Equity In Flux

Advance Equity Accounting and Modifications

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INFINITE EQUITY

Compensation Solutions Without Limits

Meet the Team

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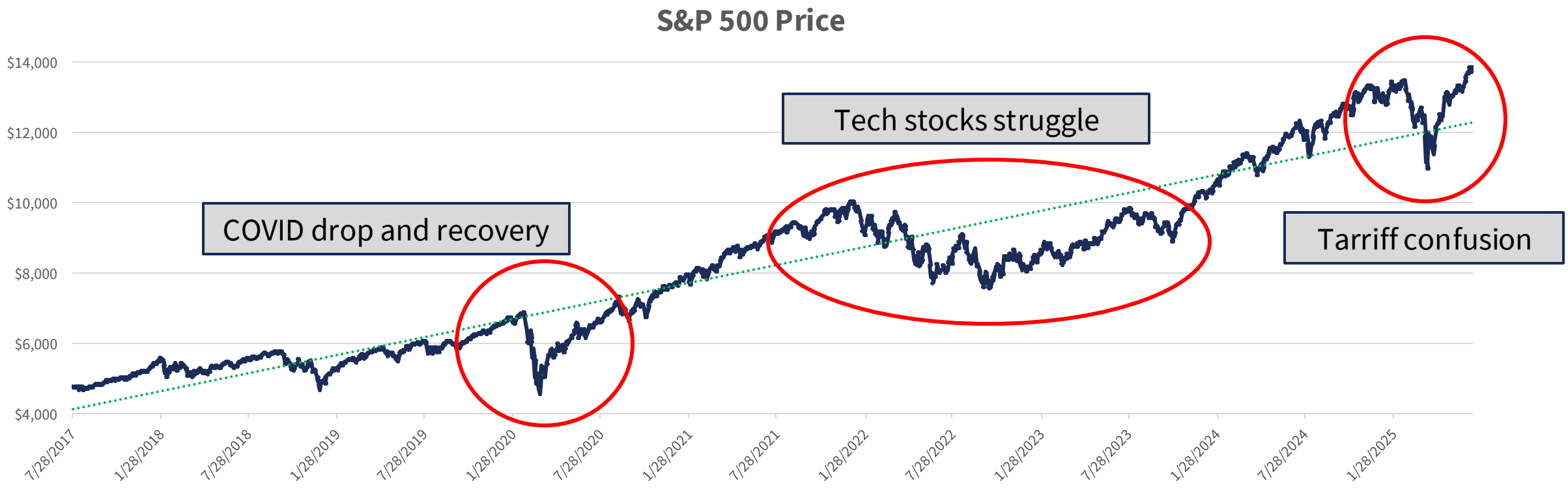
Introduction

When viewed from afar, the market has increased consistently over the last decade. But in shorter windows and on a company-to-company basis, we see periods of pronounced volatility. The only constant for a market in flux?

Change!



Agenda

- ASC 718 Modification Framework
- Options
- PSUs
- ESPP
- Acquisition / Spin-Off

ASC 718 Modification Framework

Identifying Modifications

"A change in the terms or conditions of a share-based payment award." *(ASC 718-10-20)*

What might cause a modification?

- Decisions from Management and Compensation Committee
- Changes to terms/agreements, including vesting and exercise provisions
- Key personnel changes
- Mergers, acquisitions, and spin-offs
- Capital structure changes
- Underwater stock option exchanges
- ESPP rollovers/resets

What is NOT a modification?

An event triggering an existing provision

Anything already written into:

- Original terms of the grant
- Equity Plan
- Employment agreement

For example:

- Retirement of a participant with eligible awards
- Automatic acceleration at Change in Control (CIC)
- Acceleration previously added to an agreement, but triggered by subsequent departure

Identifying Modifications

Not all modifications require accounting analysis

- The original language in ASC 718 was vague and resulted in a diversity of practice
- FASB issued clarifying guidance in ASU 2017-09
- A company does not need to account for the effects of a modification if all three of the criteria below are met:
    1. The fair value of the award immediately prior to modification and immediately after modification is the same
    2. The vesting conditions of the award do not change at all
    3. The classification of the award (liability vs. equity) is not changed

ASC 718 Modification Framework
Summary

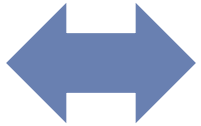
Modifications “shall be treated as an exchange of the original award for a new award.”
(ASC 718-20-35-3)

The company is essentially repurchasing the existing award at its current fair value and issuing a new award with its own fair value

This is analogous to buying a new car from a dealer and trading in your current vehicle:

New car costs $25,000

Dealer credits you $10,000



You pay $15,000

Other Considerations:

- What if you still owe money on your trade-in?
- What if your existing car was totaled?

