

Cancellations and Modifications of Underwater Stock Options Require Careful Consideration

As a result of declines in employer stock prices, companies may consider strategies intended to maintain value or provide alternative incentives associated with employee share-based awards that are "under water" (i.e., the award's exercise price is greater than the current market price of the stock). Careful consideration should be given to the accounting for such strategies. This HRS Insight discusses the accounting for various strategies that may be considered and provides practical examples for each strategy.

Key Accounting Principle

Under FAS 123(R), *Share-Based Payment*, it is generally not appropriate to reverse previously recognized compensation expense or avoid recognizing remaining compensation expense upon cancellation or modification of awards.

The following table illustrates examples of actions companies may consider taking for plain vanilla options and the related accounting impact:

Action	Accounting Impact
Cancellation with concurrent cash bonus	Total compensation expense is equal to the original grant date fair value (floor) plus any incremental fair value calculated as the excess of the cash bonus over the fair value of the share-based award <u>at the cancellation date</u>
Repricing or cancellation and concurrent re-grant	Total compensation expense is equal to the original grant date fair value (floor) plus any incremental fair value calculated as the excess of the fair value of the new or repriced award over the fair value of the original award <u>at the modification date</u>
Discretionary acceleration of vesting upon employee termination	Total compensation expense is equal to the fair value of the modified award <u>at the modification date</u> ; all previous expense associated with the original award is reversed
Cancellation with no concurrent compensation/award	Previously unrecognized compensation expense should be accelerated

Generally speaking, compensation expense is only reversed for unvested awards if the employee is not expected to earn the award under its original terms (i.e., forfeit the award).

Practical Examples

Example 1:

On January 1, 2006, Company A granted plain vanilla equity classified stock options that cliff vest in three years. As of February 1, 2008, these options are "under water". Management cancels the options in exchange for a cash bonus that will be paid on February 1, 2008.

Analysis:

The cancellation of a share-based award in exchange for a cash award shall be accounted for in accordance with paragraph 55 of FAS 123(R). Accordingly, the total compensation expense shall equal the original grant date fair value of the award plus the excess of the cash award over the fair value of the cancelled award on February 1, 2008.

Example 2:

On January 1, 2006, Company B granted plain vanilla equity classified stock options that cliff vest in three years. As of February 1, 2008, these options are "under water". Management cancels the options and grants new options with an exercise price equal to the market price on February 1, 2008.

Analysis:

The cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award, in accordance with paragraph 56 of FAS 123(R). Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award over the fair value of the cancelled award at the cancellation date in accordance with paragraph 51 of FAS 123(R). The incremental compensation cost is recorded prospectively over the remaining service period in addition to the remaining unrecognized grant date fair value. The total compensation cost for this award would be the grant date fair value of the original award plus the incremental compensation cost.

Example 3:

On January 1, 2006, Company C granted plain vanilla equity classified stock options that cliff vest in three years. On February 1, 2008, the employee is terminated. Management decides to accelerate the vesting of his/her stock options.

Analysis:

Because the individual was terminating employment prior to vesting, the employee would not have vested in the award under its original terms. The acceleration of the vesting changes the expectation (at the modification date) that the unvested award will ultimately vest and is therefore classified as a Type III (improbable-to-probable) modification. Compensation expense for the original award is zero and therefore any previously recognized expense should be reversed. In accordance with paragraph 51 of FAS 123 (R), compensation cost should equal the fair value of the accelerated award at the modification date. Note that this is one situation where the total compensation expense can be less than the original grant date fair value.

Example 4:

On January 1, 2006, Company D granted plain vanilla equity classified stock options that cliff vest in three years. As of February 1, 2008, these options are "under water". Management cancels the options without a concurrent re-grant or re-pricing.

Analysis:

The cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration is accounted for as a repurchase for no consideration, in accordance with paragraph 57 of FAS 123(R). Accordingly, any previously unrecognized compensation cost is recognized at the cancellation date. Amounts that have previously been recognized are not reversed. The accounting would be the same if the employee initiates the cancellation of an "under water" award.

Where You Can Find More Information

More information on accounting for modifications and cancellations under FAS 123(R) can be found in the *PwC Guide to Accounting for Stock-Based Compensation*, Sections 1.13.3.1; 1.13.3.2; and 1.13.9.

How We Can Help

We have considerable expertise in the accounting, tax and HR issues related to stock-based compensation. We can help companies that are considering cancelling or modifying stock option awards (e.g., as a result of a decline in stock price). We can help you better understand the accounting implications related to stock option cancellations and modifications and help you consider strategies to deal with your current situation.

For more information on the topic discussed in this *HRS Insight* or to change your address, contact your local PricewaterhouseCoopers professional.

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