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## EQUITY RESTRUCTURINGS COULD TRIGGER SIGNIFICANT COMPENSATION COST IF STOCK OPTIONS DO NOT CONTAIN ANTIDILUTION PROVISIONS

*Companies that adjust the terms of their stock-based-compensation awards to preserve the value of the awards after an equity restructuring event (e.g., a stock split, spin-off, or recapitalization through a large nonrecurring dividend) may incur significant incremental compensation cost if they were not required to make such adjustments based on an existing antidilution provision. An antidilution provision that permits adjustment of the terms of awards at the discretion of management or the compensation committee will not prevent companies from incurring compensation cost because such a provision does not require adjustment if an equity restructuring event occurs. Therefore, companies should carefully review their plans to determine whether they contain antidilution provisions and if they do, whether under those provisions adjustments are required or discretionary. Companies that desire to avoid future compensation cost should consider adding a required antidilution provision to their plans as soon as possible if their plans do not currently include such a provision or the provision is discretionary.*

### Background

Under FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R)), any change to the terms of an award constitutes a modification. Upon modification of an award, companies are required to calculate the incremental fair value of the modified award, reassess the probability of vesting (if the award is unvested), and recognize any incremental compensation cost over the remaining service period.

Modification accounting applies when a company modifies the terms of an award in connection with an equity restructuring event. Often, companies will adjust an award's terms to preserve its value after such an event. For example, to offset the decrease in the per-share price of the stock underlying a stock option after a stock split or spin-off, a company may adjust the exercise price of the stock option, the number of shares underlying the stock option, or both. To determine whether these "equitable" adjustments result in incremental compensation cost under FAS 123(R), companies will first need to assess whether the adjustments were required by an existing antidilution provision.

An award is also modified when an antidilution provision is added to its terms. However, FAS 123(R)

provides one exception to its modification accounting guidance – if an award is modified to add an antidilution provision and the provision is not added in contemplation of an equity restructuring event, then the company is not required to calculate the incremental fair value of the modified award.

This *HRS Insight* further explores the accounting consequences when awards are modified in connection with an equity restructuring event. Three scenarios are discussed:

- Awards that do not contain an antidilution provision,
- Awards that contain an antidilution provision, and
- Awards modified to add an antidilution provision.

### Awards that Do Not Contain an Antidilution Provision

If the adjustment of an award's terms in an equity restructuring was not required by an existing antidilution provision, modification accounting will likely result in significant incremental fair value. The incremental fair value is created because the award's fair value immediately before modification is based on the assumption that the equity restructuring will occur and the award will not have antidilution protection, while the fair value immediately after modification reflects the

“equitable” adjustments made to the award’s terms, thus increasing its value.

The following example illustrates the accounting for the modification of stock options to preserve their value after a 2-for-1 stock split, assuming that the options do not contain an antidilution provision.

**Facts**

Company X adopted FAS 123(R) effective January 1, 2006.

On June 1, 2006, Company X grants 10,000 “at-the-money” equity-classified stock options with an exercise price of \$10 and a grant-date fair value of \$5.77.

The options cliff-vest in four years based on a service condition.

The options’ original terms do not include antidilution protection (i.e., the plan is silent on the subject of preserving the options’ value upon a future equity restructuring event).

One year after the grant date, Company X completes a 2-for-1 stock split of its common stock when the market price of its stock is \$30.

Concurrent with the stock split, Company X modifies the options so that the exercise price is adjusted to \$5 and the number of options outstanding is increased to 20,000. The modification is intended to preserve the value of the options after the stock split.

All other fair value assumptions remain constant before and after the modification: expected volatility of 50%, expected term of 6 years, dividend yield rate of 0%, and risk-free rate of 5%.

**Analysis**

The adjustment to the options’ terms is a modification that is subject to the modification accounting guidance in FAS 123(R). Therefore, Company X should calculate the incremental fair value of the modified award. The incremental fair value is the excess of the fair value of the award immediately after the modification over its fair value immediately before the modification.

Because the options’ terms do not contain an antidilution provision, the estimated fair value of the options immediately before the modification should be based on the assumption that the market price of Company’s X stock will be reduced to \$15 as a result of the stock split and the exercise price of the options will remain at \$10. Using a Black-Scholes option-pricing model and a stock price of \$15, an exercise price of \$10, and the other

assumptions noted above, the fair value per option immediately before the modification is \$9.62. The total compensation cost for the options outstanding immediately before the modification is \$96,200 (\$9.62 x 10,000 options).