ASC 718 Modification Framework
Summary

We must also know the number of awards that are probable of vesting in order to determine the modification impact.

Modified Award:	Modified Fair Value per Award	×	Number of Awards Expected to Vest under Modified Terms	= **A.**	Total Fair Value of Modified Award
Original Award:	Original Fair Value per Award	×	Number of Awards Expected to Vest under Original Terms	= **B.**	Total Fair Value of Original Award

Incremental Expense: Maximum(A – B,0)

The “Number of Awards Expected to Vest” in the above framework requires an assessment of whether it is Probable or Improbable

ASC 718 Modification Framework
Impact on Vesting Criteria

	After	
Before	**Probable of Vesting**	**Improbable of Vesting**
Probable of Vesting	**Type I: Probable-to-Probable** Original expense: Continue to amortize (but if the original vesting conditions nor the modified vesting conditions are satisfied, expense is reversed) Modified expense: Amortize incremental expense	**Type II: Probable-to-Improbable** Original expense: Continue to amortize based on original vesting criteria (but if the original vesting conditions nor the modified vesting conditions are satisfied, expense is reversed) Modified expense: Amortize incremental expense (typically none)
Improbable of Vesting	**Type III: Improbable-to-Probable** Original expense: Original award is treated as forfeited – reverse expense for unvested awards Modified expense: Estimate new fair value	**Type IV: Improbable-to-Improbable** Original expense: Reverse for unvested Modified expense: Estimate new fair value

Incremental = Fair Value AFTER modification minus Fair Value BEFORE

Many modifications have no incremental (changes that don't impact fair value assumptions for options, RSUs)

ASC 718 Modification Framework
Common Examples of Changes to Vesting Criteria

Type		Examples
I	Probable to Probable	• Extension of post-termination exercise period for options • Repricing of vested option • Modification of a market condition (e.g., removal of a value cap)
II	Probable to Improbable	• Change to a performance goal to reflect a change in corporate tax rate or change in accounting principle • Exchange of a vested award for one with additional service vesting
III	Improbable to Probable	• Acceleration of vesting at termination • Lowering a performance goal that results in more shares expected to vest
IV	Improbable to Improbable	• Extending the performance period for a goal that is still not considered to be probable (e.g., Drug Approval)

Options

I. Accelerate Vesting and Extend the Post-Termination Exercise Period of an Option

Initial Grant *(fair value of $12)*

Company X grants 1,000 options

- **Vesting:** Annual over 4 years (25% / year)
- **Post-termination exercise window:** 90 days
- Contractual term: 10 years
- Strike Price: $30.00

Modification

After 1.5 years, Company X modifies the options in conjunction with the termination of the employee:

- **Vesting:** Any options that would have vested within 1 year of termination will vest immediately
- **Post-termination exercise window:** 1 year

You must determine if each tranche is Probable before and after the modification:

Type	I	III	IV	IV
Before Modification	Probable	Improbable	Improbable	Improbable
After Modification	Probable	Probable	Improbable	Improbable

I. Accelerate Vesting and Extending the Post-Termination Exercise of an Option

Tranche 1: Type I, Probable to Probable

Treatment: Expense associated with Tranche 1 is already accrued and should not be adjusted. Incremental expense needs to be determined and recognized immediately.

Incremental expense = Fair value of the options **immediately prior to** the modification − Fair value of the options **immediately after** the modification

Key Considerations for both fair values:

- Black-Scholes is usually appropriate
- Expected Life:
  - Before fair value reflect the 90 days and after fair value 1 year
  - Common to use either full terms or 50% of full terms (i.e., 0.25 & 1.0)
- Other assumptions:
  - Volatility history and risk-free rate commensurate with Expected Life
  - Be careful of wide disparity in before and after Volatility

I. Accelerate Vesting and Extending the Post-Termination Exercise of an Option

Tranche 2: Type III, Improbable to Probable

Treatment: Original expense: Award is treated as forfeited & expense accrued to date is reversed.

Modified expense: Based on the estimated fair value immediately after modification and recognized immediately since the modified award is fully vested.

