

There's No Accounting for Modifications: Modification Accounting Explained!

Terry Adamson, CEP, Radford Valuation Services
Elizabeth Dodge, CEP, Stock & Option Solutions, Inc.
Ellie Kehmeier, CPA, Deloitte Tax, LLP

Webcast Materials

www.sos-team.com/PDFS/mods.pdf

What Triggers Modification Accounting?

Changes to option/award not in original terms of grant

- Option Exchanges
 - Repricings, Option-for-option, Option-for-RSU, Option-for-cash
 - “Value-for-value” + NO incremental expense still accounting impact
- Restructuring (some spin-off /stock-split transactions)
- Acquisitions
- Other changes to original terms of grant
 - Extension of exercise grace period
 - Allow consultant to retain option after termination
 - Acceleration of vesting
 - 409A Exchanges – upward repricing
- Etc.

What is Modification Accounting?

Paragraph 51: A modification of the terms or conditions of an equity award shall be treated as **an exchange of the original award for a new award.**

Other Modifications

Changes to grants that are modifications for tax purposes that don't necessarily trigger modification accounting

- For example...
- Adding Net Exercise to an ISO
- Adding any additional payment terms to an ISO
- Offer to exchange more than 30 days of ISO – treated as modification

Agenda

Incremental Expense

Accrual

Tax Accounting

Diluted EPS Impact

Incremental Expense

FAS 123(R)

- Generally continue to account for original award, plus account for “incremental cost” of replacement award
 - Incremental cost = excess of fair value of new award over current fair value of original award
 - No negative incremental cost

Types of Modification Accounting Under FAS 123(R)

| Before ↓ After → Modification | Probable | Improbable |
|-------------------------------------|---|--|
| Probable | Probable to Probable Type I Example 13(a) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any | Probable to Improbable Type II Example 13(b) 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 Example 13(c) & (e) Fair value of new grant only | Improbable to Improbable Type IV Example 13(d) Fair value of new grant only |

*Not applicable if vest schedule not changed – goals before & after modification are the same.

Value-for-Value Exchange Example

Option Granted on 1/15/06, Option Price = \$15

Grant-date Fair Value = \$10; 100 Shares

...

On 7/15/09 Market Value of Stock = \$4

Re-applying Black-Scholes, current fair value = \$1

Total Fair Value = \$100

...

New RSU Grant – Per Share Fair Value = \$4

\$100 of Option Value = \$100 of RSU Value ($\$100/4 = 25$)

100 Option Shares Exchanged for 25 RSUs (4 to 1 Ratio)

Incremental Expense

| | | | | |
|---------------------------------|-------------|------------------------------------|----------|--|
| Exchange Ratio Valuation | < | Modification-Date Valuation | = | Negative (Zero) Incremental Expense |
| Exchange Ratio Valuation | > | Modification-Date Valuation | = | Positive Incremental Expense |

Why might values be different?

- Changes in stock price
- Discrepancies in estimation method of each fair value
 - Proxy Advisory Firm guidelines vs. Accounting Rules?
- Changes in valuation assumptions (volatility, interest rate, etc.)
- Methods of “banding” options

Incremental Expense Due to Market Movement

Current fair value of option = \$1, Total Fair Value = \$100

...

New RSU Grant – Per Share Fair Value = \$4

\$100 of Option Value = \$100 of RSU Value ($\$100/4 = 25$)

100 Option Shares Exchanged for 25 RSUs (4 to 1 Ratio)

...

