CPE ARTICLE

COVID-19 and Stock Compensation Awards

By Josef Rashty

CURRICULUM: Accounting and Auditing

LEVEL: Intermediate

DESIGNED FOR: CPAs in industry and public practice

OBJECTIVES: To gain an understanding of the complexities related to modification of stock compensation awards

KEY TOPICS: COVID-19 and stock compensation awards, including non-qualified stock options, incentive stock options, restricted stock units and employee stock purchase plans

PREREQUISITES: None

ADVANCED PREPARATION: None

The COVID-19 outbreak has wreaked havoc in the financial markets around the globe. Many economists predict that Western economies, including the U.S. and Europe, that dropped sharply early on will follow with a painful slow recovery.

As a result, many companies evaluate their existing compensation arrangements to determine if any specific terms, conditions or estimates have been affected, and they may decide to modify their employees' compensation and benefit arrangements. This may be more prevalent in companies with beaten-down stocks, like airline and hospitality industries.

The spread of the pandemic has created conditions often accompanied with a general economic downturn, including financial market volatility and erosion of market value, increasing unemployment, layoffs and furloughs, and other restructuring activities.

The COVID-19 crisis is redolent of the economic uncertainty surrounding the U.S. financial crisis during the past few decades. Many in the current workforce in the U.S. have been through the previous two economic downturns in recent years (the Dot-com stock market

Table 1
Characteristics of Stock Compensation Awards

Type of Awards	Employer Deductible	Employee Taxable	Employer Taxable
Statutory awards	No	No	Yes
Non-statutory awards	Yes	Yes	No

bubble of 2000 and the subprime mortgage market meltdown of 2008) and recall that economic contractions during these periods led to salary cuts for executives and many other employees – often followed by new stock compensation grants. This may actually benefit some employees in the long run since lower share prices at grant times usually offer the prospect of large gains when stock markets rebound.

This article is a compendium of several plausible scenarios for modification of four frequently and widely used stock compensation awards: non-qualified stock options (NQSOs), incentive stock options (ISOs), restricted stock units (RSUs) and employee stock purchase plans (ESPP). The objective is to canvass and deliberate on several common occurring possibilities, but it does not claim to be an overarching source for any possible modification of stock compensation awards plans. Thus, it exhorts readers to research the accounting literature and guidance applicable to their particular situation for customary practices.

Tax Implication of Stock Compensation Awards

Types of Stock Compensation Awards

There are two types of stock awards from a tax perspective: statutory awards and non-statutory awards. Table 1 summarizes the characteristics of these two types of stock awards.

Non-statutory stock awards (e.g., nonqualified stock options and restricted stock units) often create deferred tax assets (DTAs) upon recognition of compensation expense. Companies affected by current market conditions related to the COVID-19 pandemic may incur unexpected and significant losses and as a result, they may need to assess their ability to realize their DTAs prior to expiration.

Realizability of DTAs

The 2020 Coronavirus Aid, Relief, and Economic Security Act (CARES Act) has included temporary changes to income and non-income-based tax laws: for example, it eliminates the 80% of taxable income limitation by allowing net operating losses (NOLs) to offset taxable income in 2018, 2019 or 2020, and allows companies to carry back their NOLs for five years for the NOLs originated in these years. Realizability of DTAs depends on companies having sufficient taxable income and their ability of carry backs and carry forwards under the strictures of the tax law and regulations.

Realizability of Windfall Profit

The windfall tax profit is the incremental tax benefit that exceeds the previously deferred tax assets recognized for a particular award (ASC 718-640-35-2). FASB requires the application of "with and without" approach for the exercise of equity awards, whereby the windfall profit is considered realized and recognized for financial statement purposes if and only if an incremental benefit is provided after the company has considered and allocated all other available tax benefits (e.g., NOLs).

Disqualifying Disposition of Statutory Awards

Disqualifying disposition (the disposition of awards prior to the end of the holding period specified in Section 423 of the Internal Revenue Code) changes the statutory status of awards to non-statutory. Under Section 423 of the IRC, disqualifying disposition is the legal term for selling, transferring or exchanging statutory awards before satisfying their holding-period requirements (i.e., holding the awards for at least two years from date of grant and one year from date of exercise).