Immediately after the modification, the exercise price has been modified to \$5 and the number of options increased to 20,000. Using a Black-Scholes model and adjusting only the exercise price, the fair value per option is \$11.79. The total compensation cost for the options outstanding immediately after the modification is \$235,800 (\$11.79 x 20,000 options). Thus, this modification, which was intended only to make the option holders “whole,” results in incremental compensation cost of \$139,600 (\$235,800 – \$96,200). The following table summarizes the effect of the modification:

	Immediately before the modification	Immediately after the modification
<b>Market price of Company X’s stock</b>	\$15*	\$15
<b>Exercise price</b>	\$10	\$5
<b>Fair value per option</b>	\$9.62	\$11.79
<b>Number of options</b>	10,000	20,000
<b>Total compensation cost</b>	\$96,200	\$235,800

\*Although the market price of Company X’s stock is \$30 prior to the 2-for-1 stock split, the market price is assumed to be \$15 immediately before the options’ modification as it is assumed that market participants would anticipate the stock split when determining the options’ fair value.

**Observation:** *In some instances, other assumptions, such as expected term, may differ immediately before and after the modification if the award’s terms do not include antidilution protection. For example, if the options in the above illustration had an original exercise price of \$30 instead of \$10, the options would be out-of-the-money immediately before the modification, which would likely impact the expected term assumption.*

FAS 123(R)’s guidance on accounting for modifications in an equity restructuring differs from the previous guidance in FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation – an interpretation of APB Opinion No. 25 (FIN 44)*. Paragraph 53 of FIN 44 states that there is no accounting consequence for changes made to an award as a result of an equity restructuring if the award’s aggregate intrinsic value is not increased and the ratio of the exercise price per share to the market value per share is not reduced.

**Observation:** *The guidance in FAS 123(R) related to antidilution provisions represents a significant change in practice from the previous guidance in FIN 44. Under FIN 44, the accounting for a modification in connection with an equity restructuring was not affected by whether the award's terms included an antidilution provision. Under FAS 123(R), assessing whether the award contains an antidilution provision is a key factor in determining the accounting consequence of a modification in connection with an equity restructuring. When accounting for modifications in connection with such events after FAS 123(R)'s adoption, companies should not apply the guidance in FIN 44.*

### **Awards that Contain an Antidilution Provision**

If awards are adjusted based on an existing antidilution provision that requires the adjustment in the event of an equity restructuring, and is properly structured to preserve the value of the awards after the event, incremental fair value would not result from the modification. In this fact pattern, the fair value of the award immediately before the modification will reflect the anticipated required adjustment to the award's terms in accordance with the antidilution provision. Thus, the fair value of the award immediately before the modification should be equal to its fair value immediately after the modification.

However, if the antidilution provision does not require adjustment to the award's terms (e.g., such adjustments are at the discretion of the compensation committee), the accounting is the same as if an antidilution provision did not exist. This treatment is applied because the company cannot assume that the terms of the award will be adjusted in the determination of award's fair value immediately before the modification.

**Observation:** *To avoid treatment as a discretionary provision, it is not necessary for an antidilution provision to specify how the awards will be adjusted; however, the provision should state that an "equitable" or "proportionate" adjustment is required. When assessing whether an antidilution provision is discretionary, consideration should be given to whether the employees could require the company to make "equitable" adjustments to an award's terms if an equity restructuring event occurs. This may be a legal determination that necessitates the opinion of legal counsel.*