During TO period, stock price decreases to \$2

New Fair Value per Share = \$0.25, New RSU Fair Value = \$2

| New Value of Old Option | Replacement RSU Value | Incremental Expense |
|---------------------------------|-----------------------------|---------------------|
| \$25 (\$0.25 shr * 100 shrs) | \$50 (\$2 shr * 25 shrs) | \$25 |

Banding Options for Fewer Ratios

To avoid many, many exchange ratios

- Some companies ‘band’ similar ratios together
 - All options priced from \$10 to \$15 = 3 for 1
 - All options priced from \$6 to \$9 = 2 for 1

Banding techniques can = incremental expense

Ways to avoid

- Discount fair value of original grant before computing incremental expense (90% value?)
- Don’t band – communicate each exchange ratio individually
- Always round DOWN

Expected Term for Original Options

To determine current fair value for original options, reassess EACH Black-Scholes Input:

- Price (fixed)
- Market Value (current Market Value)
- Volatility
- Risk-free Interest Rate
- Dividend Rate
- **Expected Term**
 - Normal methods for valuing at-the-money option grants, unlikely to be appropriate

Expected Term for Original Options

Expected Term

- Normal methods for valuing at-the-money option grants, unlikely to be appropriate
- Remaining contractual term?
 - Most aggressive
 - Longer term = higher value for current option = less incremental expense
- SAB 107?
 - Says should only be used for at-the-money awards
- Binomial model / Monte Carlo Simulation
 - Account for “underwater” of options when calculating possible outcomes

Expected Term for Original Options

Important to recognize underwater options must be held longer than at-the-money options (combines voluntary and involuntary exercise behavior)

Quantify exercise behavior as a function of time and spread between stock price and strike price using binomial model (traditional Black-Scholes uses only time)

Expected Holding Period From Today (Yrs)

| | | | | |
|--|-------------|--------------------|--------------------|--------------------|
| Stock Price/ Exercise Price Ratio | 100% | 4.0 | 3.0 | 2.0 |
| | 80% | 5.0 | 3.8 | 2.9 |
| | 60% | 6.0 | 4.5 | 3.8 |
| Time Already Held: | | 0.0-2.0 Yrs | 2.1-4.0 Yrs | 4.1-6.0 Yrs |

EXAMPLE ONLY

Accrual: Option-for-Cash Exchange

Incremental expense =

- Cash outlay to participant **minus** current market value of option cancelled
- Never less than \$0

No accrual over service period, accelerates all remaining expense into current period

- Remaining unamortized + incremental expense
- Both accelerated

Accrual: Option-for-Option or RS/RSU

Bifurcated Approach

- Method prescribed in FAS 123(R)
- Accrual of original grant expense continues over original vest schedule
- Accrual of incremental expense (if any) over new vest schedule

