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Underwater Stock Options and Deferred Tax Assets

By Mitchell Kopelman, CPA and Rob Casey, CPA

What do you do when your company has "underwater" stock options and you have deferred tax assets related to the compensation expense that was recognized for book purposes?

Under Financial Accounting Standards Board Statement No. 123(R), *Share-Based Payment* (FASB 123R), companies are required to recognize compensation expense for stock options, which can be calculated using various valuation techniques such as the Black-Scholes method. Incentive stock options (ISOs) generally do not result in a future tax deduction when exercised unless certain rules, including minimum holding period, are not met and, as a result, do not create deferred tax assets. Non-qualified stock options (NQOs) may result in a future tax deduction when exercised and companies can record a deferred tax asset based on the compensation recognized for book purposes and their tax rates.

When the employee exercises an NQO, the actual tax deduction may be higher or lower than the deferred tax asset recognized at the time the compensation was recorded, due to several factors:

- The deferred tax asset is not adjusted for changes in the underlying stock price but is reduced if the company determines it will more than likely not have the taxable income sufficient to utilize the deferred tax asset.
- When the tax deduction is higher than the compensation expense recognized for book purposes, the excess of the tax deduction over the previously recognized deferred tax asset is recorded as additional paid-in capital (APIC).
- When the tax deduction is lower than the compensation expense recognized for book purposes, the difference is adjusted through APIC to the extent of any previously recognized excess tax benefits.
- If the APIC previously recognized for excess tax benefits is insufficient to absorb the tax deficiencies, the remaining deficiencies are charged to income tax expense in the income statement unless there was a valuation allowance on the deferred tax asset.

Many companies have recorded compensation expense and related deferred tax assets related to NQOs over the last few years. If those options issued are now underwater, the company has two issues to deal with.

First, the company's employees have options that may never provide a benefit because they will expire before the stock price exceeds the option price. A significant benefit of NQOs is to help retain good employees and motivate them to increase the value of the company. If the options are underwater, the motivation for the employee diminishes.

Second, the company may have a deferred tax asset on its books that it may never be able to benefit from in the future. If the options begin to expire, and the

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The Push for "Say on Pay" Escalates

The idea of giving shareholders a vote on executive compensation (known as "say on pay") has been percolating for years. But mere talk has morphed into significant action this year as public outrage over executive salaries has escalated during this economic crisis.

In particular, companies receiving funds from the Troubled Assets Relief Program (TARP) have come under scrutiny.

Before TARP was introduced, about 100 companies were expected to be targeted for say-on-pay resolutions this year.

And the numbers will increase this year. TARP requires forming advisory say-on-pay shareholder votes. Senate Banking Committee chair Christopher Dodd sent a letter to the SEC suggesting that firms receiving TARP funds, whose preliminary proxy statements were submitted to the SEC after the effective date of the legislation (February 17, 2009), must allow for shareholder say-on-pay votes.

The SEC issued a guidance letter on February 26, 2009: www.sec.gov/divisions/corpfin/guidance/arrainterp.htm.

The result is that hundreds of companies will be required to have spring advisory votes – a major victory for say-on-pay proponents whose campaign for shareholder votes has been building since 2006.

The movement is supported by SEC chair, Mary Schapiro, who said in a recent speech, "There is much we can do to accelerate that process [of building investor confidence], including giving shareholders a greater say on who serves on corporate boards, and how company executives are paid."

In 2008, AFLAC became the first publicly traded U.S. company to give shareholders a nonbinding vote on executive compensation. Say-on-pay resolutions have been common for years in the U.K. and Australia, and the U.S. appears to be moving in the same direction.

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New E-Proxy Requirements

In 2007, the Securities and Exchange Commission (SEC) adopted amendments to the proxy rules under the Securities Exchange Act of 1934 to provide shareholders with the ability to choose the way in which they could access proxy materials. The amendments required issuers and other soliciting persons to post their proxy materials on a publicly accessible website (other than the SEC EDGAR website) and notify shareholders about the electronic availability of proxy materials. Shareholders may choose to request delivery of a paper copy of the proxy materials at no charge.

The effective compliance date was January 1, 2008 for large accelerated filers, other than registered investment companies. All other companies, including registered investment companies, persons other than issuers and issuers that are not large accelerated filers were required to comply with the amendments beginning January 1, 2009.

Companies will need to build in a planning process for satisfying these requirements and may want to develop a strategy for taking advantage of the cost savings and flexibility of Internet delivery.

The e-proxy materials may be delivered via one of two methods: the "notice-only" option or the "full-set delivery" option. The rules allow companies to use the notice-only option to provide materials to some shareholders and the full-set delivery option for other shareholders. Companies should strategically determine what criteria to use in deciding which delivery method is best for shareholders. Criteria may include the number of shares held, ZIP code, domestic vs. foreign, and other factors.

As part of your company's planning, it's important to coordinate the timing of notices with the website posting, and in the case of the notice-only option, issue the notice 40 days before the meeting date. To read the full text of the amendment, please download the document: www.sec.gov/rules/final/2007/34-56135.pdf.

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company has not previously recognized any excess tax benefit for stock options, the expiration of the options will result in a charge to income tax expense that will directly reduce a company's earnings. Although the result of the expense is a non-cash item, the expense will still reduce earnings.

This may not affect every company with significant excess tax benefits (Cisco Systems, Inc. has recorded excess tax benefits of over $1.7 billion in the last three years), but it may affect some companies that have not had the luxury of excess tax benefits. This is just another consideration for companies struggling to hit earnings.

Many companies are considering re-pricing their existing NQOs in light of the depression of the stock market. Another consideration is how to treat the deferred tax asset currently recorded on a company's balance sheet if its NQOs are re-priced.

As your company considers layoffs of employees with NQOs and/or re-pricing NQOs, be sure to consider the financial statement impact. Your company may have a material deferred tax asset related to the options held by exiting employees or by retained employees whose options may be re-priced. Be sure that your SEC reporting group as well as your auditors are in agreement on how to handle these matters to avoid financial reporting surprises.

If you have questions about these or similar matters please contact Mitchell Kopelman (mitchell.kopelman@hawcpa.com) or Rob Casey (rob.casey@hawcpa.com).

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SOX 404 Delays – Over for Smaller Companies?

New Securities and Exchange Commission Chair, Mary Schapiro, has indicated that she is in favor of small public companies to begin complying with the Sarbanes-Oxley Act requirements for audits of internal control over financial reporting (Section 404).

Schapiro told Senator Carl Levin, "Right now, we have a system where some issuers are complying with 404 and others are still exempt from it. It's time that we bring uniformity to the system so that investors know what to expect from companies, while being sensitive to the needs of small businesses. I look forward to working with the small business community in making sure they have the tools they need to comply with 404."

An extension approved last year by the SEC delayed the deadline for compliance with the auditor attestation requirement for non-accelerated filers until their annual reports for fiscal years ending on or after December 15, 2009.

The SEC is currently conducting a cost-benefit study to assess the effectiveness of efforts to minimize the compliance burden. The study results will be used in a determination of next actions.

Meanwhile, the nearly 5,000 companies with less than $75 million in market capitalization that have – so far – escaped complying with this requirement of the 2002 law, are watching and waiting to see what 2009 brings.

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