Total expense will be equal to the After Fair Value

Tranches 3 & 4: Type IV, Improbable to Improbable

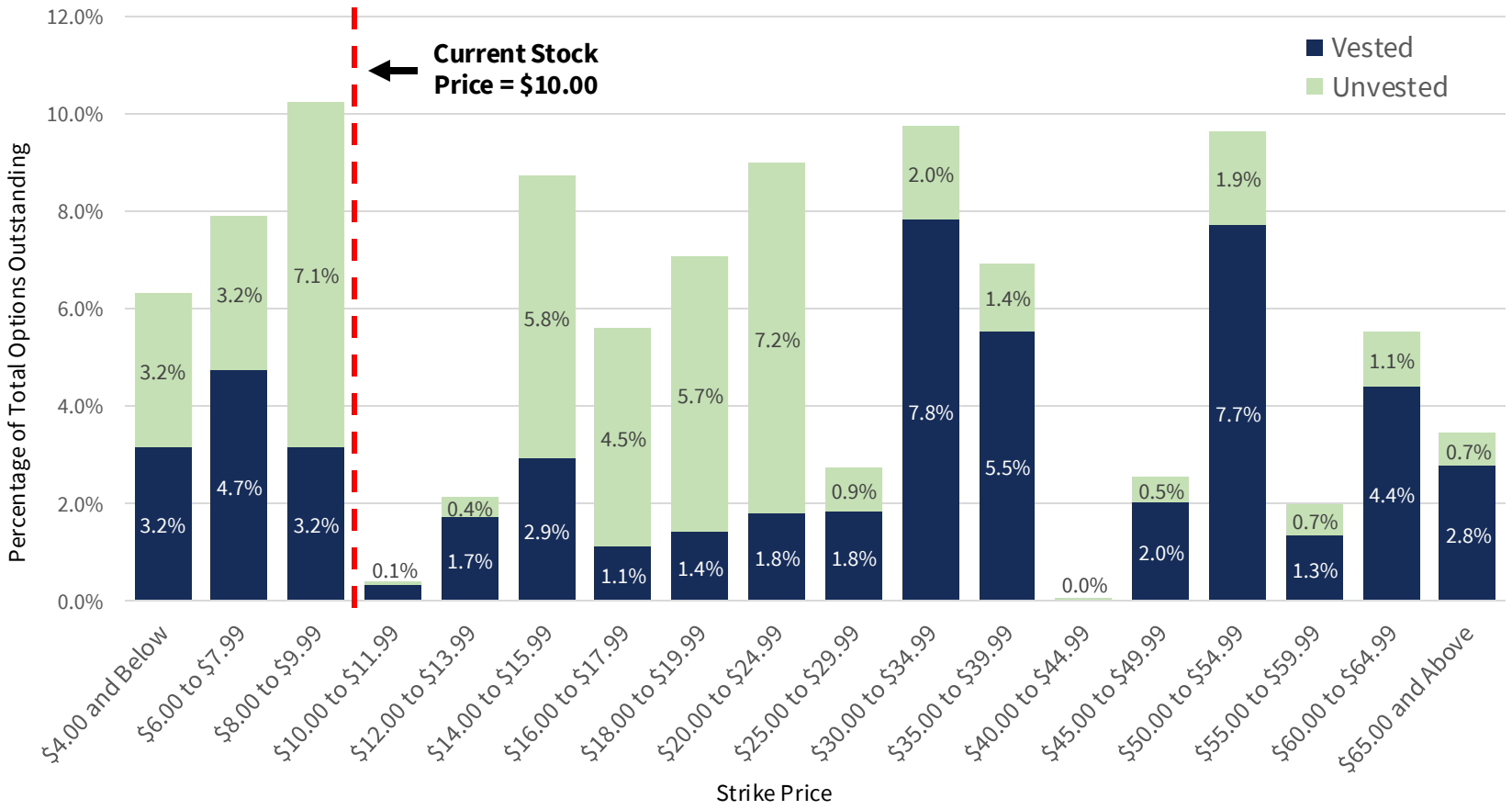
Treatment: Original expense: Award is treated as forfeited & expense accrued to date is reversed.

Modified expense: None

$0 Expense

II. Underwater Stock Options
Initial Assessment: Is an exchange worth pursuing?

Examine the distribution of strike prices to form key observations on the current situation



Key statistics regarding underwater options:

- **76%** of **total outstanding**
- **80%** of **vested**, which tend to be held by longest tenured employees
- **6 years** is the average **remaining term**
- **>50%** held by **non-executives**

II. Underwater Stock Options

Example: Company X initially granted 1,000 stock options with a strike price of $50 and is exchanging them for new stock options with a strike price of $25

Type I, Probable to Probable

Treatment: Continue to amortize original expense and calculate incremental expense

Application: Do not adjust expense accrued and the incremental expense should be based on the difference between the fair value of the options immediately prior to and after the modification

Original Grant Date	6/20/2019	
Strike Price	$50.00	
Options Outstanding	1,000	
Exchange Date	11/5/2019	
Exchange Date Price	$25.00	
Vesting Schedule	1yr Cliff / 3yr Qly	
Contractual Term	10 years	
	Pre-Modification	**Post-Modification**
Price	$25.00	$25.00
Strike	$50.00	$25.00
Expected Term	6.66	5.73
Volatility	40.00%	39.00%
Risk-free Rate	2.00%	1.80%
Dividend Yield	0.00%	0.00%
Fair Value	**$6.13**	**$9.82**
Value Neutral Ratio	**0.6242**	
Approved Exchange	**Exchange 5 for 3**	
New Options	**571**	
Incremental Expense	**$0**	

