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Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981

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Financial Accounting Standards Board
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FTB 82-2: Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981

References:
ARB No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 13B, "Compensation Involved in Stock Option and Stock Purchase Plans"
APB Opinion No. 25, Accounting for Stock Issued to Employees
FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans

Question

1. What are the accounting implications for companies that convert previously issued stock options into incentive stock options (ISOs) as a result of the Economic Recovery Tax Act of 1981 (Act)?

Background

2. The Act includes provisions that grant favorable tax treatment to individuals who own incentive stock options. Enterprises can provide individuals with ISOs in two ways, by issuing new ISOs and by converting previously issued options into ISOs through changes to conform those options to the requirements of the Act. Accounting issues arise for enterprises with respect to plan modifications that are undertaken to convert existing options into ISOs.

3. One ISO requirement is that the option price must either equal or exceed the fair market value of the stock either at the date of grant or, if the option has been modified or renewed, at the date of the most recent amendment providing benefits to the option holder. This is commonly referred to as the "repricing" requirement of the Act. Enterprises electing to convert existing options into ISOs may be forced to raise option prices to meet the repricing requirement.
4. The Act allows enterprises to limit or eliminate the need to raise option prices by cancelling certain prior plan amendments. For example, assume the option price and stock price at date of grant are $8 and $10, respectively, for a nonqualified plan and that a plan amendment is later introduced when the stock price is $17. By cancelling the amendment, the option can be repriced at $10, resulting in $2 of additional cost to the employee; if the amendment is not cancelled, the repricing is at $17 and the employee's additional cost is $9. In recent years, several stock option plans have been amended to add a tandem stock appreciation right (SAR). Therefore, if they are converting the underlying stock option into an ISO, some enterprises may elect to cancel SARs that were previously added through plan amendments.

5. ARB 43, Chapter 13B, states in paragraph 10 that "...in most cases... valuation should be made of the option as of the date of grant." Opinion 25 did not change that underlying principle for plans that do not have variable terms. Paragraph 29 of Opinion 25 defines plans with variable terms:

   ... The characteristic that identifies plans in this group is that the terms prevent determining at the date of grant or award either the number of shares of stock that may be acquired by or awarded to an employee or the price to be paid by the employee, or both.

Regarding the determination of the measurement date, paragraph 10(b) of Opinion 25 states that:

   The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. ... The measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

6. Paragraph 5 of Interpretation 28 addresses tandem plans and states that:

   ... If an enterprise has been accruing compensation for a stock appreciation right or other variable plan award and a change in circumstances provides evidence that the employee will likely elect to exercise the related stock option, accrued compensation recorded for the right or award shall not be adjusted.\(^7\) If the employee elects to exercise the stock option, the accrued compensation recorded for the right or award shall be recognized as a consideration for the stock issued. If all parts of the grant or award (e.g., both the option and the right or award) are forfeited or cancelled, accrued compensation shall be adjusted by decreasing compensation expense in that period.

\(^7\)A change in the circumstances may be indicated by ... cancellation or forfeiture of the stock appreciation right or other variable plan award without a concurrent cancellation or forfeiture of the related stock option.
7. Paragraph 17 of Opinion 25 describes accounting for income tax benefits under stock option plans:

An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. . . . The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.

Response

Repricing

8. Opinion 25 requires that an enterprises record compensation for services it receives for stock issued to employees through a stock option plan. That compensation is equal to the quoted market price of the stock on the measurement date less the amount the employee is required to pay. The compensation cost is charged to expense over the periods in which the employee performs the related services. Increasing the option price to meet the repricing requirement described in paragraph 3 of this Bulletin results in the enterprise's recapturing the compensation cost that arose when the option was granted. In recognition of that recapture, enterprises should reverse, in the period in which the option price is increased, the portion of total compensation cost that arose when the option was granted and has been charged to expense in subsequent periods.

9. A variable plan is a plan that has variable terms at its inception, as described in paragraph 5 of this Bulletin. A variable plan therefore differs from a plan with terms that are fixed at inception, modified once to increase the option price to conform to the Act, and remain fixed thereafter. A stock option plan that has fixed terms does not become a variable plan simply because the option price is raised to meet the repricing requirements of the Act. Accordingly, the increase in the option price to 100 percent of the fair market value at the date of grant to qualify an option under the Act does not result in a new measurement date.
Tandem Plans

10. *Presumption as to Exercise.* Interpretation 28 clarifies how compensation expense shall be recorded in connection with a combination or tandem stock option and SAR plan. Paragraph 5 of that Interpretation states that "...compensation expense... shall be measured according to the terms an employee is most likely to elect based on the facts available each period. An enterprise shall presume that the employee will elect to exercise the stock appreciation rights or other variable plan awards, but the presumption may be overcome. . . ." The fact that the Act grants more favorable tax treatment to holders of stock options does not invalidate the presumption of Interpretation 28 that the SAR will be exercised. However, it may be an important factor in evaluating what the employee is most likely to elect.

11. *Cancellation of SAR Only.* Interpretation 28 also discusses accounting for the cancellation of the SAR in a tandem SAR and stock option plan. Paragraph 5 and footnote 7 of that Interpretation (refer to paragraph 6 of this Bulletin) state that accrued compensation recorded for a SAR shall not be adjusted if cancellation or forfeiture of the SAR occurs without a concurrent cancellation or forfeiture of the related stock option. Enterprises that cancel SARs under the circumstances described in paragraph 4 of this Bulletin should look to paragraph 5 and footnote 7 of Interpretation 28 for guidance. Those sections of Interpretation 28 also include guidance concerning the ultimate disposition of the accrued compensation amount if the option is exercised, canceled, or forfeited.

Combination of Circumstances

12. A combination of certain of the circumstances described in the preceding paragraphs may exist. For example, the cancellation of a tandem SAR may be combined with the repricing of the underlying option. If that happens, the portion of total accrued compensation that relates to the repricing should be reversed as described in paragraph 8 of this Bulletin; the balance of accrued compensation relates to the cancellation of the SAR and should be accounted for under the provisions of paragraph 11 of this Bulletin. As an illustration, assume the following: (a) a nonqualified option for $110 was granted when the market value of the stock was $130, (b) a tandem SAR was subsequently introduced through a plan amendment, (c) all compensation costs for the option and SAR relate to prior periods and have been charged to expense, and (d) the enterprise decides to cancel the SAR and reprice the stock option to a $130 option price when the market value of the stock is $180. The accounting result is that $20 of accrued compensation (computed $130 - $110) is reversed in the current period and the remaining $50 (computed $180 - $130) is retained as accrued compensation.

Taxes

13. Certain of the guidance in this Bulletin involves adjustments to compensation expense. For
accounting purposes, the tax effects of those adjustments should be determined in accordance with the general guidance concerning accounting for income tax benefits under stock option plans found in paragraph 17 of Opinion 25 (refer to paragraph 7 of this Bulletin). For example, a reversal of compensation expense in connection with a repricing as described in paragraph 8 of this Bulletin results in a corresponding reversal of the related deferred tax benefits. Likewise, if a tandem SAR is canceled as described in paragraph 11, the tax benefit is not adjusted, but is retained along with the accrued compensation that gave rise to it. Ultimately, depending on the employee's actions, the compensation and tax benefit are disposed of in the same manner—together, they are either reversed or applied to additional paid-in capital.

The Financial Accounting Standards Board has authorized its staff to issue FASB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis. Although Board Members are provided with copies of proposed Bulletins prior to issuance, the Board does not approve them.