Pooled Approach

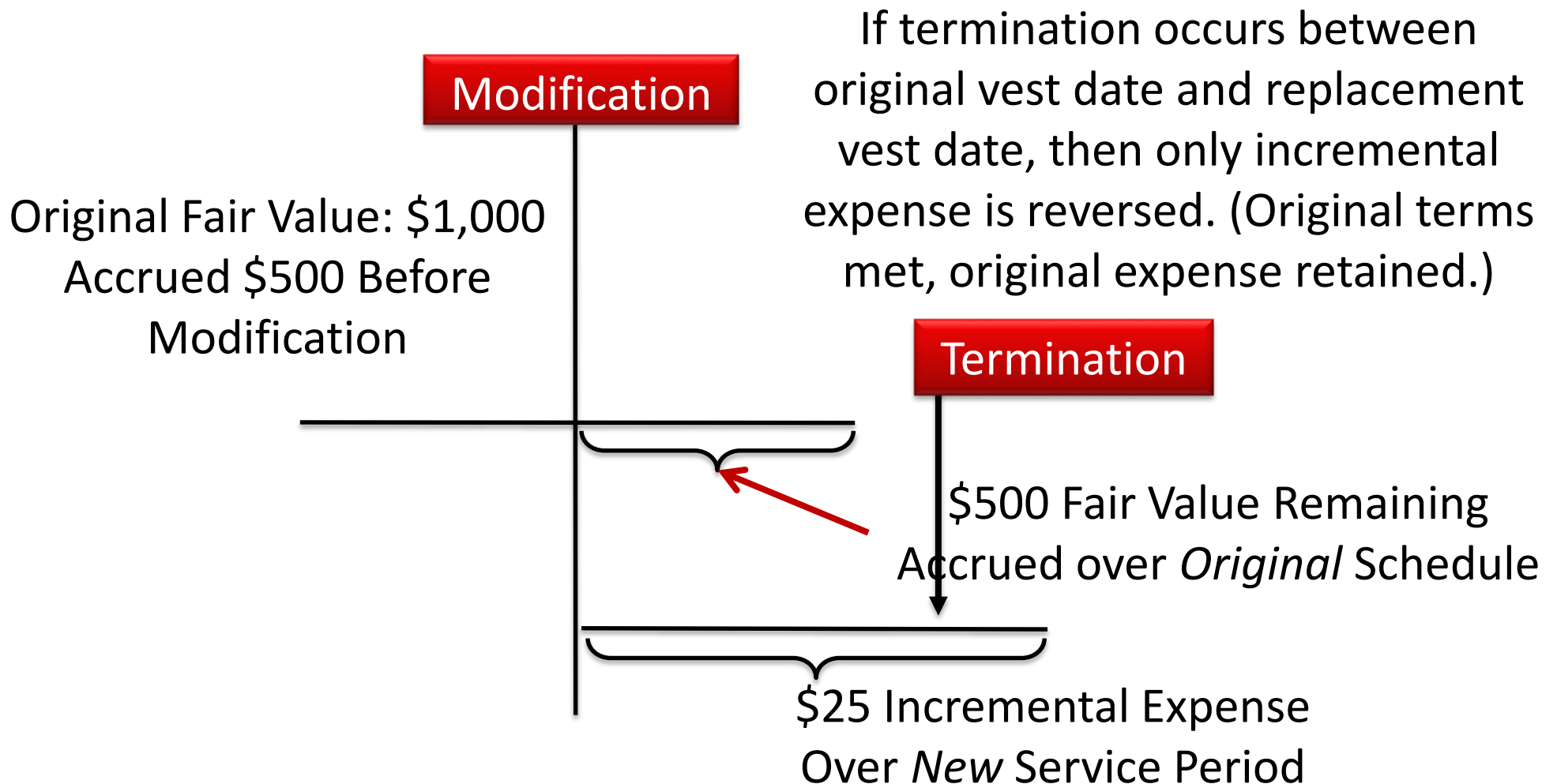
- Conclusion of the FAS 123(R) Resource Group - May 26, 2005
 - http://www.financialexecutives.org/download/FASB_FEI_5_26_05.pdf
- Unamortized expense from original grant “carried forward” to replacement grant
- Remaining original expense + incremental expense (if any) accrued over new service period

