



## Resolutions and **Solutions** for Accounting for Equity Awards

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### **Disclaimer**

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## Today's Objectives

1. Review issues we see in company's Equity Databases, that cause problems in performing FAS123R (ASC 718) calculations.
2. Discuss solutions to these issues.
3. Following this presentation, you should be more knowledgeable on how to protect your equity records to achieve quality accounting calculations.
4. Goal is not to achieve perfection, but rather the ongoing discipline to search for "Mastery"

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## Final Objective

"I just had to stop to tell you I am almost gleaming while booking Q3 stock comp. I used to dread it, but now with the new custom report - it is a piece of cake. I feel in charge and in control of the report and numbers now, rather than just assuming *my software* is doing everything correctly. I am just about done with the analysis for the quarter, and only spent a couple hours on it."

- Kevin Lane - Openlane

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## Agenda

- Best practices for challenging accounting situations:
  - Modifications of equity awards
  - M&A transactions
  - Impact of transactional data issues on ASC Topic 718 (FAS123R) Reporting
- SOS solutions for complex equity accounting calculations
  - Implementing accounting audits and roll forwards
  - SOS accounting programs
    - Data Audit
    - Crystal Reports
    - Automation of reporting

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## MODIFICATION ACCOUNTING

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## What Triggers Modification Accounting?

- Changes to option/award not in original terms of grant
  - Option Exchanges
    - Repricings, Option-for-option, Option-for-RSU, Option-for-cash
    - “Value-for-value” + NO incremental expense still accounting impact
  - Restructuring (some spin-off /stock-split transactions)
    - If no anti-dilution provision in your plan(s)
  - Acquisitions
  - Other changes to original terms of grant
    - Extension of exercise grace period
    - Allow consultant to retain option after termination
    - Acceleration of vesting
    - 409A Exchanges – upward repricing
  - Etc. (anything that changes)

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## Modification Accounting Types Under ASC 718

Before ↓ After → Modification	Probable	Improbable
<b>Probable</b>	<b>Probable to Probable Type I</b> Case A (20-55-111) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any	<b>Probable to Improbable Type II</b> Case B (20-55-113) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any
<b>Improbable</b>	<b>Improbable to Probable Type III</b> Case C (20-55-116 & Example 15) Fair value of new grant only	<b>Improbable to Improbable Type IV</b> Example 13(d) Fair value of new grant only

\*Not applicable if vest schedule not changed – goals before & after modification are the same.

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## Common Termination Modifications

- Extension of Grace Period
  - Modification requires valuation before and after
    - Type I – Vested shares
- Vesting Acceleration
  - Can contain two types of modifications
    - Type III – Unvested Shares (new fair value)

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## OPTION EXCHANGES

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## Incremental expense

- FAS 123R
  - Continue to account for original award, plus account for “incremental cost” of replacement award
    - Incremental cost = excess of “fair value” of replacement or repriced award (measured immediately after repricing) over “fair value” of original award (measured immediately before repricing)



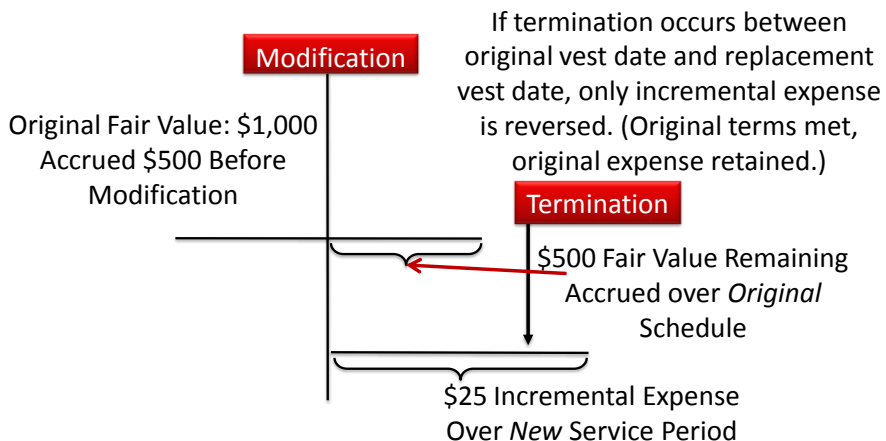
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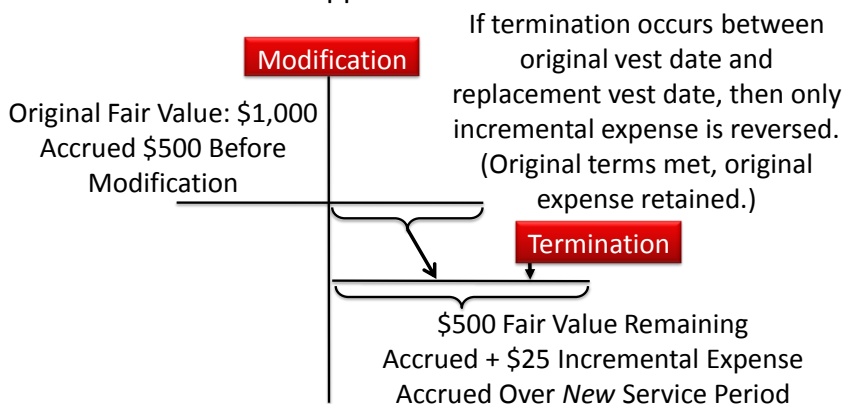
## Accrual – Bifurcated Approach

