July 2021

With a Surge in Equity Award Modifications, Employers Should Beware of External Considerations

Evolving regulations and pandemic-related uncertainty resulted in more modifications to equity awards than in recent history with no sign of slowing down. Here's what firms should be aware of when considering equity modifications from an employee and investor perspective.

Modifications of equity awards have been a hot topic for years, with a lot of debate surrounding issues like what "probable" versus "improbable" means, what constitutes "material changes," and how all of these things impact company disclosure and taxable events.

While we often think of modifications as events — such as adding extra exercise windows to stock options upon an employee departure or adding retirement treatment to awards upon someone's retirement — there have been several external factors that have caused more modifications than ever before and required intervention from the Financial Accounting Standards Board. What's more, these events don't seem to be slowing down.

The Tax Cuts & Jobs Act of 2017 got the ball rolling with changes to Net Income that impacted a lot of in-flight performance awards. The Financial Accounting Standards Board also came through with two significant Accounting Standards updates in ASC 606 (Revenue Recognition) and ASC 842 (Lease Accounting) that, once again, hit Net Income and caused issues with performance awards. While these might have been captured as "legislation or regulatory changes" in award agreements, the impact of the COVID-19 pandemic on equity award modifications cannot be contributed to regulation. All of these scenarios produced an inordinate amount of modifications and resulted in increased disclosure and scrutiny from shareholders, advisory firms and auditors.

While modifications can be complex, they can also save outstanding awards from hanging over the company and employees with little to no value and re-align the interests of the award-holder with the interests of shareholders and the company. Figure 1 highlights some recent ways companies have modified in-flight awards.

Empower Results®

Figure 1

Examples of Recent Modifications to In-Flight Equity Awards

Company	Concept	Modification
Expedia Group, Inc.	Extending exercisability to mitigate the impact that a macroeconomic event had on the stock market	Provided a one-year extension to the term for their outstanding options that were due to expire
Aptevo Therapeutics, Inc.	Offering an option exchange for underwater stock options (note, this type of modification is very difficult to execute as most programs require shareholder approval and proxy advisors heavily scrutinize them)	Invited eligible employees to exchange their out-of-the-money options for a lesser number of in-the-money options
Nike, Inc.	Amending the performance or market conditions connected to vesting	Modified their LTIP award so that payout was tied to Relative TSR rather than Revenue and Diluted EPS

Source 10-K filings

Modifying outstanding awards is not an easy task and requires significant analysis by the company to ensure the change makes sense. Modifications can create increased expense, unfavorable taxation and/or scrutiny from shareholders, so paying attend to the details is paramount. However, there are also real benefits to doing so in some circumstances, like employee retention and accounting for unforeseen events, which must be weighed carefully before making a decision.

ASU 2017-09 further clarified the definition of a modification for accounting purposes by delineating that there are changes that can be made to an award that are not deemed modifications. If a change to an award does not alter the fair value, vesting conditions, or the classification of the award (i.e., liability or equity), it is not considered a modification for accounting purposes and, thus, no accounting changes need be made. A change that modifies any one of these things is deemed a modification and must be accounted for as such. For example, under ASC 718, a cancel and regrant is considered a modification and not a cancellation and is oftentimes referred to as an indirect repricing.

Types of Award Modifications

When companies elect to alter their in-flight awards, the modification can fall into one of four categories according to the accounting guidance from ASC Topic 718. While these classifications come from accounting text, it's helpful to think about modifications in these terms to better understand the impact of such a change.

Figure 2

Types of In-Flight Equity Award Modifications

Modification Type	Explanation	Example
Type I: Probable-to-Probable	An award that was likely to vest prior to the modification and is still likely to vest after the modification	An underwater stock option exchange, although valueless to the employee because it is out-of-the-money, the award is still technically “likely to vest” prior to the modification and continues to be “likely to vest” after the modification
Type II: Probable-to-Improbable	An award that was likely to vest prior to the modification and is unlikely to vest after the modification (these are rare and could trigger a lawsuit due to taking value away from employees that is earned)	Not applicable since these are rare modifications.
Type III: Improbable-to-Probable	An award that was unlikely to vest prior to the modification and is likely to vest after the modification	Upon retirement, a company modifies the award to allow an additional tranche of vesting to occur that wouldn’t have prior to modification
Type IV: Improbable-to-Improbable	An award that was unlikely to vest prior to the modification and is still unlikely to vest after the modification	Upon termination, a company extends the exercise window of an unvested tranche of stock options

Most modifications that occur are Type I and Type III modifications. Common Type I modifications are often increasing to vested stock option exercise windows, underwater stock option exchanges, spin-off transactions, special dividends, changes to performance periods or alterations to payout schedules.

It is important to note that adjustments to market-based awards (e.g., altering the threshold for payout of a Relative Total Shareholder Return) are always considered a Type I modification rather than a Type III modification. This is because of the valuation methodology used in determining the award value for accounting purposes, which already incorporates the probability of the award holding no value. That is, the award will still vest even though it holds no value.

Common Type III modifications are typically in connection to a termination, whether for cause, for no cause, or for something else like retirement or a restructuring event. In instances where macroeconomic events or regulatory and legislation changes change the course of performance awards, companies have often made changes to the payout threshold of internal metrics, switched from an internal metric to Relative Total Shareholder Return, or extended the performance period to allow for a "catch up" of performance.

