Accounting for Terminations?? What?

"A charge for terminations?" "Don't we just reverse expense… what is this charge?"

Well not ALL terminations require special calculations and occasionally some "extra" expense, just those that involve a modification to original terms and conditions of an option or award in conjunction with the termination, which happens a lot more often than you might think (especially for executives/key employees). Depending on the type of modification and the current status of the award, you can end up with a **Type I Modification** or a **Type III Modification**, per FASB ASC 718 (formerly FAS 123R). And in some cases, you may actually end up recording less expense instead of more.

Modifications are very fact specific and while some modifications may appear to be similar, they are not. FASB ASC 718-20-20 defines "modification" as "a change in the terms or conditions of a share-based payment award." The FASB released some new guidance in May 2017 related to simplifying the accounting for modifications. Please refer to our Accounting Update on FASB ASC 718 article for details. SOS always recommends its clients carefully review their equity plan document, award agreements and any employment agreements and severance agreements when dealing with modifications. Also, obtain input from legal, accounting/audit and tax advisors before taking action. The chart below summarizes the various modification types provided for under FASB ASC Topic 718. The most common types we see in practice are Type I and Type III.

Before ↓ After → Modification	Probable	Improbable
Probable	**Probable to Probable** **Type I** Case A (20-55-111) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any	**Probable to Improbable** **Type II** Case B (20-55-113) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any
Improbable	**Improbable to Probable** **Type III** Case C (20-55-116 & Example 15) Fair value of new grant only	**Improbable to Improbable** **Type IV** Example 13(d) Fair value of new grant only

Now let's consider some examples.

Acceleration of Vesting in Connection with a Termination

Let's say an executive is leaving and he/she has a stock option grant that is partially vested and partially unvested. The company decides to accelerate the unvested shares so that the exec can exercise the options before the grant expires (generally after a termination, recipients have from 30-90 days to exercise their vested options and they immediately forfeit their unvested options). In this case, we have a Type III Modification - only the unvested shares are being modified - improbable to probable. The shares were improbable of vesting before the modification (aka they were not going to vest since under the original terms of the award they were about to be cancelled), but since the modification accelerated (vested) them, they are now "probable" of vesting.

For a Type III Modification, as you can see above, you should actually reverse the expense previously accrued on those unvested shares under the original grant date fair value. The only fair value that should be recognized is the fair value of the new (modified) grant. So, you revalue the grant immediately after its modification. As the grant was an option use the appropriate option-pricing inputs (pay careful attention to expected term, since the employee is terminating you may need to use contractual term as with non-employee accounting). If the grant was an RSU, use the current market value. If the market value has remained relatively flat during the time since the grant, for options the expense is likely be lower since the market value and price will be similar to the original grant, but the expected term may be shorter (and therefore interest rate and volatility are likely to also be lower), resulting in a lower fair value.

Acceleration of Vesting and Extension of Term at Termination

If a participant is leaving and his/her equity grants are not being modified EXCEPT to extend the post - termination exercise period, and all the shares being modified are already vested, what is the accounting treatment?

In our next example, again some of the shares were vested and some unvested, but instead of simply accelerating the vesting of the grant, the period of time to exercise is also extended from the standard 90-day grace period to one year. Here we have two different types of modifications in one transaction: for the extension of term example above, the vested shares are a Type I Modification (they were going to get the shares before and after the modification, since the shares were already vested) and the unvested shares are a Type III Modification (improbable to probable, as above). For the vested shares, the grant is valued immediately before the modification and immediately after. The 90-day term should be used as the expected term for the before fair value and up to the full one-year term used for the after fair value. The original grant-date fair value is not used. If the "after" fair value is greater than the "before" fair value, the modification has resulted in incremental expense and since the grant is now vested, all the incremental expense should be recognized immediately on the modification date. For the unvested shares, since this is a Type III Modification, the expense previously recognized from the original grant-date fair value should be reversed. The new expense, using the new fair value computed using the same inputs for the "after" fair value should be booked. In practical terms, you don't really "reverse" the expense you booked before. You simply calculate what you've accrued to date, compare that amount to the new fair value, and true up or down to the new fair value.

For the vested shares, that is a Type I Modification, so you perform a “before and after” valuation, using the original term for the before fair value - often a 90-day post-termination grace period, and the full, modified term (one year for example) for the after fair value, to determine incremental expense. And, since the shares are all vested, you'd book the incremental expense in the current quarter as of the modification date. If the stock price has risen since the grant date and an option is in-the-money, these types of changes can result in substantial expense.

Questions or comments? Please email us at xtra@sos-team.com

About Stock & Option Solutions

Stock & Option Solutions (SOS) has built a team of extremely qualified and dedicated professionals for the outsourced management or staffing of your stock plans and special projects. SOS’s Stock Plan Outsourcing Solution is the most comprehensive outsourcing service in the marketplace, making the choice easy. Beyond our total outsourcing solutions, we are focused on helping companies like yours through challenging steps with temporary staffing, permanent placement, expert project resources, and high level project management. Call us today at 408.979.8700 to learn more or visit us online at www.sos-team.com.

This article was originally published in December 2010 and updated in September 2017.