

ACCOUNTING FOR TERMINATIONS?? WHAT?

A recent email from a colleague reminded me yet again how common this occurrence is (it had been at least a month since my last work for a client on a termination charge in equity compensation accounting).

"A charge for terminations?!", you cry, "Don't we just reverse expense? What is this charge of which you speak?"

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

The chart below summarizes the various modification types provided for under ASC Topic 718. The only types that are actually common 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 at Termination

Let's say an executive is leaving and he has a grant that is partially vested and partially unvested. The company decides to accelerate the unvested shares so that the exec can exercise before the shares expire. 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 (since 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 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. If the grant is 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 is 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.

Only Extension of Term at Termination

I received this question twice this week: if a participant is leaving and we're not modifying the grant EXCEPT to change the term, and all the shares being modified are already vested, what is the accounting treatment?

Acceleration and Extension of Term at Termination

In our next example again some of the shares were vested and some unvested, but instead of simply accelerating the grant, the 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: as in the extension example above, the vested shares are a Type I modification (probable to probable, since they 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. 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" what you booked before. You calculate what you've accrued to date and then true up / down to the new fair value.)

For the vested shares it 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 expense in the current quarter. If the stock price has risen since grant and an option is in-the-money, these types of changes can result in substantial expense.

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