One type of statutory stock awards is ISOs, where employers generally do not receive a tax deduction on employees' exercise of their options. Internal Revenue Code Section 423 also designates qualified employee stock purchase plans (ESPPs) as statutory grants. ESPPs, similar to ISOs, do not provide a tax deduction for employers. Statutory stock awards change their statutory status upon disqualifying disposition of the awards and companies treat disqualified statutory compensatory awards similar to non-statutory awards for accounting purposes.

Table 2
Types of Modification Under ASC 718

Type of Modification	Compensation Expense	Basis for Recognition
Type I Modification Probable-to-probable ASC 718-20-55-111 and 55-112	Companies record it either under original terms or modified terms	Grant date fair value plus incremental fair value, if any (cumulative compensation cost)
Type II Modification Probable-to-improbable ASC 718-20-55-113 through 55-115	Companies record it either under original terms or modified terms	Grant date fair value plus incremental fair value, if any (cumulative compensation cost)
Type III Modification Improbable-to-probable ASC 718-20-55-116 and 55-117	Companies record it as if awards are vested under the modified terms	Modification date fair value
Type IV Modification Improbable-to-improbable ASC 718-20-55-118 and 55-119	Companies record it as if awards are vested under the modified terms	Modification date fair value

Modification of Stock Awards

COVID-19 has caused significant volatility in stock prices and as a result, many companies may decide to modify their stock award programs. They can make changes to vesting period, performance and/or market conditions. Upon making changes to the terms or conditions of existing compensatory awards, companies must assess if that change results in modification accounting (ASC 718-10-20). Companies record any incremental value of the new (or modified) awards as compensation costs on the modification date (for vested awards) or over the remaining vesting period (for the unvested awards).

Changes made to a service, performance or market condition generally require modification accounting. Companies apply modification accounting when either the fair value, vesting conditions or the classification of the award are not the same immediately before or after the modification (718-20-35-2A through 35-9). Companies should not apply modification accounting if all the following are the same immediately before and after the modification:

- Fair value;
- Vesting conditions;
- Classification (as either liability or equity instruments).

ASC 718-20-35-2A states that if any of the above conditions does not apply, companies should apply modification accounting, wherein equity-classified or liability-classified awards are treated as exchange (or repurchase) of the original awards for new awards of equal or greater value. When companies cancel certain awards and accompany the cancellation by a concurrent grant or offer to grant, they should account for the transaction as modification. Table 2 summarizes the types of modification under ASC 718.

Stock Options

There are generally two types of stock options: non-statutory stock options (NQSOs) and statutory stock

Table 3
Journal Entries for Illustration 1

Year 1

Stock compensation	$300	
Additional paid-in capital (APIC)		$300

100 NQSOs at $6 BSM fair value divided by two

DTA	$30	
Deferred tax benefits		$30

Taxes at 10% for $600 stock compensation

Year 2

Since the modification is Type III modification (improbable-to-probable), the fair value of the new options at modification is the new basis for expense recognition.

Stock compensation	$700	
APIC		$700

100 NQSOs at $7 BSM fair value

DTA	$70	
Deferred tax benefits		$70

Taxes at 10% for $700 stock compensation

APIC	$300	
Stock compensation		$300
Deferred tax benefits	$30	
DTA		$30

Reversal of Year 1 journal entries since the original awards are cancelled and forfeited

Cash	$800	
APIC		$800

Exercise of 100 NQSOs at $8 (assuming no par value)

Deferred tax benefits	$70	
DTA		$70

Reversal of previously booked DTAs for Year 2

Taxes payable	$90	
Tax expense		$90

10% tax on exercise of $100 NQSOs at $9 ($17 less $8). There is a windfall (an excess tax benefit) of $20 ($90 less $70) that will be reflected in earnings.

Employer deduction equals to employee's income of $900 (based on intrinsic value – the difference between the stock price and exercise price).

options (ISOs). NQSOs are flexible and companies grant them to both employees and non-employees. NQSOs are generally taxable to employees and tax deductible for employers, whereas ISOs are not taxable to employees until the underlying stock is sold and non-tax deductible for employers; however, ISOs must meet certain statutory requirements to qualify for such favorable tax treatment (discussed in more detail earlier in this article).

Non-Qualified Stock Options

NQSOs are non-statutory stock compensation awards. IRC Section 83(h) provides that upon the transfer of property (transferring the stock awards) in connection with the performance of services, the employer (or the grantor) claims a tax deduction under IRC Section 162. The amount of employer's tax deduction equals the amount that the service providers or grantees (employees or non-employees) include in their gross income. The following illustration reflects the tax treatment and modification accounting of NQSOs.