Pre-modification expected term reflects the expected time underwater

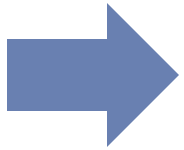
The goal of an exchange could be to have $0 incremental expense

PSUs

III. Modifying a Performance Condition (Part A)

Initial Grant (*Stock price of $15)*
Company X granted 1,000 target PSUs:

- **Performance Goal:** Sell 1,000,000 widgets



Modification (*Stock price of $20)*
After 2 years, Company X decides the 1,000,000 goal is not likely to be achieved and modifies the PSUs:
Performance Goal: Sell 800,000 widgets

Type III, Improbable to Probable

Treatment: Expense accrued to date is reversed and the fair value immediately after modification is estimated

Application: Since the goal of 1,000,000 was not probable, there is $0 expense to reverse.
Expense immediately after the modification is estimated. Final expense will be based on the number of awards that ultimately vest.

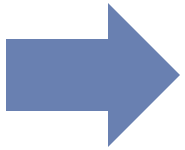
	Pre-Modification	Post- Modification
PSUs Expected to Vest	0	1,000
Fair Value	n/a	$20
Aggregate Expense	n/a	$20,000
Incremental Expense	$20,000	

III. Modifying a Performance Condition (Part B)

Initial Grant (*Stock price of $15)*

Company X granted 1,000 target PSUs:

- **Performance metric:** EPS Growth
- **Probable Payout:** 80% as of end of year PP



Modification (*Stock price of $20)*

Company modifies goal to adjust for an acquisition

- **Performance metric:** Adjusted EPS Growth
- **Probable Payout:** 120% as of end of PP

Type I and III, 80% Probable to Probable, 40% Improbable to Probable

Treatment: Expense associated with originally probable shares is not adjusted and incremental expense associated with additional probable shares recognized

Application: Expense accrued to date based on 80% payout unchanged and incremental expense for 40% recognized based on modified fair value

	Pre-Modification	Post- Modification
Type I. Expected to Vest	800	800
Type I. Fair Value	$20	$20
Type I. Aggregate Expense	$16,000	$16,000
Type III. Expected to Vest	N/A	400
Type III. Fair Value	N/A	$20
Type III. Aggregate Expense	N/A	$8,000
Incremental Expense	**$8,000**	

IV. Modifying a Market Condition

Initial Grant (*Stock price of $20)*
Company X granted 1,000 target PSUs:

Goal: Achieve $40 stock price by end of 4 years

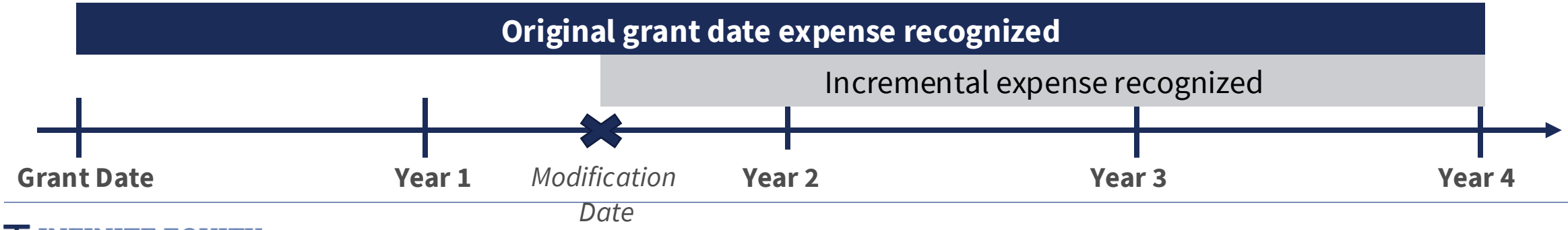
Modification (*Stock price of $10)*
After 1.5 years, Company X decides the $40 goal is not likely to be achieved and modifies the PSUs:
Goal: Achieve $30 stock price by end of 4 years (2.5 years from modification)

Market conditions are not considered "vesting" conditions, and therefore we skip the probable assessment and just perform the incremental expense

Type I, Probable to Probable

Treatment: Original expense: Continue to amortize based on original schedule

Modified expense: Amortize incremental expense over remaining period (i.e., as if it were a new award)



ESPP

V. Employee Stock Purchase Plans

Adjustments to expense:

- **True up for:**
  - Terminations
  - Salary changes
- **Do not true up for:**
  - Decreased contributions
  - Withdrawals
  - More shares purchased because price dropped

