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Accounting for Option Exchanges

We continue to get calls every day from clients considering exchanges and the alternatives to exchanges. As we work with these clients and explore their needs, we are finding that some misunderstand the accounting ramifications of exchanges and even more are unaware of the tax accounting and EPS impacts. Many assume that their software or provider will automatically compute the results of the modification correctly from accrual to tax accounting to diluted EPS. Unfortunately, often that's not the case. What follows is a quick, English-language description of the accounting, tax accounting, and EPS impact of exchanges to help you understand this side of the story.

Modification Accounting & Incremental Expense

Exchanges require modification accounting under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718 (FASB ASC 718, formerly FAS 123(R)), but can be structured to minimize (or even eliminate) the "incremental expense" that may result from the modification. You compute the current fair value of the exchanged (the "old") option and the value of the new grant, and the excess of the new grant over the exchanged grant is the incremental expense that will be recognized in addition to the original fair value. For computing incremental expense, the original grant-date fair value of the original grant is not considered. You compute the fair value today as of the modification date, generally using a Black-Scholes option-pricing model and working up all the same inputs (exercise price, market value, volatility, interest rate, dividend rate, expected term) for your underwater options.

Let's consider an example of an option-for-option exchange: the original option for 1,000 shares was granted in 2007 when the market value of the stock was \$10. The exercise price is also \$10. The expected term was 5.5 years, the risk-free interest rate was 3.6%, and the company's volatility was 22%. (Dividends were not paid.) Plugging those values into a Black-Scholes model, at the time of grant, resulted in a fair value on grant date of \$2.87 or a total fair value of \$2,870 (1,000 options * \$2.87 fair value per share).

Now in 2009, the current market value is \$3; however, the exercise price remains \$10. To arrive at the current fair value of this option, we need to revalue the original option with new assumptions. The expected term is recalculated at 6.5 years (the option is deeply underwater so the expected term was derived using a Monte Carlo simulation or binomial model and is now longer than the original expected term), the interest rate is 1.8%, and the volatility has increased to 34%. The current fair value of the original option is now \$0.21 a share, for a total fair value of \$210.

Next, we compute a fair value for the new option (the "regrant"): market value is \$3, and exercise price is \$3. Expected term is 5.5 years (shorter, since the much lower exercise price makes the option more likely to be in-the-money, and therefore exercised, sooner). Interest rate and volatility are also lower than the revalued 2007 grant, because of the shorter expected term, at 1.7% and 32% respectively. The option fair value is calculated to be \$0.98 a share for a total fair value of \$980.

If our company had decided to do an exchange with a 2-for-1 exchange ratio, the value of the new grant would be \$490 (500 options * \$0.98 fair value). Since the current fair value of the old grant is \$210, the incremental expense of the new grant (new grant fair value less "revalue" of 2007 grant) would be \$280. Remember that the original grant date fair value of \$2,870 is not a part of the calculation of incremental expense.

But let's say that our company has instead decided to do a value-for-value exchange. To compute the exchange ratio (the number of shares a participant would have to give up under their revalued 2007 option to receive a regrant) for a value-for-value exchange, we simply divide the current fair value of the old grant, \$210, by the fair value of a share of the new grant (\$0.98) to determine how many new shares are "equal" to the fair value of the old grant (rounding down generates 214 shares). For this value-for-value exchange the participant will have to "tender" back to the company approximately five shares for every one new share received in return.

Since each set of options with the same attributes will have a different fair value (because of different valuation assumptions such as price, expected terms, volatility and interest rates), to do a true value-for-value exchange, the result is many different exchange ratios. If your company only grants options once a year, this may be manageable, but since many companies grant options throughout the year, this could mean hundreds of different exchange ratios for one company. Therefore, most companies choose to "band together" sets of options with similar fair values (and therefore similar ratios) and may say, for example, that options granted in 2007 have a 5-to-1 ratio while those in granted in 2006 have a 4-to-1 ratio.

Even if you do structure your exchange program as a "value-for-value" exchange, in many cases you will end up with some incremental expense, either because of the "banding" technique described above, or because different methodologies were used to compute the exchange ratio and the accounting expense. In some cases, this incremental expense is due to stock price movement during the tender offer period. So, in any case, understanding and computing incremental expense is something to consider for all exchange programs.