In Illustration 1, Entity A grants to one of its sales executives 100 NQSOs at-the-money with two-year cliff vesting. The grant date stock price and exercise price are both at $10 and its BSM fair value is $6. Entity A accounts for forfeitures on an actual basis and there was no forfeiture for this grant. The grant has a performance condition, in addition to its time provision, that the sales executive must achieve a $4 million goal in sales at the end of Year 2.

At the beginning of Year 2, the stock price declines to $8 and economic conditions deteriorate. Entity A lowers the performance goal from $4 million (considered improbable) to $2.5 million (considered probable), reduces the exercise price from $10 to $8 (a Type III improbable-to-probable modification), and cancels the original awards and issues new grants.

All options fully vest at the end of Year 2, and the employee meets the performance goal. The employee exercises (but does not sell) 100 NQSOs at $8 exercise price when price per share was $17 at the end of Year 2. The BSM fair value of options was $7 after modification and it was nil before modification. Tax rate is 10%. The journal entries in Table 3 reflect the above transaction.

Table 4
Journal Entries for Illustration 2

Year 1

Stock compensation	$250	
APIC		$250

100 ISOs at $5 BSM fair value divided by two

Year 2

Since the modification is the Type I modification (probable-to-probable), grant date fair value plus incremental fair value (cumulative compensation cost) is the basis for recognition. Thus, $7 (BSM fair value after modification) less $1 (BSM fair value before modification) = $6 (incremental compensation cost). $6 (incremental compensation cost) plus $5 (original fair value) = $11 (cumulative compensation cost).

Stock compensation	$300	
APIC		$300

Expense adjustment for 50 ISOs vested at the end of Year 1 at $6 (incremental compensation cost)

Stock compensation	$550	
APIC		$550

50 ISOs vested at the end of Year 2 at $11 (cumulative compensation cost)

Cash	$800	
APIC		$800

Exercise of 100 ISOs at $8 exercise price (assuming no par value)

There is no tax deduction for Entity A if the employee holds on to options for the statutory period; otherwise, if the employee sells the stock for $1,700 a few days later, ISOs will be treated like NQSOs and tax deductible for the employer and taxable to the employee (ordinary income) for $900 ($1,700 less $800) and Entity A records the following journal entry:

Taxes payable	$90	
Tax expense		$90

10% tax on disqualified disposition of $100 ISOs at $9 ($17 less $8).

In this scenario, Entity A has a compensation expense for $1,100 and a tax deduction for $900; thus, there is a tax shortfall for $20 ($200 times 10%) that will be reflected in earnings.

Incentive Stock Options

In addition to complying with the statutory holding-period requirement, ISOs must satisfy a slew of other conditions, such as: they must be granted only to employees; the life of the grant may not be longer than 10 years; options must be exercised within three months of employees' termination; and several other conditions.

Illustration 2 reflects accounting for ISO modification.

Entity A grants one of its sale executives 100 ISOs at-the-money with two-year graded vesting (50% vesting at the completion of each year). The grant date stock price is $10 and its BSM fair value is $5. Entity A accounts for forfeitures on an actual basis and there was no forfeiture for this grant. The grant has a performance condition, in addition to its time provision, that the sales executive must achieve a $2 million goal in sales at the end of each year.

At the beginning of Year 2, the stock price declines to $8 and economic conditions deteriorate. Entity A lowers the performance goal for the second year from $2 million (considered still to be probable) to $1 million (considered to be most likely probable) and it also reduced the exercise price from $10 to $8 (a Type I probable-to-probable modification).

The executive achieves the performance goal at the end of Year 1 and as a result, 50 ISOs were fully vested but not exercised. The remaining 50 options were fully vested at the end of Year 2 since the executive met the Year 2 performance goal. The employee exercises (but does not sell) 100 ISOs at $8 when the price per share was $17 at the end of Year 2. The BSM fair value of options after modification was at $7 and before modification was at $1; therefore, the incremental fair value was $6. The journal entries in Table 4 reflect the above transaction.