Modification with Incremental Expense & *extension of vest schedule* – Bifurcated Approach



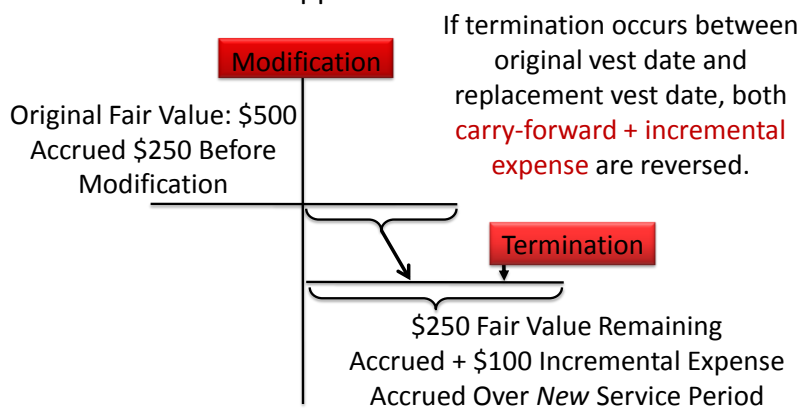
## Accrual: Pooled Approach

Modification with Incremental Expense & *extension of vest schedule*– Pooled Approach



## Exchange: System Accrual

Modification with Incremental Expense & *extension of vest schedule*– Pooled Approach



## Exchange / Accrual: Pooled or Bifurcated?

	Pros	Cons
Pooled	<ul style="list-style-type: none"> <li>• More systems support</li> <li>• Easier to “work around” in systems that do not have built-in support</li> <li>• (Usually) spreads expense out over a longer period</li> <li>• Diluted EPS unamortized calcs need consider only regrant</li> </ul>	<ul style="list-style-type: none"> <li>• More difficult to true up at termination if termination occurs between original vest date(s) and new vest date(s)</li> <li>• Harder to audit initially</li> <li>• IFRS 2 will not permit</li> </ul>
Bifurcated	<ul style="list-style-type: none"> <li>• Easier to true up at termination</li> <li>• Easier to audit initially</li> <li>• Permitted by IFRS 2</li> </ul>	<ul style="list-style-type: none"> <li>• Most systems cannot support</li> <li>• Workarounds difficult (multiple databases?)</li> <li>• Diluted EPS unamortized calculation must consider expense from two grants with different vesting schedules.</li> <li>• (Usually) expense accrued more quickly</li> </ul>

