

HRS Insight

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Companies are announcing special dividends—consider impact on stock compensation accounting

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Over the last few weeks there have been some high-profile reports of companies announcing special one-time cash dividends that will be made before the end of the year. The main motivation is anticipation of higher dividend tax rates come 2013.

The White House and Congress are feverishly working to bridge differences over how to address the fiscal cliff. But it's uncertain what action might be taken during this lame duck session. If no action is taken, beginning next year, dividends will be treated as ordinary income rather than taxed at the current rate of 15%.

Some companies with available cash have decided to make special one-time dividends before the end of the year so that investors will pay taxes on the dividends at the current rate. In connection with a special dividend, companies commonly make adjustments to employee stock awards to keep the holder whole.

This HRS Insight discusses potential accounting issues to consider when modifying stock compensation awards due to a special one-time dividend.



Impact on stock-based compensation

A large non-recurring cash dividend generally results in what's called an equity restructuring, which is a nonreciprocal transaction with shareholders that causes the per-share value of a company's shares to change. Other common examples are stock dividends, stock splits, or spin-offs.

These equity restructurings impact stock-based compensation awards. Think about a stock option that was granted yesterday at-the-money when the stock price was \$10. If a special dividend of \$2 is made today, the stock price may drop to \$8. Since the option's strike price is \$10, it's now out-of-the-money by \$2.

The stock price decreases because of the dividend, not a change in the market's outlook on the company. Because of this, companies almost always want to make an adjustment to the option holders to make them whole. In our simple example, this adjustment might be to reduce the strike price by \$2.

This adjustment represents a modification under the accounting rules¹. So it's necessary to assess whether the modification results in an additional compensation charge. This is done by comparing the fair value of the award immediately before the modification with its value immediately after. If the value after is higher, the company has given the employee incremental value, which will be recognized as compensation expense.

¹ ASC 718, Compensation - Stock Compensation.

Some awards have terms that require or allow for adjustment of the award to protect the holder if there is a special one-time dividend or other equity restructuring event. This is generally called an antidilution provision. If the award doesn't include an antidilution provision, or if the provision doesn't *require* an adjustment, modifying the terms of the award to make the holder whole after an equity restructuring event will likely result in an additional compensation charge.

Awards that don't contain an antidilution provision

While less common, some stock awards don't include antidilution protection. If a make-whole adjustment is made in an equity restructuring, but not required under the agreement, modification accounting will result in incremental compensation expense.

What causes the incremental expense? In this situation, the award's fair value calculated immediately before the modification assumes the equity restructuring will occur (so the stock price will decline), but the award won't be adjusted (since it doesn't have an antidilution provision). The fair value immediately after modification reflects the "equitable" adjustments made to the award's terms, thus increasing its value.

Consider our earlier example. The value of the option before modification in this case is based on a strike price of \$10 and a post-dividend stock price of \$8 (i.e., \$2 out-of-the-money). After the modification, the strike price is reset to \$8, so the award is now at-the-money. The post-modification award is clearly more valuable.

Some companies may choose, especially with one-time dividends, to make award holders whole with a cash payment rather than by modifying the award terms. This is also treated as a modification. The value of the award before the equity restructuring is compared to the value of the unmodified award after the dividend, plus the cash. Again, any incremental fair value is additional compensation cost².

Awards that contain an antidilution provision

Most awards do include antidilution protection. When adjustments are *required* based on an existing antidilution provision and the adjustment is structured to preserve the fair value of the awards, incremental value generally won't result from the modification.

In this situation, the fair value of the award immediately before the modification will reflect the required adjustment to the award's terms in accordance with the antidilution provision. So the fair value of the award immediately before the modification should generally be equal to its fair value immediately after the modification. But comparison of values should still be done to ensure that the company hasn't provided additional value through its adjustment mechanism.

² Note: the period over which to recognize the additional compensation cost will depend on whether there is further vesting required, and is beyond the scope of this HRS Insight. For more detail, see PwC's *Guide to Accounting for Stock-based Compensation*, available at www.cfodirect.com.

PwC observation

The comparison of value before and after modification should be based on the fair value of the award. A Black-Scholes or other option pricing model would generally be used.

How PwC can help

We've worked with many companies that have made adjustments to stock-based compensation awards as a result of special dividends and other equity restructurings. If you'd like to discuss some of these issues in more detail, please contact one of the individuals listed on the next page.

For more information, please do not hesitate to contact:

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