Stock Informatics™

Equity Award (Stock Option) Modification Overview

FAS 123R

*“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. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring **additional** compensation cost for any incremental value. If an equity award is modified after the grant date, **incremental compensation cost** will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.”*

ASC 718
Compensation – Stock Compensation

Modification – is a change in any of the terms or conditions of a share-based payment award.

Modification of an Award

718-20-35-3 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. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring **additional** compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Topic over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 718-10-30-20, references to fair value throughout this Topic shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10- 35-3 and other guidance in Examples 13 through 14 (see paragraphs 718-10-55-103 through 55-119).

b. Total **recognized compensation** cost for an equity award shall at least equal the fair value of the award at the [original] grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

1. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date.

2. The incremental cost, if any, resulting from the modification.

Cancellation and Replacement

718-20-35-8 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. (The phrase offer to grant is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 718-20-35-3. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the **[original]** grant-date fair value of the **original award** for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

Stock Informatics Interpretation

Modifying or tendering an equity award in exchange for a replacement award are both considered modifications under ASC 718. If the fair value of the modified equity award exceeds the re-computed fair value of the original award immediately prior to the modification, then the company must recognize the incremental additional compensation cost, plus any unrecognized compensation expense attributable to the original grant date fair value. At a minimum, the company must recognize the remaining unrecognized expense of the original award based on the grant date fair value.

The re-computed fair value of the original equity award – immediately prior to modification - is based on current award valuation assumptions (using the original pre-modification exercise price, current market price, current expected life, current expected stock price volatility and current expected cash dividend yield) which are determined immediately prior to the modification. The incremental compensation expense to be recognized is equal to the difference between the re-computed fair value of the original award immediately prior to the modification and the fair value of the modified award.

- In most cases there is an incremental fair value component to the calculation since in all likelihood the modified options will have a fair value in excess of the fair value of the original exchanged options just prior to the modification.

- Some companies attempt to contain or neutralize the cost of the modification by issuing a lesser number of modified grants or establishing an exercise price on the modified grant higher than the prevailing market price on the date of modification, but more favorable than the original grant's exercise price.

- In all cases, if the vesting period is extended, the recomputed compensation expense can be recognized over either the remaining vesting period of the original grant, or the vesting period of the modified award. Most companies elect to spread the cost over the vesting period of the modified grant.

- If the equity award is currently classified as an Incentive Stock Option (ISO) under the Internal Revenue Code, affording the optionee favorable tax treatment upon exercise of the grant, care must be taken in modifying the grant so as not to trigger an unintended conversion to a Non Qualified Equity Award. This is particularly important with regard to modifications which extend the contractual term of the grant beyond the original ten year term. Please consult with your tax professionals to obtain an opinion regarding the preservation of ISO classification status subsequent to any contemplated modification. A summary of ISO Income Tax Rules applicable to common stock based compensation is attached.

Income Tax Rules Applicable to Common Stock Based Compensation Overview

Favorable tax treatment applies to employees who are granted qualified Incentive Stock Options (ISOs), provided that certain requirements are met. To be an ISO, the option must meet the following statutory requirements:

1. The option plan must: (a) specify the aggregate number of shares that may be issued, (b) identify the employees or class of employees eligible, and (c) be approved by the shareholders within 12 months before or after the plan is adopted.
2. The option must be granted within 10 years of the earlier of either the adoption of the plan or its approval by the shareholders.
3. The maximum term of the option must be limited to 10 years.
4. The exercise price must not be less than the fair market value of the stock at the grant date.
5. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.
6. If the employee owns, immediately before the option is granted, more than 10% of the combined voting power of the employer, or its parent or subsidiary, the option price must be at least 110% of the stock's fair market value at the grant date and the option must not be exercisable for more than five years after grant.
7. In addition to the previous requirements, the maximum Market Value of ISOs **that can become exercisable** (i.e vested) in a calendar year is $100,000.
    - This limit is based on the grant-date **Market Value** of the shares subject to the option, which is not to be confused with the **Fair Value** of the option grant as derived by an option pricing model such as the Black Scholes model.
    - Options, or portions of options, corresponding to shares with a grant-date **Market Value** that vest in any year in excess of $100,000 per year will be treated as Non-Qualified stock options.

A **Non-Qualified Stock Option** (NQSO)is an option that does not meet all of the foregoing requirements of an ISO.

Generally for NQSOs, at exercise, the excess of the fair market value of the stock over the exercise price is taxed as ordinary income.

For ISOs, subject to there being no "disqualifying disposition" there is no taxable income realized by the employee, however, at exercise the difference between the fair market value of the shares received and the exercise price of those shares is a tax preference item for purposes of calculating any alternative minimum tax liability that the employee may have.

Stock Informatics Interpretation

Item number seven above can be the most difficult concept in consistently applying whether an option is classified as an ISO or NQSO. The operative statement **“that can become exercisable”** is key to understand as it is not meant to refer to when the option is eventually exercised, but rather when each tranche of options becomes **“exercisable”** or **vested**.

It is therefore important to schedule out the vesting of each grant, and for large option recipients, make sure that no more than $100,000 in grant-date Market Value annually vests among all of their grants. If any Market Value vesting is potentially possible which would exceed $100,000 annual aggregate vesting, adjusting the vesting schedule of new grants can avoid the NQSO threshold.