IFRS News

Emerging issues and practical guidance*

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Looking for better options?

Richard Davis of PwC's Global Accounting Consulting Services' central team looks at the benefits and accounting implications of share option repricings (modifications).

The downward slide of stock markets in the current global crisis presents challenges to many companies that offer share option based rewards. Management and employees holding options have realised that the current share price has sunk well below the exercise price. The challenge is how to modify such 'underwater' options for employee motivation and reward, while managing the financial reporting consequences and shareholder and market expectations.

What can management do?

Cancellations, in broad terms, accelerate the recognition of expense. Increasing the value now for a share-based payment, even if only restoring some of the value that it may have lost in recent months, leads to additional expense. These changes can have a significant impact on the income statement.

Cancelling awards?

Cancellation requires the immediate recognition of an expense based on the grant date fair value of the original awards. Management should bear that in mind when considering cancellation of awards – either because employees no longer place any value on the awards or because they are unlikely to vest as performance conditions will not be met. However, when non-market performance conditions or service conditions are not met by the end of the vesting period, the cumulative expense of share-based payments will be zero, because no awards will have vested. If those awards were cancelled before the end of the vesting period, the remaining unrecognised grant date fair value for all of the cancelled options is recognised immediately in the income statement.

Repricing options

There are several other strategies that management might consider to revive underwater options. One is to simply reprice the options – that is, to lower the exercise price to the current market share price. This is equivalent to replacing existing underwater options with new options at the current market price. This is the most straightforward strategy and will increase the incentive to the employees. There is, however, no benefit to investors who have also lost value and are unable to participate in the repricing. Moreover, the

incremental value to the employees resulting from the repricing is recorded as an additional expense over the remaining vesting period.

Repricing and reducing number of options

There are repricing strategies that involve more 'give and take'. One example is to reprice and at the same time reduce the number of options. This revives, to some extent, the value of underwater options, and it may counter investor resistance. It may also reduce the additional expense, as the entity will have to account for a lower number of options.

Repricing and extending service period

Another strategy is to reprice the options and extend the employee's service period (with or without extending the expiration term). Management may find this modification advantageous, as it requires the employee to work for a longer period to earn the options. The original grant date fair value remains spread over the original vesting period, but any incremental expense will be amortised over a longer vesting period. The fair value of the options is increased, leading to a higher incremental charge, if the expiration period is also extended.

Repricing and adding performance/market condition

Management might also consider repricing options and adding a performance or market vesting condition. These modification strategies are more complex but can help management meet other objectives. For example, investors may consider that adding a performance condition – such as a revenue or EBITDA target that must be achieved before the repriced options vest – is more desirable. The employee will only benefit from the options if the entity has positive results. The employees, however, may feel they have been penalised by the weak market, which has caused their stock options to lose value.

One way to address such a concern is to add a market condition to the award – for example, the shares outperforming an industry or market index prior to the vesting of the repriced options. These may be sound alternatives to simple repricing, but the accounting is complex and the valuation implications are beyond the scope of this article. We recommend that management consults valuation experts if they are considering this strategy.

Swapping options for shares

An alternative to repricing options is to swap them for shares that are subject to the same vesting conditions as the options. Management might view this as a better strategy, as it can restore the alignment of interests between employees and investors. Employees may also consider that share grants provide more security in a bear market because repriced share options can go underwater again.

The income statement impact depends on how much 'incremental' value is provided to the employees. Exchanging options for a smaller number of restricted shares may help to reduce or even eliminate any additional expense.

Employee cancellations

There are current examples of senior employees waiving their entitlement to bonuses, some of which may be share-based payments. The treatment of an employee giving up an unvested award is not clear in the current version of IFRS 2. Entities have a choice to treat the waiver as a cancellation, which will accelerate the expense, or ignore the waiver and continue to account for the expense based on grant date fair value. This choice will go away from 1 January 2009. IFRS 2 has been amended to make it clear that the treatment would be the same as a cancellation by the employer (acceleration of expense).

Changing an award from equity-settled to cash settled

Management could change an award from being equity settled to cash settled. Care should be taken unless the cash payment is fixed at the date of the modification because a cash-settled award will introduce income statement volatility, as the liability is marked to fair value. IFRS 2 requires the original grant date fair value to be recognised, in addition to any post-modification change in fair value, so the cumulative expense will be the original grant date fair value plus any fair value movements in the liability. A fixed cash award will still result in the original grant date expense plus any incremental fair value being recognised.

Other considerations

Management might adopt a combination of the above and other strategies to address underwater options. Management might also tailor the changes to include or exclude certain options and/or groups of employees. The decision should carefully balance factors including employee expectations, investor interests, market perception and financial reporting impacts. It is also important to be aware of any legal and contractual implications – for example, some option agreements may prohibit the employer from modifying the awards without approval of the option holders. Finally, management should consider the tax consequences, if any, of option repricing in the relevant jurisdiction.