Modifications triggered by:

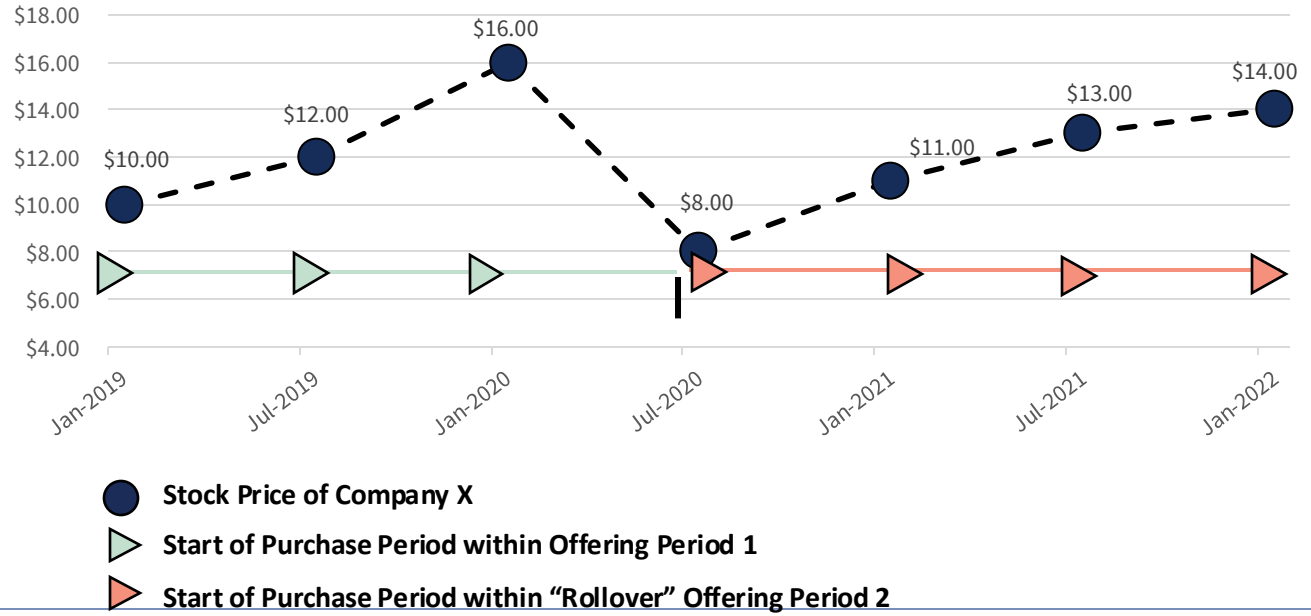
- **Reset / rollover**
  - Continue original expense
  - Calculate incremental expense (before/after)
- **Increase in contribution %**
  - New fair value for “new grant”
    - If changes are allowed during the purchase period = lots of new ‘grant dates’, but can be consolidated for practical application

V. Employee Stock Purchase Plans
Rollover

Typical Cadillac ESPP:

- 24-month offering period with 4 6-month purchase periods
- 15% discount with a look-back to the beginning stock price
- Automatic rollover if stock price decreases on a purchase date. A rollover cancels the remaining purchase periods in the offering and re-enrolls everyone in a new offering based on the lower price.

Illustration:



Accounting Treatment:
Total expense will be equal to:

1. Expense floor from initial offer
2. Incremental expense from rollover, resulting from:
   i. Increase in per unit fair value due to lower strike price
   ii. Increase in the number of shares that can be purchase

V. Employee Stock Purchase Plans

Determining the incremental expense for ESPPs with roll-over requires many elements

Step	Estimated Contributions	Offering Price	Purchase Price	Shares Purchased	Fair Value	Compensation Expense
	A	*B*	*C = B x 85%*	*D = A / C*	*E*	*F = D x E*
Pre-Modification	$10,000	$10.00	$8.50	1,176	$2.20	$2,588
Post-Modification	$10,000	$8.00	$6.80	1,476	$2.50	$3,676
					Incremental Expense	$1,088

However, with proper logic, you can quickly determine and simplify expense to a function of contributions (i.e., cents per $ contributions)

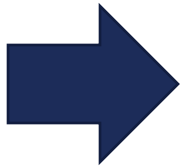
- Fair value and shares purchased are both a function of stock price
- Expense simplifies to two steps: 1) Estimate Contributions and 2) Calculate Fair Values

Acquisition / Spin-Off

VI. Acquisition

There are various ways to handle outstanding equity when a company completes an acquisition.