Accounting for Modifications

For cases where an award change is considered a modification, there are accounting implications. ASC 718 requires that modifications be assessed at the time of the modification by comparing the fair value of the award immediately before the modification to the fair value of the award immediately after the modification. The difference between the fair value immediately before the modification and the fair value immediately after the modification is known as the incremental expense and represents the change in the fair value attributable to the modification. If an award has already vested, the incremental expense must be recognized immediately. If the award has not yet vested or the vesting schedule has been extended, the incremental expense will be recognized over the remaining vesting schedule of the award.

For Type I modifications, the incremental expense is added to the original grant date fair value of the award. If no incremental expense is generated, the original grant date fair value is recognized. In no circumstances can the accounting expense go down as a result of a Type I modification. On the contrary, a Type III modification is, in essence, a forfeiture of the original award (i.e., improbable) and a grant of a new award in its place. As such, the original grant date fair value is reversed out and replaced by the new fair value assessed on the modification date.

Modifications and Taxation

Taxation and expense accounting diverge on the treatment of modification. Unlike the expense discussion above, for tax purposes, modifications are treated as the cancellation of the original award and the grant of a replacement award and the taxation and IRS reporting should reflect this.

If a company is pursuing an underwater stock option exchange of incentive stock options (ISOs) or modifying terms of the award, such as extending the expiration date or exercise period, it is important that they attend very carefully to the details of the modification. It is possible to maintain ISO status if an award is modified, but an award can lose ISO status if not modified correctly. To retain their tax-preferred status, the repricing terms must meet all ISO requirements, including:

- Adjusting the exercise price to be at least 100% of the fair market value of the ISO on the modification date
- Restarting holding periods as of the modification date
- The IRS $100,000 annual limit must be re-evaluated anytime exercisability changes, such that:
    - Any original options that vested or would have vested in the year of the modification will continue to count against the IRS $100,000 ISO annual limit.
    - Any replacement options that vested or are scheduled to vest at grant also will count against the $100,000 limit for that year.

- If the combination of cancelled and replacement ISOs first exercisable in a modification year exceeds $100,000, any options over the value will be considered disqualified and will be treated as nonqualified stock options.

If these requirements are all met, modified ISOs can retain their tax-preferred status. One other issue to note regarding underwater stock option exchanges and taxes is that IRC Section 162(m) requires companies to count the value of the original options and the value of the reprice options when calculating the per-person $1 million limit on corporate tax deductions.

Governance Considerations

In addition to understanding and evaluating the valuation and accounting consequences of a modification, a percipient company would also consider the governance implications before moving forward. From a compliance side, a company should consider if, what and when the modification must be included in a filing. Luckily, plan modifications rarely need to be disclosed in a separate Form 8-k filing at the time of modification. Item 5.02 of 8-K would only be triggered if a modification was within an employment agreement with an individual executive (the CEO, for example). Otherwise, a company can wait until the proxy statement rolls around. In the proxy statement, the Summary Compensation Table must include a Type 1 modification if there is an incremental expense or any Type III modification.

The CD&A narrative in the proxy statement, however, is equally important, as this disclosure is where proxy advisory firms and investors will assess the changes and whether to support the say-on-pay proposal. Modifications can sway the vote decision. Not only are proxy advisors and investors focused on potential quantum increases, they will be hyper-focused on the rationale for these changes. A company will mitigate concerns by including details of the modification, as well as background on the internal or external circumstances that necessitated these modifications. A discussion of how these changes have affected payout opportunities for the executives, as well as how these modifications align with the best interests of the company as well as long-term shareholders, is essential.

Next Steps

Whether modifying awards for termination, retirement, lack of performance, changes in regulation, or a global pandemic, there is a long list of considerations from accounting expense to shareholder response, all of which should be weighed before making a decision. Ultimately, there is often a balancing act between the optics of a modification and the potential ramifications of no modification, such as lack of employee retention, unnecessary expense with no value delivered, a reduction in engagement, and more.

Regardless of the path that the company takes, the measurement of these facets and narrative surrounding the thought process gives every company an opportunity to make the decision to meet their human capital goals and ensure success in their equity compensation programs.

If you'd like to explore how a modification can work for you, please write to us at rewards-solutions@aon.com.

Author Contact Information

Dan Kapinos, CEP, CECP, FGE
Partner, Rewards Solutions
Aon
+1.215.255.1874
dkapinos@aon.com

Kellie Matthews, CEP
Consultant, Rewards Solutions
Aon
+1.215.255.2033
kellie.matthews@aon.com

Amanda Benincasa Arena, CEP, MBA
Associate Partner, Rewards Solutions
Aon
+1.215.255.2025
amanda.benincasa@aon.com

David Eaton
Associate Partner, Rewards Solutions
Aon
+1.415.486.7232
dave.eaton@aon.com

Rachel Lopez, Ph.D., CEP
Consultant, Rewards Solutions
Aon
+1.201.460.6729
rachel.lopez@aon.com

About Rewards Solutions

The Rewards Solutions practice at Aon empowers business leaders to reimagine their approach to rewards in the digital age through a powerful mix of data, analytics and advisory capabilities. Our colleagues support clients across a full spectrum of needs, including compensation benchmarking, pay and workforce modeling, and expert insights on rewards strategy and plan design. To learn more, visit: rewards.aon.com.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information, please visit aon.com.

This article provides general information for reference purposes only. Readers should not use this article as a replacement for legal, tax, accounting or consulting advice that is specific to the facts and circumstances of their business. We encourage readers to consult with appropriate advisors before acting on any of the information contained in this article.

The contents of this article may not be reused, reprinted or redistributed without the expressed written consent of Radford. To use information in this article, please write to our team.

© 2021 Aon plc. All rights reserved