Restricted Stock Units

Restricted Stock Units (RSUs) are stock awards that an employer grants to its employees provided that certain vesting conditions are met. RSUs are not transfer of shares at grant date, but merely a promise to deliver

Table 5
Journal Entries for Illustration 3

Year 1			**Year 2**		
Stock compensation	$5,000		Stock compensation	$7,400	
APIC		$5,000	APIC		$7,400
At the end of Year 1, 500 RSUs are vested and transferred to employees (1,000 RSU divided by 2 times $10). There is no par value for the shares granted.			*Vesting of 900 RSUs: At the end of Year 2, 500 RSUs are vested and transferred to employees (1,000 RSUs divided by 2 times $10 = $5,000), plus 400 RSUs vested and transferred to employees (400 RSUs times $6 = $2,400). There is no par value for the shares granted.*		

Table 6
Journal Entries Assuming No Section 83(b) Election

Year 1		
Tax liability	$750	
Tax expense		$750
Tax expense at 10% of $7,500 (500 shares times $15 – share price at the end of Year 1)		
Year 2		
Tax liability	$810	
Tax expense		$810
Tax expense at 10% times $8,100 (900 shares times $9)		

Total expenses for RSUs were $12,400 that would have created $1,240 DTA in Year 1 and Year 2. The actual taxes are $1,560 ($810 plus $750) and include a windfall (excess tax benefit) of $320 ($1,560 less $1,240).

stock awards at a future date. RSUs may have dividend rights while not vested, but usually they do not have any voting or dividend rights prior to vesting. RSUs are non-statutory stock awards and deductible by employers for tax purposes.

Illustration 3 reflects accounting for RSU modification.

Entity A grants 1,000 RSUs to its employees at the beginning of Year 1 when the price of stock is at $10 per share (intrinsic value). The awards have two-year graded vesting period with 50% annual vesting in each anniversary. Applicable tax rate is 10%. The price of the stock drops from $15 (at the end of Year 1) to $6 per share at the beginning of Year 2.

Entity A decides to maintain the grants as they are since they retain their values partially despite the decline in stock price; however, it grants an additional 400 RSUs at $6 per share (intrinsic value) at the beginning of Year 2 to offset the steep decline in the price of the shares at the end of Year 1. The additional RSUs have the same vesting period as the original RSUs (50% immediately vested and the remaining will vest at the end of Year 2).

This modification is a Type I probable-to-probable modification since the original RSUs get vested at the end of the second year despite the sharp decline in market price of Entity A's shares and maintain some of their original values. Entity A calculates its forfeiture based on the actual rate and does not have any forfeited awards. The basis for expense recognition in this type of modification is grant date fair value plus incremental fair value (cumulative compensation cost), if any. The price of stock was $9 at the end of Year 2.

Accounting Under ASC 718

RSU stock compensation expense is based on grant-date fair value and number of shares that vest over a service period. The journal entries in Table 5 reflect the above transaction.

U.S. Taxation

Employers have a tax deduction equal to employees' income when taxed. Employees are subject to tax at vesting based on stock price on that date; however, under IRC Section 83(b), if they elect, they can be taxed based on RSUs' grant date original fair value. The journal entries in Table 6 on the previous page assume no Section 83(b) election.

Employee Stock Purchase Plan

ESPPs are designed to promote employee stock ownership by providing employees with a convenient means to acquire their employers' shares. It is a contractual promise that permits acquisition of shares on a future date under the terms and conditions that the contract establishes at the grant date.

The acquisition of shares typically occurs through payroll deduction whereby employees set aside a certain percentage of their compensation (usually over one year or less) to purchase their employer's stock. The employer then uses the amount withheld to acquire the company's stock from the market at a discounted price at the end of the period and submit the shares to the employee.

There is a safe harbor level of 5% for the discount that an employer could offer an employee without the ESPP being considered compensatory. If considered compensatory, the fair value of the entire award related to the plan may be included in the calculation of share-based payment compensation cost (ASC 718-50-25-1(a)(2)).

The discount typically applies to the lesser of the beginning or ending of the offering period stock price. In this scenario, if the stock price declines significantly, the employees still benefit since they acquire the stock at the end of the period low price; however, if the stock price is in a free fall mode, they may not benefit if the price continues to decline after they acquired the stock.

Companies usually allow enrolled employees in an ESPP plan to withdraw their contributed funds prior to the end of the offering period for various reasons, including possible termination or emergency. Some companies even allow employees to reduce their contribution percentage during the period. In these scenarios, the employees can potentially avoid losses if they act timely.

A broad decline in the company's share price, due to COVID-19 or other reasons, may not impact the participants of an ESPP plan, since the employees (who are usually the only participants) can always reduce or stop their contributions to an ESPP plan. If the share price continues its decline, the risk can still be avoided if the employees sell the shares immediately subsequent to their acquisition.