Target Company employee has **2 shares each worth $50**



Acquirer Company converts to **1 share of $100**

Other common award treatments may still trigger application of modification accounting under Topic 805:

Award Treatment at Acquisition	Modification Considerations
1. Acceleration or cash out awards in original grant agreement	No
2. Acceleration or cash out awards as part of the merger agreement	Yes, before and after fair value
3. Cancel awards at acquisition; issue new awards	No; but allocation of expense
4. Replace awards with acquirer's equity	Yes, before and after fair value

VI. Acquisition

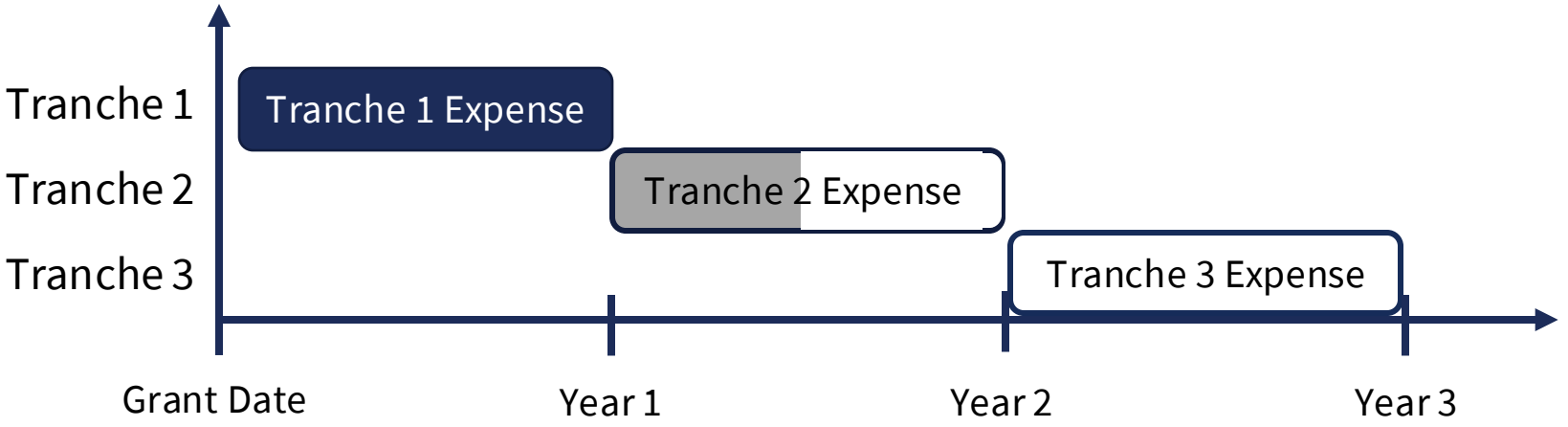
Incremental expense must be calculated if the awards are replaced

Post-combination expense is recognized on the financial statements of the acquiring company over the service period for the replacement awards	Measured as of the acquisition date and reflects conversion ratio	Equals fair value of awards that are replaced as of acquisition date multiplied by: $\frac{(Prior\ Service\ Provided)}{\max(Original\ Vesting\ Period, New\ Vesting\ Period)}$

VI. Acquisition

$$\frac{(Prior\ Service\ Provided)}{\max(Original\ Vesting\ Period, New\ Vesting\ Period)}$$

Example: At acquisition, any vested shares will be exchanged for fully vested awards. Any unvested awards will be exchanged for new awards that vest according to the original schedule.



$$\frac{1\ year}{\max(1\ year,\ 1\ year)} = 100\%$$

$$\frac{0.5\ years}{\max(1\ year, 1\ years)} = 50\%$$

$$\frac{0\ years}{\max(1\ year, 1\ years)} = 0\%$$

Single Trigger: Ratio typically goes to 100% because service end date is acquisition date by definition.
Double Trigger: Ratio does not go to 100% because second trigger is controlled by acquirer. Any post-combo expense typically recognized entirely on Acquisition Date.

VI. Acquisition

Example:

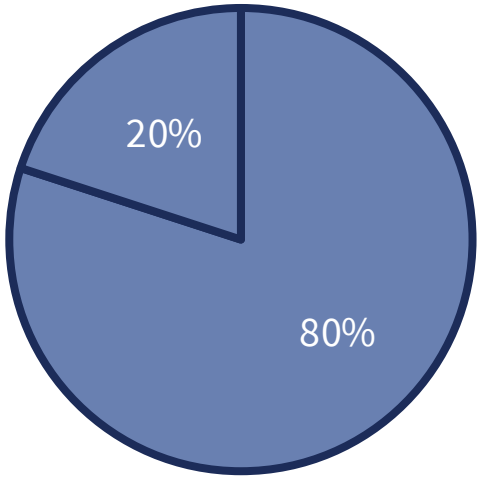
- Original Awards: 100
- Exchange ratio: 0.50 (i.e., 1 for every 2 held)
- Replacement Awards: 50
- Value of Target Award: $14/share
- Value of Acquirer Award: $30/share.
- Vesting Schedule: 6-months of the original 1-year vesting schedule have elapsed, and there will be no change to vest date due to acquisition.