In our example, let's assume the exchange ratio selected was 5-to-1, so the participant received 200 new options in exchange for the 1,000 original options. However, during the 20 days of the tender offer, the market value declined from \$3.00 to \$2.50. So now on the date the exchange is finally implemented, the current fair value of the original grant (the revalued 2007 grant) is \$0.12 per share (down from \$0.21 per share) for a total value of \$120 (1,000 options x \$0.12) and the fair value of the regrant has changed to \$0.82 a share (down from \$0.98 per share), for a total value of \$164 (200 options x \$0.82). The value of the new option exceeds the current value of the revalued 2007 option resulting in incremental expense of \$44. (This may not seem like a significant dollar amount, but with larger dollar and share amounts, multiplied by all the grants being exchanged, the expense can really add up, sometimes into the millions.)

Accrual of Expense & True Up for Forfeitures

Exchanges with Incremental Expense

Now that you have this incremental expense, how do you accrue it? That actually depends on whether or not you "reset" or extend your vesting as part of the exchange. Many companies add on at least a little vesting to the new grant rather than keeping the original vesting schedule intact, to put some 'teeth' back in the retention tool we call options (especially for grants or tranches that are already vested).

If you do not choose to change the vest schedule, but instead continue the original vest schedule, the accrual of any incremental expense is simply added to the original fair value and accrued over the remaining service period, along with any of the original expense yet to be accrued. If you do choose to modify the vest schedule, FASB ASC 718 prescribes that the original fair value should continue to be accrued over the original vest schedule and any incremental expense should be accrued over the new vest schedule. (An easy way to remember this is "old expense, old vest schedule; new expense, new vest schedule".) However, a little-known conclusion of the previous FAS 123(R) Resource Group made on May 26, 2005, provides another choice for the accrual of any unamortized expense from the original grant. The alternate method allows the total compensation expense (i.e., the unrecognized expense from the original award and the incremental expense from the modification) to be carried forward and accrued over the service period of the new grant. Your company can choose which method it prefers to use.

But, regardless of which expense accrual method is used, if the grant is forfeited between the original vest date and the new vest date, only the incremental expense is reversed, not the original expense. (The logic here is that since the original goal of the grant was met – staying employed until the original vest date – then the original expense is “locked in” just as it would be if the grant were never modified. Your company shouldn’t ever recognize less expense due to a modification. There are exceptions to this rule, but only for Type III Improbable-to-Probable modifications, which are not generally applicable to grants with solely time-based vesting and are beyond the scope of this article.)

Accrual for Cash Exchanges (aka Cash Settlements)

Many companies are looking for a way, anyway, to eliminate or at least reduce the expense for the original grants, which are likely to expire underwater. Unfortunately, there is no way to avoid this expense unless the employee terminates prior to the vesting date of the grant. And, though some companies have said that a cash offer “reduces future expense” that is somewhat misleading. Yes, it reduces future expense by accelerating all the remaining, unamortized expense into the current period. So, though it reduces future expense, it increases current expense. (Though, it is possible that for some companies this is a benefit rather than a detriment.)

Tendering/Canceling Shares for No Consideration

And, believe it or not, the same is true for turning your options in without any consideration. Some companies, because of dwindling share reserves or high overhang have asked executives to turn in underwater shares and receive nothing in return. And yes, some executives have done so. But under FASB ASC 718, this somewhat voluntary or mutual cancellation of an award is considered a repurchase by the company for no consideration and thus, any previously unrecognized compensation expense is accelerated as of the cancellation date. So, there is a non-cash cost to the company in doing this kind of “tender” transaction.

Tax Accounting for Modifications

Now on to everybody’s favorite topic: tax accounting... Unlike the accrual of expense in connection with an option exchange program, where the old expense remains with the old grant and the new (incremental) expense is tied to the new grant, for tax accounting generally both the old (original) and the new (incremental) expense are tied to the new grant. Both are therefore used when determining whether a transaction (exercise, expiration, etc.) has created an excess or deficiency for tax accounting purposes and the associated deferred tax assets (DTA) from both the old and the new grant are reversed at the time of exercise, expiration, etc.