Company can choose method it prefers to use

- Best practice suggests confirming with audit firm

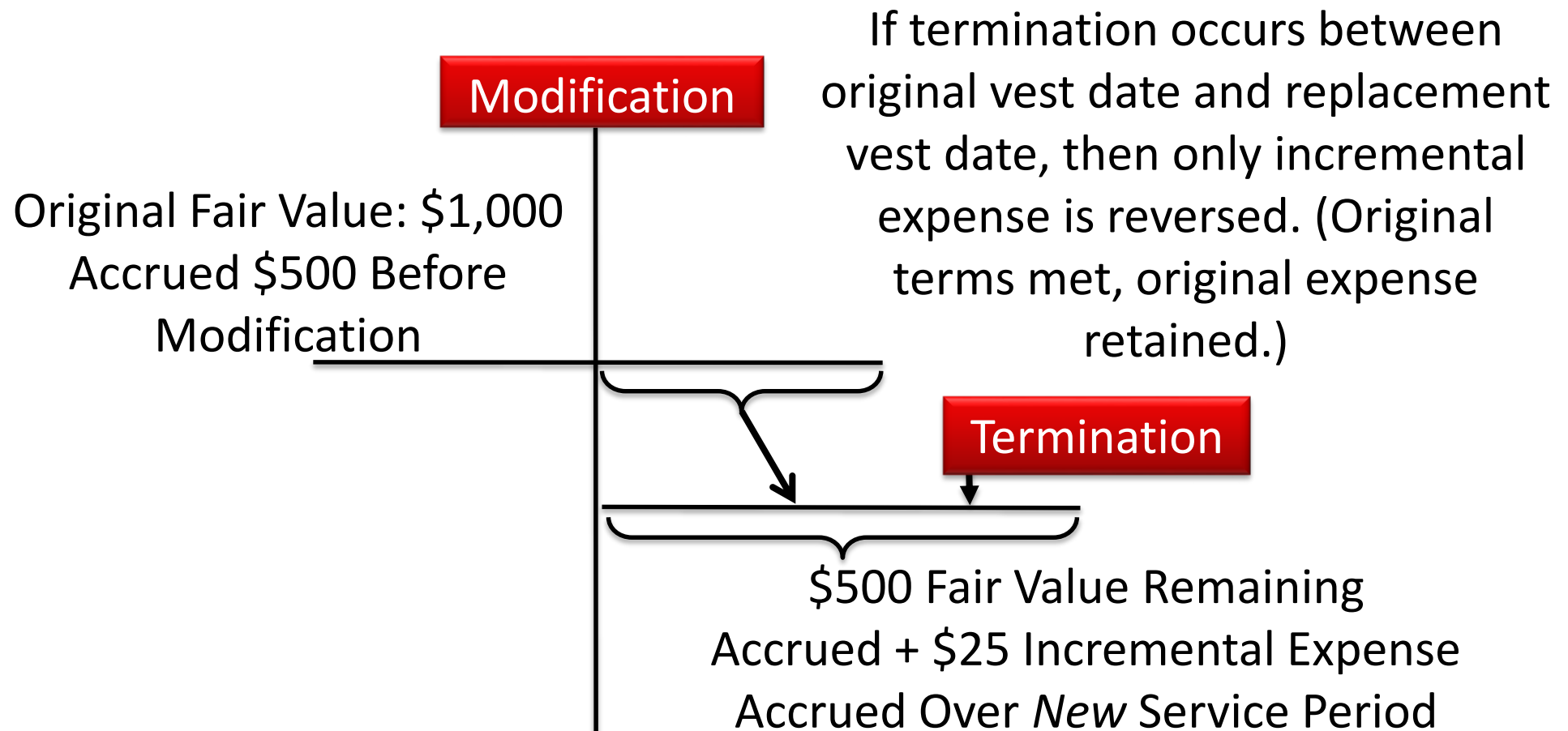
Accrual – Bifurcated Approach

Modification with Incremental Expense & *extension of vest schedule* – Bifurcated Approach



Accrual: Pooled Approach

Modification with Incremental Expense & *extension of vest schedule*– Pooled Approach



Extension of Exercisable Period - Example

Company ABC grants

- 10,000 stock options on 1/1/2007
- 1-year cliff vesting (vested already on 1/1/2008)
- Strike price of \$10
- Original fair value of stock options \$5

On 1/1/2009, participant terminates

- Market Value \$5
- Since options have no intrinsic value
- Company ABC elects to extend the exercisable period post-termination from 30 days to 5 years

What are the accounting ramifications of the modification?

Extension of Exercisable Period - Answer

Modification requires valuation before and after

Immediately before modification:

- Participant has **30 days** to exercise
- Expected life in determining fair value = 30 days

Immediately after the modification:

- Participant has **5 years** remaining on contractual term
- No longer employee, refer to EITF 96-18
- Generally, company should calculate fair value using the full contractual term of 5 years

(In certain circumstances, when company can illustrate that non-employees exercise sub-optimally, company can select an expected life shorter than the contractual term.)

Extension of Exercisable Period - Answer

Any incremental cost should be recognized immediately. Even if new vesting is added which restricts exercise, **since there is no risk of forfeiture**, incremental expense should be recognized in the current reporting period.

| | Immediately Before | Immediately After | Incremental |
|--------------------------|--------------------|-------------------|-------------|
| Stock Price | \$5.00 | \$5.00 | |
| Strike Price | \$10.00 | \$10.00 | |
| Expected Life | 0.0833 | 5.0000 | |
| Black-Scholes Fair Value | \$0.00 | \$1.31 | \$1.31 |
| Number Modified | 10,000 | 10,000 | 10,000 |
| Expense | \$0 | \$13,085 | \$13,085 |

Acceleration of Vesting - Example

Company ABC grants

- 10,000 stock options on 1/1/2007
- 4-year cliff vesting (scheduled to vest on 1/1/2011)
- Strike price of \$10
- Original fair value = \$5

On 1/1/2009, participant terminates

- Company ABC elects to accelerate vesting
- Market Value \$20
- Historically, Company ABC has applied a forfeiture rate of 10% per year
- Company ABC currently believes that 10% per year continues to be a reliable estimate of expected forfeitures.