### **Awards Modified to Add an Antidilution Provision**

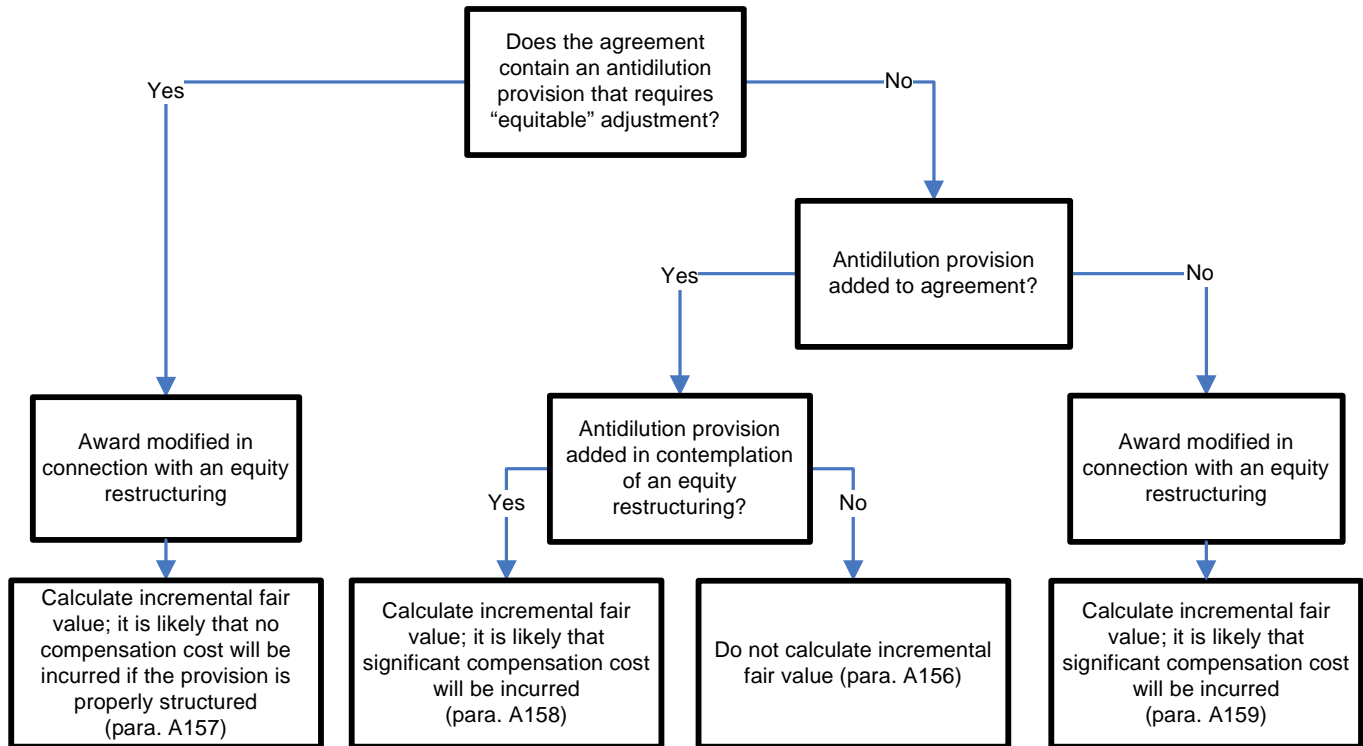
As noted earlier, although adding an antidilution provision to an award is a modification of its terms, FAS 123(R) provides that if the antidilution provision is not added in contemplation of an equity restructuring event, modification accounting is not required. Thus, the addition of an antidilution provision to an award will not result in incremental compensation cost if the modification is not in contemplation of an equity restructuring event. However, if an antidilution provision is added in contemplation of an equity restructuring event, modification accounting is required and would likely result in significant compensation cost. Similar to the illustration provided above in the scenario entitled "Awards that Do Not Contain an Antidilution Provision," the fair value immediately before the modification to add the antidilution provision would reflect the anticipated effect of the equity restructuring and assume no antidilution protection.

**Observation:** *Companies that wish to add an antidilution provision to their plans or modify an existing provision should do so as soon as possible to avoid the accounting consequences of adding an antidilution provision in contemplation of an equity restructuring event. FAS 123(R) does not define "in contemplation." In Illustration 12(e) of FAS 123(R), it is assumed that a modification to add an antidilution provision is considered to be in contemplation of an equity restructuring event if the event has been announced. Once announced, the information becomes available to market participants who would incorporate the anticipated effect of the equity restructuring event when determining the fair value of the award. Prior to the announcement of an equity restructuring event, judgment will be required to determine whether the antidilution provision was added in contemplation of that event.*

### **How Can We Help**

We can help you better understand the implications and potential impact of the equity restructurings. PwC has expertise in accounting, taxation, and compensation consulting to assist you in your analysis of these events.

**Appendix A: Flowchart of FAS 123(R)'s Modification Guidance (Paragraphs A156-A159)**



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

<a href="#">Atlanta, GA</a>	Ann O'Connell	678-419-2820	<a href="#">Houston, TX</a>	Ed Kimura	713-356-6185
<a href="#">Boston, MA</a>	Ed Donovan	617-530-4722	<a href="#">Los Angeles, CA</a>	Kevin Roach	213-356-6639
<a href="#">Charlotte, NC</a>	Robert Lyerly	704-344-7521	<a href="#">Miami, FL</a>	Allison Shipley	305-375-6303
<a href="#">Chicago, IL</a>	Pat Meyer	312-298-6229	<a href="#">New York Metro</a>	Steve Heindel	646-471-1885
	Paul Perry	312-298-3157	<a href="#">Philadelphia, PA</a>	Ted Volz	267-330-3180
<a href="#">Cleveland, OH</a>	Lynn Ford	216-875-3065	<a href="#">San Francisco, CA</a>	Rich Zook	408-817-5942
<a href="#">Dallas, TX</a>	Charlie Wheeler	214-754-5023	<a href="#">St. Louis, MO</a>	Becky Weaver	314-206-8490
<a href="#">Detroit, MI</a>	Theresa Gee	313-394-6947	<a href="#">Washington, DC</a>	Dave Dawson	202-414-1014

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