	Replacement Awards	Original Awards
Number of Replacement Awards	50	100
Value of Replacement Awards	$30.00/RSU	$14.00/RSU
Total Value of Replacement Awards	$1,500	$1,400
Service Ratio	n/a	0.50 / 1.00 years = 50%
Consideration Transferred	n/a	$700
Post-Combination Expense	$800 (= $1,500 - $700)	

VII. Spin-off
Equity Transition Approaches

An employee holds shares in ParentCo, which is going to complete an 80/20 split

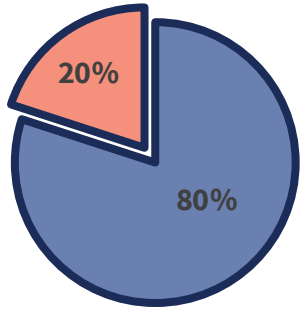
Total Shares



There are two common ways to transition equity:

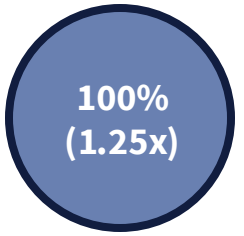
1. Shareholder approach

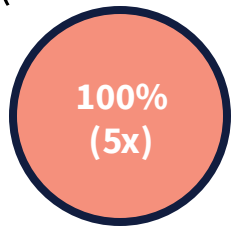
80% RemainCo / 20% SpinCo
(Gets 1x RemainCo and 1x SpinCo)



2. Concentration approach

RemainCo employee holds all RemainCo
(Receives 1.25x awards for every 1)





SpinCo employee holds all SpinCo
(Receives 5x awards for every 1)

VII. Spin-off
Equity Transition Approaches

There are generally two common ways companies transition equity related to a spin-off:

	Concentration Approach	Shareholder Approach
Description	**Equity is translated into one of the post-spin entity's equity**	**Equity is translated to both post-spin entities on a one-for-one basis**
Considerations	Ensure award holders are directly aligned with the ongoing entity Most common approach	Provides equal value and opportunity in both post-spin entities
RSU Treatment	Multiply the pre-spin shares by a ratio of pre-spin to post-spin prices	One pre-spin share converts to one each of post-spin shares
Option Treatment	Both the exercise prices and number of options are translated	Exercise prices are converted, but the number of options remains the same

The decision on which to apply should consider plan documentation, any provisions that govern how awards need to be treated and be supported by the Board of Directors.

VII. Spin-off
Concentration Approach Example

The following example assumes the Stock Price is split 80/20 Post-Spin

Equity is translated to one of the Post-Spin Entities depending on the individual employee

The Post-Spin Value to both a RemainCo Employee and a SpinCo Employee remains the same as it was Pre-Spin

	RSUs	Options
Pre-Spin		
Stock Price	$100.00 *(a.)*	$100.00 *(a.)*
Exercise Price	N/A *(b.)*	$70.00 *(b.)*
Shares	1,000 *(c.)*	1,000 *(c.)*
Value	$100,000 *(d.) = (a.) * (c.)*	$30,000 *(d.) = [(a.) - (b.)] * (c.)*
Post-Spin		
RemainCo Employee		
RemainCo Stock Price	$80.00 *(e.) = (a.) * 80%*	$80.00 *(e.) = (a.) * 80%*
RemainCo Exercise Price	N/A *(f.)*	$56.00 *(f.) = (b.) * 80%*
RemainCo Shares	1,250 *(g.) = (a.) * (c.) / (e.)*	1,250 *(g.) = (d.) / [(e.) - (f.)]*
RemainCo Value	$100,000 *(h.) = (e.) * (g.)*	$30,000 *(h.) = (d.)*
SpinCo Employee		
RemainCo Stock Price	$20.00 *(i.) = (a.) * 20%*	$20.00 *(i.) = (a.) * 20%*
SpinCo Exercise Price	N/A *(j.)*	$14.00 *(j.) = (b.) *20%*
SpinCo Shares	5,000 *(k.) = (a.) * (c.) / (i.)*	5,000 *(k.) = (d.) / [(i.) - (j.)]*
SpinCo Value	$100,000 *(l.) = (k.) * (i.)*	$30,000 *(l.) = (d.)*

VII. Spin-off
Discretionary Vs. Non-Discretionary Modifications

The **accounting treatment** of adjustments to the outstanding awards due to a spin-off or other corporate event **depends on whether the modification is considered discretionary or non-discretionary**

Discretionary	Non-Discretionary
Modification is not required	Modification is required
"May" The plan document/award agreement implies discretion	**"Shall"** Required to make an "equitable adjustment" by the plan document/ award agreement
Much more expensive (Pre-modification price is the post-spin price)	Often NO incremental expense (Pre-modification price is the pre-spin price)

VII. Spin-off
Discretionary Vs. Non-Discretionary Modifications

Example:
Employee A has 1,000 unvested RSUs when the stock is trading at $20.