Classification of Stock Awards

The classification of an award as equity or liability is an important aspect of the accounting for share-based arrangement: liability-classified awards are remeasured to fair value in each period until the reward is settled, whereas equity-classified awards are measured at grant date fair value with no subsequent remeasurement. Topic 718 requires companies to account for the following stock awards as liability-classified awards:

- Awards with cash-based settlement or repurchase features, such as share appreciation rights (SARs) with a cash-settlement feature, are liability-classified awards;
- Awards that vest or become exercisable based on the achievement of a condition other than service, performance or market condition;
- ASU 2016-09 requires that for awards with a net-settlement feature, if the amount that is withheld is in excess of the grantee's maximum individual statutory tax rate in the applicable jurisdiction, the entire award would be liability-classified.

Modification of stock compensation awards from equity to liability is rare, but could have severe implications since it requires the employers to remeasure the stock compensation cost in each period. For example, if a company changes the performance condition of its stock compensation awards from achieving a certain performance goal to availability of a medicine or vaccine for COVID-19, it has made its stock compensation awards exercisable based on the achievement of a condition

other than service, performance or market condition. In this scenario, the awards may be reclassified as liability.

Accounting for Stock Compensation Awards

COVID-19 started a turmoil in the relatively staid world of accounting by creating a confluence of issues that companies have to grapple with in the next several years. One consideration is compensation accounting and in particular, accounting for stock compensation awards.

Many companies have reduced the salaries of their executives and employees as the COVID-19 pandemic swept across the economy. These salary deductions often get offset by additional stock compensation grants to neutralize the compensation reversal that, until early 2020, was at its peak due to a record bull market in a robust economy.

Companies' comportment to salary reductions differ: some may decide to modify or enhance their stock compensation plans to retain and motivate their employees and attract new hires, and some may disregard the economic impact of downturn on their employees' compensation plans and pursue other means to remedy their employees' compensation losses.

Changes to stock compensation plans have ramifications and companies need to consider the relevant accounting implications before embarking on such projects. It is imperative that companies take into account the provisions of ASC 718 and its recent amendments, as well as the CARES Act and other tax legislation related to stock compensation awards.

Finally, financial planning and forecasting is particularly challenging at the time of COVID-19 and its vicissitudes. Companies need to consider the possible resurgence of infections in parts of the country followed by extended economic shutdowns and business restrictions and disruptions. The majority of economists expect a "swoosh" shape recovery (resembling the Nike® logo), with an economic decline at the beginning followed by a slow gradual recovery.

Additional stock compensation expense due to plan modifications, as well as the realizability of DTAs due to deteriorating economic conditions, may impact the future earnings and earnings per share (EPS) of companies materially. These economic impacts require proper disclosure and analysis in the periodic financial reporting of companies.

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CPE ARTICLE: COVID-19 AND STOCK COMPENSATION AWARDS

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1. The article argues that the spread of the pandemic has created the following condition(s):

a. General economic downturn
b. Financial market volatility
c. Layoffs and furloughs
d. All of the above

2. The disqualifying disposition changes:

a. The non-statutory status of awards to statutory
b. The statutory status of awards to non-statutory
c. Both a and b
d. Nothing at all

3. Which of the following awards is considered statutory awards?

a. ISOs
b. ESPPs
c. NQSOs
d. Both a and b

4. The basis of recognition for Type III modifications (improbable-to-probable) is:

a. Grant date fair value plus incremental fair value, if any
b. Modification date fair value
c. Grant date fair value based on BSM
d. Either b or c

5. ISOs must be exercised within ___________ of employees' termination.

a. Three months
b. 10 years
c. One month
d. Three years

6. RSUs _________ dividend rights while not vested.

a. May have
b. Do not have
c. Always have
d. None of the above

7. RSUs are __________ by employers for tax purposes.

a. Non-deductible
b. Reportable
c. Deductible
d. Ignored

8. Under IRC Section 83(b), if elected, RSUs can be taxed based on their:

a. Grant date original fair values
b. Vesting date fair value
c. Market values a day prior to vesting
d. Market values a day after vesting

9. The acquisition of ESPP shares typically occurs through:

a. A loan
b. Cash payment upon acquisition
c. Payroll deduction
d. Advance payment by employers

10. Liability-classified awards:

a. Do not exist
b. Are remeasured to fair value in each period until the reward is settled
c. Are not remeasured
d. Are measured as frequently as possible

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