What are the accounting ramifications of the modification?

Acceleration of Vesting - Answer

It is not as simple as accelerating all unamortized expense as of the modification date.

First, we need to categorize what % of the options are **Expected To Vest** (Type 1 Modifications – Probable to Probable), and those that are **Not Expected To Vest** (Type 3 Modifications – Improbable to Probable).

As of 1/1/2009, **8,100** options are **Expected To Vest** and therefore are Type 1 modifications, calculated as follows:

$$8,100 = 10,000 \times (1 - 10\%)^2$$

Therefore, **1,900** options are considered **Not Expected To Vest** and are Type 3 modifications.

Acceleration of Vesting – Answer (Cont.)

Modification requires valuation before and after

8,100 Type 1 options valued immediately before and after yielding a fair value of \$11 each

–No incremental expense

–Only difference in assumptions is shorter expected life since no vesting, and therefore a lower valuation immediately after

–Only accounting effect is immediate recognition of any unamortized expense, \$20,250, as of the modification date:

$$\$20,250 = \frac{8,100 \times \$5}{2}$$

Acceleration of Vesting – Answer (Cont.)

1,900 Type 3 options valued immediately after

–Fair value = \$11

However, since participant has already terminated

–Before valuation = \$0

–Since no probability of vesting

–Therefore, incremental expense = full value immediately after modification of \$20,900 (1,900 x \$11).

The net expense from modification = \$11,400:

| Absent Modification | | |
|---------------------|--------|-----------------|
| | Number | FAS123R Expense |
| Awards | 10,000 | \$50,000 |

| With Modification | | |
|-------------------|--------|-----------------|
| Category | Number | FAS123R Expense |
| Type 1 Awards | 8,100 | \$40,500 |
| Type 3 Awards | 1,900 | \$20,900 |
| TOTAL | 10,000 | \$61,400 |

Acceleration of Vesting – Answer (Cont.)

What if stock price drops from \$10 at 1/1/2007 to \$2 on 1/1/2009, and fair value of the modified awards on 1/1/2009 is \$.20?

Same treatment applies, except now fair value of Type 3 awards are significantly less...

| Absent Modification | | |
|---------------------|--------|-----------------|
| | Number | FAS123R Expense |
| Awards | 10,000 | \$50,000 |

| With Modification | | |
|-------------------|--------|-----------------|
| Category | Number | FAS123R Expense |
| Type 1 Awards | 8,100 | \$40,500 |
| Type 3 Awards | 1,900 | \$380 |
| TOTAL | 10,000 | \$40,880 |

Corporate governance /HR considerations perception issues, but expense savings can be large. See Illustration 13(e), Paragraph A170 of FAS123R for an additional example.

Tax Accounting 101

Corporate tax deduction for NQ/RS/RSU at exercise or delivery

- To anticipate future deduction, company books
 - Deferred Tax Asset (DTA) as expense accrues (**expense** * corporate tax rate) ¹
- At settlement, true up DTA to ACTUAL Tax Benefit

| If | Result | Impact |
|---------------------------------|------------------------|---|
| Actual Tax Benefit > DTA | Excess / Windfall | Increase APIC |
| Actual Tax Benefit < DTA | Deficiency / Shortfall | Decrease APIC / Increase Tax Expense |

¹ At same time Deferred Tax Benefit reduces income tax expense.