Let’s look at our example from above as it relates to tax accounting: the original 2007 grant with a fair value of \$2,870 results in a DTA of \$1,148 (assuming a 40% corporate tax rate - $\$2,870 \text{ fair value} \times 40\% \text{ corporate tax rate}$) which is being booked over the vesting period. The new grant of 200 shares, with a 5-to-1 exchange ratio, resulted in an incremental expense of \$44, which resulted in an additional DTA of approximately \$18 ($\$44 \times 40\% \text{ corporate tax rate}$). Assume that the option (exercise price of \$2.50) is exercised in 2015 when the stock price is \$5.50 per share, resulting in a tax benefit of \$240 ($(\$5.50 - \$2.50) \times 200 \text{ options} = \$600 \text{ gain multiplied by the } 40\% \text{ tax rate}$). To calculate whether or not the exercise results in an excess or deficiency you compare the total DTA booked (original fair value of 2007 grant plus the incremental fair value of the regrant multiplied by the corporate tax rate) to the actual tax benefit. If the DTA exceeds the tax benefit, as in this case, the result is a deficiency of \$926 ($\$1,166 \text{ DTA less } \$240 \text{ actual tax benefit}$) which either reduces your additional paid-in capital (APIC) pool or, if sufficient APIC pool does not exist, increases your tax expense. (**Note:** Since this article was originally published, new accounting guidance was issued by the FASB in March 2016 (FASB ASU 2016-09- see article link below), which eliminates the APIC Pool and requires excess tax benefits/deficiencies be recorded straight to the income statement.)

The entire DTA is also reversed at the time of the exercise. If only the DTA from the regrant is considered at the time of exercise (as is the case in many systems), the DTA from the original 2007 grant is “orphaned” and is never reversed. Now, to our knowledge, there is no published guidance on this treatment either from the FASB or from any major accounting firm.

We encountered a compensation practitioner that was so surprised by this treatment that he referred to it as “voodoo accounting” and sought confirmation from another professional within his firm. His (in our opinion, justifiable) concern was that the tax deduction from the new, often much smaller, grant in many cases will never result in an excess tax deduction so any excessive DTA that has been or will be accrued should be reversed at the time of the exchange. In our example above, the option would have to be exercised while the stock price is at or above \$17.07 to “break even” in terms of the total DTA that has been or will be booked [$\$17.07 = ((\$1,166 \text{ DTA} \div 40\% \text{ corporate tax rate}) \div 200 \text{ options}) + \$2.50 \text{ exercise price}$]. That’s a stock price increase of nearly 700% from the \$2.50 exercise price! While this argument certainly does have merit, we haven’t yet seen practitioners implementing it. If you have seen diversity in practice, please drop us a line, we’d love to discuss it further.

Modification Accounting & Diluted EPS

No discussion on accounting could be complete without a mention of diluted earnings per share (EPS), but don’t worry, we’ll keep it brief. With the release of FASB ASU 2016-09 in March 2016, there are now two sources for “assumed” proceeds for your diluted share calculations under FASB ASC 260 (formerly FAS 128). One of the two proceeds is impacted by modification accounting, therefore, the EPS numbers will also be impacted. “Assumed proceeds” are calculated as part of the Treasury Stock Method prescribed by FASB ASC 260, whereby all outstanding options are first assumed to be exercised and dilutive, and then this impact is offset by assuming that “assumed proceeds” from the exercise are used by the company to hypothetically buy back shares from the open market, thereby reducing the impact of full dilution. The two sources of “assumed proceeds” are 1) proceeds from the exercise price and 2) proceeds from the average unamortized expense. A third bucket was related to proceeds from tax benefits but FASB ASU 2016-09 eliminated that bucket. See our [Diluted EPS: Treasury Stock Method Overview](#) and [FASB ASU 2016-09: Amendments to ASC 718](#) articles for more details. So, the changes to expense accrual, as discussed above, will impact the “average unamortized expense” portion of your assumed proceeds calculation.

Conclusion

Though accounting for modifications is a dense topic, if you break it down to its more basic elements, it is understandable, even by those of us that typically shy away from accounting topics. However, please do not assume that just because your software or system allows you to enter the modification that it can perform the appropriate accounting calculations without at least a little manual intervention. If you are considering or have implemented an exchange, please talk to your equity database provider about what the system can and cannot support and loop your accounting team in early to begin testing the results produced by your system.

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

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