Accounting treatment

Below are some examples to illustrate, at a high level, the accounting impact of some of the repricing strategies described above. Remember that every company's share option plan is unique, so we recommend that management model and estimate the potential income statement effect of various scenarios to determine which is most effective to achieve its goals and to consult at an early stage.

The following examples are for ‘plain vanilla’ share options with a service condition such that all awards vest after the fourth year, expiry at the tenth year and a zero forfeiture rate. The repricing is assumed to take place at the end of the third year.

Simple repricing

The exercise price is reduced to current market value; all other terms of the original option are the same.

	Fair value at grant date	Fair value before repricing	Fair value after repricing
Market price	C50	C20	C20
Exercise price	C50	C50	**C20**
Expected term	7	4	4*
Volatility	20%	30%	30%
Risk-free interest rate	3%	3%	3%
Fair value per option	C15	C1	C6
Number of options	100	100	100
Total value of options	C1,500	C100	C600

Total share compensation expense in the remaining vesting period (year 4) will be C875, calculated as the unrecognised compensation expense remaining for the original award (C1, 500 over 4 years), plus the incremental fair value of C500 calculated above (C600 - C100). [IFRS 2 paras 26-27; IG Example 7].

* The modification may impact the expected term, but it remains the same in this example for simplicity.

Fair value balanced

The exercise price is reduced to current market value, and the number of options is also reduced so there is no incremental fair value to the employee. The accounting for this can be looked at in two different ways. One view is that for the options that remain, the treatment is the same as in the ‘simple repricing’ above, and the other options are cancelled, so the recognition of the grant date fair value is accelerated. The alternative view, which we believe better reflects the economics, is that there is no change in the aggregate fair value so there is neither an incremental fair value nor a cancellation. The examples set out below are based on this view.

The accounting treatment applied to a reduction in the number of awards and a corresponding, or greater, increase in the fair value of each award is a judgment that will depend on the specific facts of each case and should be applied consistently. Views may vary.

This modification will require no additional share compensation expense, but it may result in a decline in the number of share options that limits the incentive to employees.

	Fair value at grant date	Fair value before repricing	Fair value after repricing
Market price	C50	C20	C20
Exercise price	C50	C50	**C20**
Expected term	7	4	4*
Volatility	20%	**30%**	**30%**
Risk-free interest rate	3%	3%	3%
Fair value per option	C15	C1	C6
Number of options	100	100	17
Total value of options	C1,500	C100	C100

The number of repriced options is determined by dividing the aggregate fair value of C100 by the fair value of one repriced option. The 17 remaining options have the same total fair value as the 100 options before the repricing. There is no incremental compensation expense. Only the C375 of unrecognised share compensation expense from the original award is recorded in the fourth year. [IFRS 2 paras 26-27].

* The modification may impact the expected term, but it remains the same in this example for simplicity.

Extended life

The exercise price is reduced to current market value, and the life of the option (both the vesting period and the expected term) is increased by two years. The company is still required to record the unrecognised share compensation expense of the original awards over the original vesting period*.

	Fair value at grant date	Fair value before repricing	Fair value after repricing
Market price	C50	C20	C20
Exercise price	C50	C50	**C20**
Expected term	7	4	**6**
Volatility	20%	**30%**	**30%**
Risk-free interest rate	3%	3%	3%
Fair value per option	C15	C1	C7
Number of options	100	100	100
Total value of options	C1,500	C100	C700

This modification has resulted in incremental fair value of C600 that will be recognised over the remaining modified vesting period.

The company will still be required to record the unrecognised portion of the original award (C375) in the fourth year, as follows:

	Option grant	Expense after repricing	Repricing impact on expense
	C	C	
Year 1	375	375	-
Year 2	375	375	-
Year 3	375	375	-
Year 4	375	575	200
Year 5	0	200	200
Year 6	0	200	200
Total	1,500	2,100	600

[IFRS 2 para 26-27].

* If the employee leaves during year 5 or 6 and thus fails to meet the revised vesting condition, it is only the repricing impact that is reversed; the original grant date fair value expense of C1,500 is unaffected because the employee satisfied the four-year service condition for the original award.

Swap option for unvested shares

The share option is cancelled and immediately replaced by an unvested share award, providing the employee 25 shares that will be earned over the remaining one-year vesting period of the original award.

	Fair value at grant date	Fair value before swap	Fair value of restricted shares
Market price	C50	C20	C20
Exercise price	C50	C50	**C0**
Expected term	7	4	-
Volatility	20%	**30%**	-
Risk-free interest rate	3%	3%	-
Fair value per option	C15	C1	C20
Number of awards	100	100	25
Total value of awards	C1,500	C100	C500

Total share compensation expense in year 4 will be C775, calculated as the unrecognised compensation expense remaining for the original award (C1, 500 / 4 years), plus the incremental fair value of C400 calculated above (C500 - C100).