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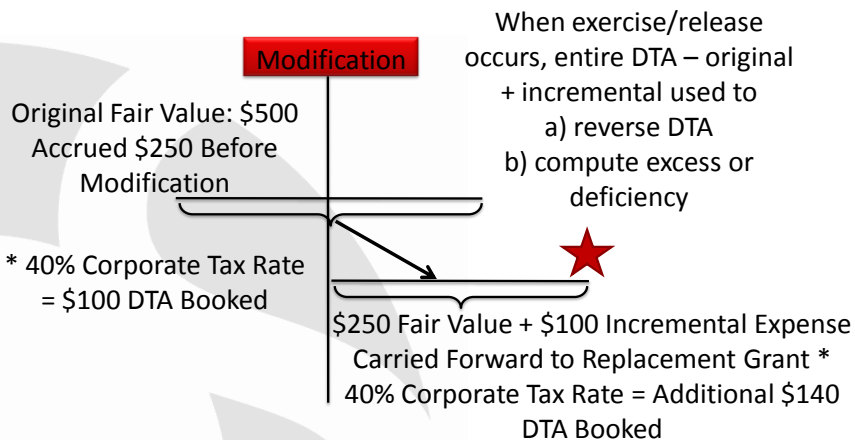
## Exchange: Tax Accounting

- Both the old (original) and the new (incremental) expense tied to the new grant
  - Both used when determining excess or deficiency for tax accounting purposes
  - Deferred tax assets (DTA) from both the old and the new grant are reversed at the time of exercise, expiration, etc.
  - Equity Edge cannot support
    - Only unamortized expense from original grant + incremental value used
    - “Orphans” DTA accrued prior to exchange
    - Overstates benefit / understates deficiency
  - No published guidance on this treatment
    - Prevailing practice – may be diversity in practice
  - Also impacts tax benefit calculations for Diluted EPS

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## Exchange: Tax Accounting

Modification with Incremental Expense & *extension of vest schedule*

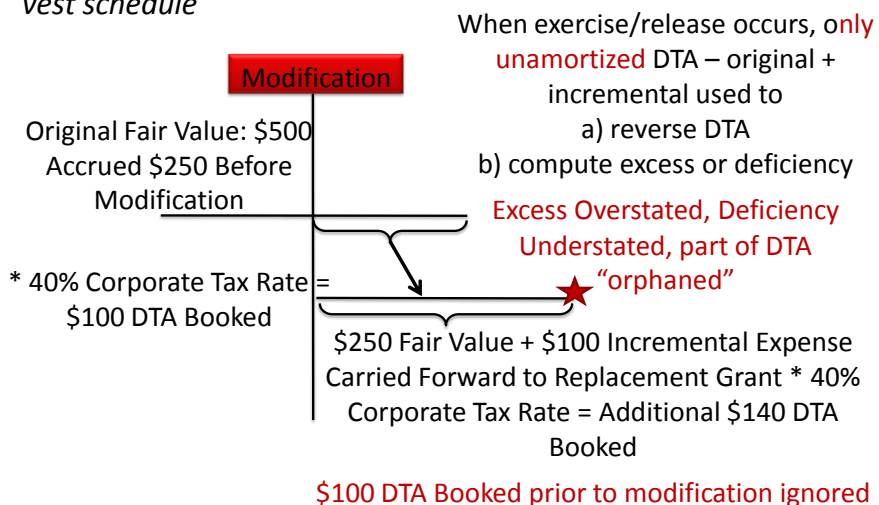


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## Exchange: System Tax Accounting

Modification with Incremental Expense & *extension of vest schedule*



## Diluted EPS Impact

### EPS Under FAS 128 in Four “Easy” Steps

1. Assume all vested & exercised/released
2. Weight shares for time outstanding
3. Calculate assumed proceeds / buyback shares
  - a. Exercise Proceeds (price)  
Not for RS/RSUs
  - b. Average Unamortized Expense
  - c. Hypothetical Tax Benefit / Deficiency
4. Compare weighted shares outstanding to buyback shares



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## Diluted EPS Calculations

- Impacted by modification accounting
  - Average Unamortized Expense During Period
    - If pooled approach used, carrying forward expense will allow Equity Edge to compute this correctly
  - Tax Benefit Calculations
    - Includes only unamortized original DTA and DTA from incremental expense (if any)
    - Excess overstated, deficiency understated, DTA accrued before modification is “orphaned”
  - Once calculations “adjusted” recompute dilutive or anti-dilutive status of the grant

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## M&A ACCOUNTING & TAX ACCOUNTING



### M&A Accounting: FV + Accrual

#### 1. Value the awards – new fair value

- Grant date fair value no longer relevant
- New grant *may be* worth more than old grant, but not common (if so, “incremental expense”)
- Standard methods for fair value may not apply

