinion 25 says an IRC §423 plan is a noncompensatory plan, the FASB cannot say that it is not.

\* \* \* \*

The next meeting on the Opinion 25 Interpretation project is scheduled for September 9 or 16 to discuss issues concerning “leased” employees, accounting for deferred taxes, and definition of grant date. It is now expected that an exposure draft will be released during the first quarter of 1999, and that the Interpretation will be effective around January 1, 2000. The FASB has not yet addressed implementation and transition issues. But normally, new pronouncements are prospective for new grants or modifications after the effective date.

Specific questions of applicability to company situations should be addressed to a company’s financial staff or auditors. General questions may be addressed to Fred Cook at (212) 986-6330. Readers are invited to visit our website at [FredericWCook.com](http://FredericWCook.com) for information on this and other subjects we have written about in the past.