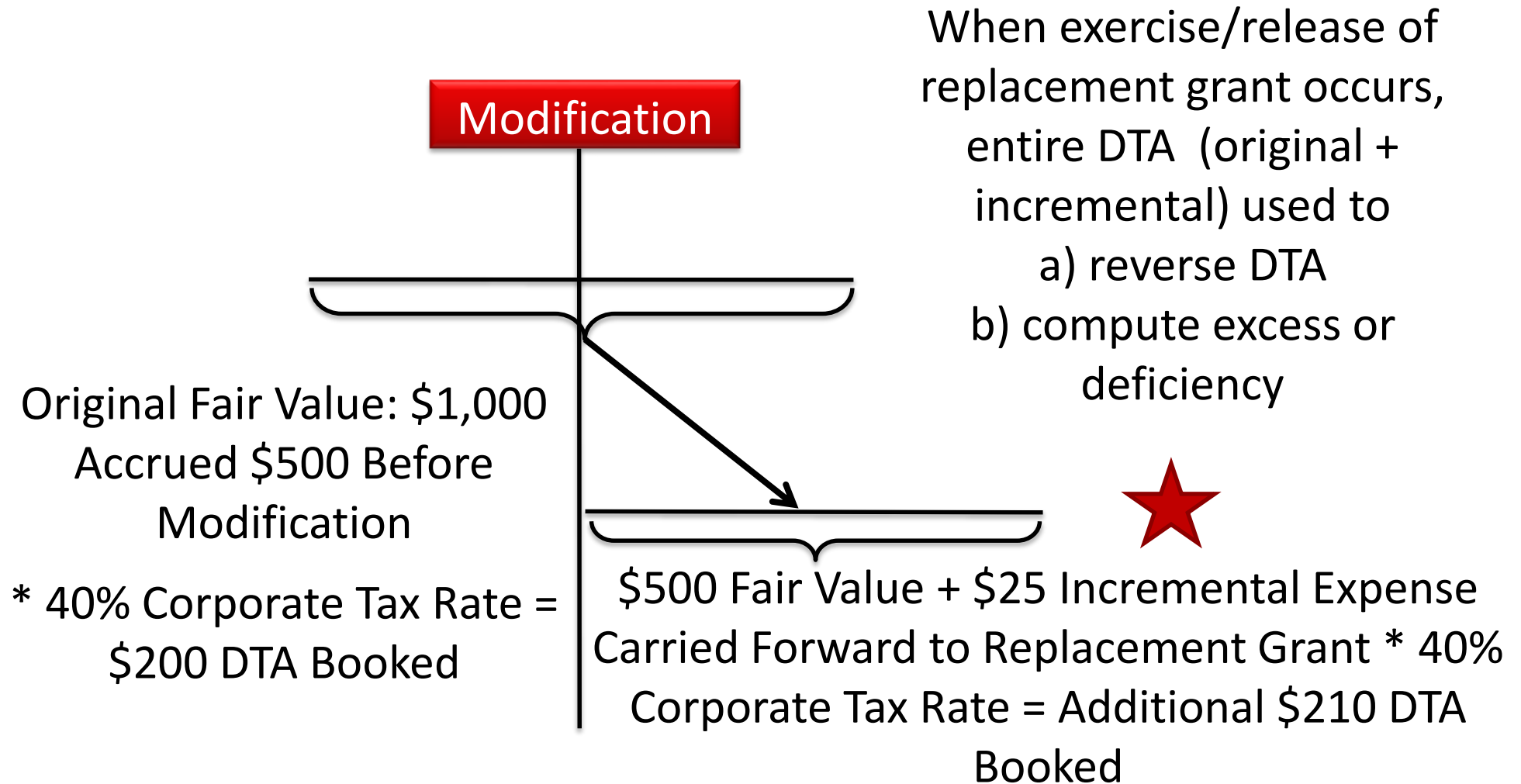
Tax Accounting for Modifications

Both the old (original) and the new (incremental) expense tied to new grant

- Both used when determining excess or deficiency for tax accounting purposes
- Deferred tax assets (DTA) from both old and new grant are reversed at time of settlement
- **Published guidance on this treatment is scarce**
 - Prevailing practice – may be diversity in practice
- **Expect deficiencies!**

Tax Accounting for Modifications

Modification with Incremental Expense



Combined \$410 DTA to Reverse

Tax Accounting Example

Option Granted on 1/15/06, Option Price = \$15

Grant-date Fair Value = \$10; 100 Shares

...