#### 2. Allocate the new fair value to pre-/post-combination

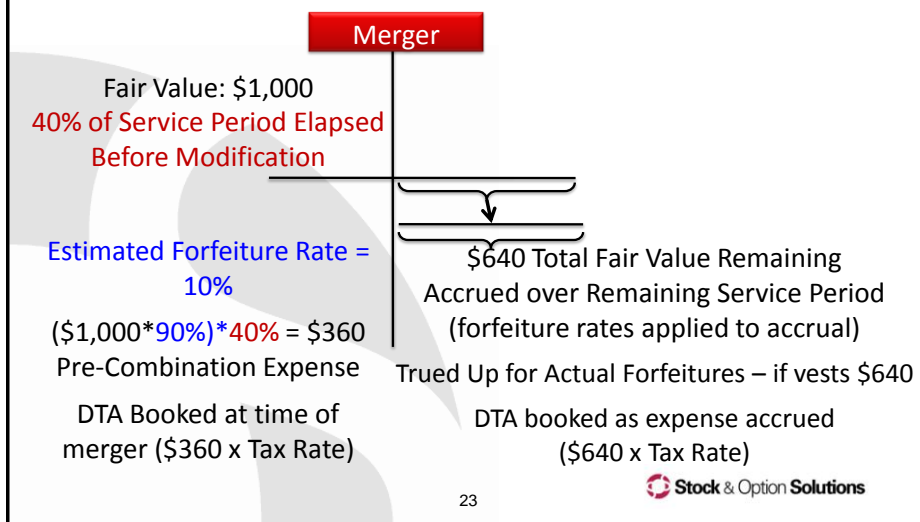
- How much of the service period has already passed?
  - = pre-combination expense = part of purchase price (haircut for estimated forfeiture rate)
  - Deferred Tax Asset (DTA) Booked for this pre-combo expense
- What’s left?
  - = post-combination expense = accrued over remaining service period
  - Includes incremental expense, if any

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## M& A: Accrual Example

New Fair Value = \$10 \* 100 Shares = \$1,000



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## M&A True Up at Termination

- Three Types of Tranches – each with different treatment
  - Vested at time of merger
    - No adjustment to expense (catch up or reversal)
  - “Straddle” tranches
    - Expense began prior to merger, vested after
    - Only partial adjustment – only post-combination expense reversed – no adjustments to pre-combination portion of expense
  - Post-combination tranches
    - Full adjustment – reverse expense if not vested at termination

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## M&A Tax Accounting

- At settlement
  - Exercise/release
  - Expirations
- Full DTA used to calculate impact to Additional Paid-in Capital (APIC)
  - Pre-combination expense/DTA+ post combination expense/DTA
  - \$10/share, in previous example
  - NOT only post-combination expense (not just \$6.40 – don't forget about \$3.60 of pre-combo)
    - Your system may not automatically use full DTA

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## M&A Diluted EPS

- Two Parts Impacted by M&A accounting
  - Average Unamortized Expense During Period
    - Only Post-combination expense (includes incremental)
    - \$640 in example
    - System should be able to support with custom valuation
  - Tax Benefit Calculations
    - Whole DTA recorded on entire award, not just post-combo
    - \$10 per share
    - Your system may not automatically use full DTA
  - Compute assumed proceeds and buyback shares based on adjusted calculations, then determine dilutive vs. anti-dilutive

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## TRANSACTIONAL DATA ISSUES



### Transactional Data Issues

- Mostly Common Sense, but consequences are much greater than fixing the transaction
- What happens with IFRS if we make mistakes?
  - When FAS123R was adopted, the change caused significant “Restatements”
- How do you find these type of issues?
- Do you have processes in place to protect against errors?
- Value the concept of catching issues early. It is only a mistake if it does not get caught in time.

## Transactional Data Issues

- Termination errors or delays
  - Additional Expense, True up, forfeiture analysis
- Grants after termination or cancellation
  - How do you expense that? Is that an “employee” award?
- Out of sequence exercises (Exercise after cancellation, exercise before vest)
  - DTA impacts, EPS impacts, What does your system do?
- Bad Vesting Schedule (zero tranches)
  - Can you amortize zero shares?
- Vesting schedule adjustments
  - Is this a modification issue? Now DTA/APIC and EPS...