Immediately following the spin-off the price drops to $16. To reflect the 20% reduction in the value of the award, the board issues 250 more shares to maintain the pre-spin value of $20,000.

	Discretionary	Non-Discretionary
Pre-spin	$16,000 = 1,000 * $16	$20,000 = 1,250 * $16
Post-spin	$20,000 = 1,250 * $16	$20,000 = 1,250 * $16
Incremental Expense	**$4,000**	**$0**

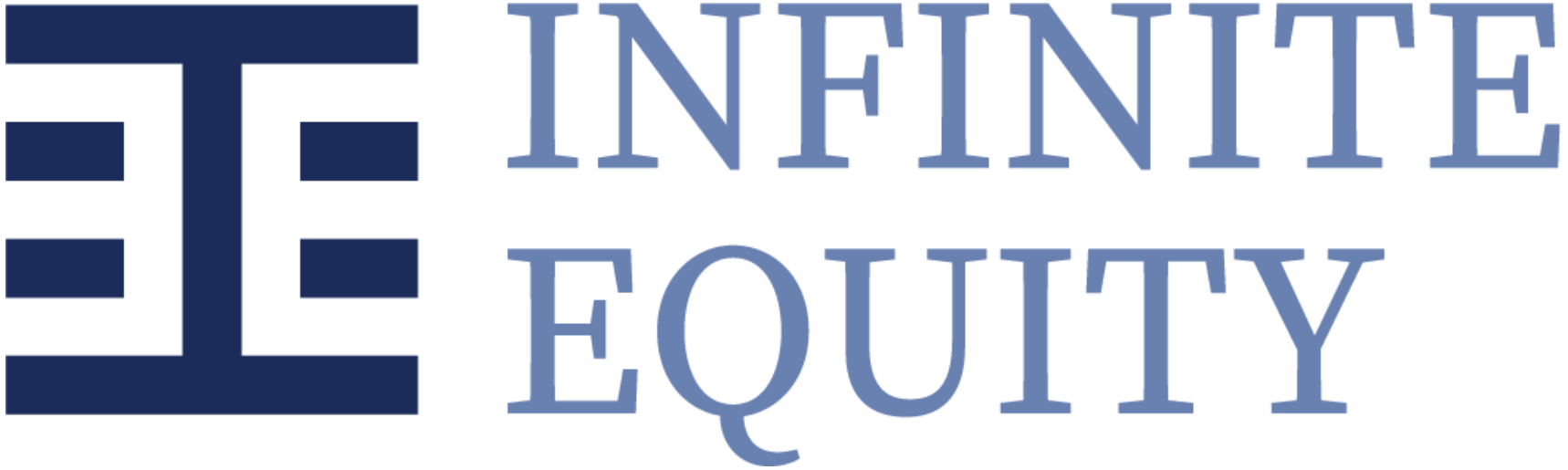
VII. Spin-off Considerations

Unanticipated consequences can arise if the modification accounting is not contemplated ahead of the spinoff with appropriate due diligence

	Key Considerations	To Note

Valuation Assumption Methodology	**There may be a disconnect between stock prices used when modifying the awards and the stock prices used for financial accounting**
	• **Modifying the Awards** (typically)**:**
	Pre-Modification Stock Price = Closing price on the last trading day immediately before
	Post-Spin Stock Price = Closing price at the end of the first day of trading
	• **Financial Accounting:** Many stocks begin to trade on a "when issued" basis approximately two weeks prior to the spin.
	  • SpinCo: Pre-spin and post-spin price of equals the "when issued" price on the last trading session immediately before the spin.
	  • RemainCo: The post-spin price of equals the difference between pre-spin price of RemainCo and the post-spin price of SpinCo
	Volatility: Either use a consistent methodology Pre-Spin and Post-Spin, or independently develop for each ongoing entity
		Reliable and observable stock prices may not be available
		
		The variance in the methodology between the stock prices used when modifying the awards and the stock prices that are used for financial accounting can give rise to unanticipated compensation expense
		
		RemainCo and SpinCo may have different characteristics

Expensing	Proper system reporting and review is key to ensure the modification is properly reflected. Earnings per Share may also be impacted	Grant activity (e,g., cancellation, exercise, etc.) needs to be linked correctly to the initial grant



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