On 7/15/09 Market Value of Stock = \$4

Re-applying Black-Scholes, current fair value = \$1

Total Fair Value = \$100

...

New RSU Grant – Per Share Fair Value = \$4

\$100 of Option Value = \$100 of RSU Value ($\$100/4 = 25$)

100 Options Exchanged for 25 RSUs (4 to 1 Ratio)

Tax Accounting Example

Value-for-value exchange: 4 to 1 Ratio

40% Corporate Tax Rate

Original 100 shares, fair value of \$1,000 = **DTA of \$400**

New RSU grant of 25 shares = incremental expense = \$25 = **additional DTA of \$10**

RSU is released in 2010 when the stock price is \$9.00 per share = **tax benefit of \$90**

Excess or deficiency?

| Market Value | Gain | Actual Tax Benefit | Total DTA | Excess / (Deficiency) |
|--------------|---------|--------------------|-----------|-----------------------|
| \$9.00 | \$225 | \$90 | \$410 | (\$320) |
| \$41.00 | \$1,025 | \$410 | \$410 | \$0 |

DTA / Incremental Expense Catch Up

If any shares VESTED at time of modification
AND incremental expense > \$0

- In quarter of modification (immediately)
- Book incremental expense for vested shares
- Book additional DTA/DTB for incremental expense for vested shares

ISO vs. NQ Catch Up

If ISOs replaced with NQs

- No Deferred Tax Asset has been booked for ISOs (no tax deduction can be “expected” so no DTA allowable)
- DTA should be booked for fair value of ISO * percent of service period completed * applicable corporate tax rate at time of exchange
- No published guidance on this treatment
 - Seems to be the prevailing practice

Hypothetical Deficiencies

“Straddle Grants”

- Granted prior to FAS 123(R)
- Part of fair value disclosed, part recognized

Two different calculations for APIC

- One with recognized fair value - decreases APIC
- One with TOTAL fair value – decreases APIC POOL
- Difference between = Hypothetical deficiency

Depending on Method of Calculating APIC Beginning Balance, impacts different grants:

- Long-form
 - Grants fully vested at adoption & straddle grants
- Short cut Method
 - Straddle grants only

Diluted EPS Impact

EPS Under FAS 128 in Four “Easy” Steps

1. Assume all vested & exercised/released
2. Weight shares for time outstanding
3. Calculate assumed proceeds / buyback shares
 - a. Exercise Proceeds (price)
Not for RS/RSUs
 - b. Average Unamortized Expense
 - c. Hypothetical Tax Benefit / Deficiency
4. Compare weighted shares outstanding to buyback shares

Diluted EPS Impact

Average Unamortized Expense

- Impacted by changes to accrual

Hypothetical Tax Benefit / Deficiency

- Both original¹ & new DTA must be considered & compared to hypothetical gain at exercise

Compare weighted shares outstanding to buyback shares

- Compute buyback shares & compare to weighted shares outstanding

¹ Including disclosed depending on accounting policy

Contact Information



Stock & Option Solutions

Elizabeth Dodge, CEP
Vice President, Product Management
6399 San Ignacio Avenue, Suite 100
San Jose, CA 95119 USA
Bus: (408) 754-4609
Mobile: (650) 773-2142
E-mail: edodge@sos-team.com

RADFORD

SURVEYS + CONSULTING

Terry Adamson, CEP
Senior Vice President
1650 Market Street
Philadelphia, PA 19103-7301 USA
Bus: (215) 255-1802
E-mail: tadamson@Radford.com

Deloitte.

Ellie Kehmeier
Tax Director, Deloitte Tax LLP
225 W Santa Clara St Ste 600
San Jose, CA 95113-1728
Bus: (408-704-4350
E-mail: ekehmeier@deloitte.com