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## Transactional Data Issues

### Common Issues

- Bad participant level data (Department or Location)
  - Where do you allocate the expense?
  - Tax Liability from incorrect tax withholding
- Adjusting data that alters, de-links, or deletes fair value records
  - What is being expensed then?
- Duplicate Records or Ids
  - Terminate the wrong person, double expense/shares?
- Re-hires that activate old grants
  - Expense more than you need

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## SOS Solutions

- Solutions customized to your requirements and needs
  - Diversity in application of the standard, Interpretations differ
  - Let your software system do all it can, then supplement the functionality
  - True Up at Vest / True Up at Forfeiture
  - FIN 28 vs. Straight-line, straddle grants, changes to number of vest tranches, etc..

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## Transactional Data Issues - Solutions

- Learn from your application
  - “Judy Messages” – we have blocked out warnings
  - Read all Manuals and White papers from provider
- Lean on your internal auditors
- Hire outside firm to run check on your database – SOS Data Audit Software

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## Audits

- Create Standard Transactional Procedures
- Create a Change log
  - Use systems logs if possible
  - Must track “Why?” and authorization for change
- Use System Error Reports
- Audit Process designed to:
  - Prove outside data source matches system after process

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## Audits – Expense Roll Forward

- End of Period Unamortized FAS123R Balance reconciles to last month
  - Prior Month Unamortized Expense – current month expense + forfeiture adjustment = **Current Unamortized Balance**
- Calculate forfeiture adjustments
  - Rerun last month with new forfeiture rate and compare unamortized difference
  - Prior Month Unamortized Expense in current run + Current month Booked Expense – Current Month Unamortized Expense = **Forfeiture True Up Adjustment**
  - Run the reports at the same time otherwise you might pick up changes in data since last period

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## Audits – Roll Forwards

- DTA End of period balance on GL
  - Booked Expense to date – Settlements to date = GL Balance
  - Expense Report from start of FAS123 (understand how your beginning DTA balance was calculated)
  - Settlement report since FAS123R
- Weighted Shares Outstanding – EPS calcs
  - Roll forward your share balances and check to see transactions reconcile with your detail reports transaction reports on EPS
  - Reconcile your outstanding award balance at beginning of report
  - May need to combine dilutive & anti-dilutive

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## SOS Solutions

- Custom Reports
  - Crystal Reports
    - Can be added to your software and run with a few clicks
  - Access-based
    - Can pull in data from multiple sources (flat files, spreadsheets, exports, etc.)
    - System data can be supplemented with additional data
- Database Solutions
  - Web-based interface
  - Oracle database backend
    - System data can be supplemented with additional data
    - Better for larger data sets, more complicated scenarios

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# SOS Custom Reports

TEST Database



EXPENSES										ADJUSTMENTS					CUSTOM ADJUSTMENTS REPORT				
Grant Begin Expense Date	Service Date	Total Days	Srv. Date	Unadjusted Current Period Expense (\$)	To Date Recognized Expense (\$)	Cancel Date	Vested Shares Recognized Expense (\$)	Current Period Adjustment (\$)	Recognized To Date Term Expense (\$)	Adjusted Fair Value per Share	Total Vested Adjusted at Term	To Date Actual Expense	Recognized To Date Adjustment						
0000895	04/30/10	04/30/10	0	0.00	0.00	0.00	100.00	(100.00)	100.00	0.00	0.00	0.00	(100.00)						
0000895	04/30/10	05/20/10	20	0.05	20		98.77	100.00	(1.23)	100.00	98.77	98.77	(1.23)						
0000895	05/20/10	06/20/10	31	0.14	31		153.09	100.00	53.09	100.00	153.09	153.09	53.09						
0000895	06/20/10	07/20/10	30	0.22	30		98.76	148.14	0.00	148.14	0.00	148.14	0.00						
0000895	04/30/10	07/20/10	81	81	81		98.76	400.00	300.00	100.00	300.00	251.86	(48.14)						
<b>Totals</b>																			
				Excluding Estimated Forfeitures	98.76	400.00	300.00	100.00	300.00		400.00	251.86	(48.14)						
				Including Estimated Forfeitures	98.21														

**EXPENSE SUMMARY**  
 UNADJUSTED CURRENT PERIOD EXPENSE: \$98.21  
 CURRENT PERIOD ADJUSTMENT: \$105.00  
 CURRENT PERIOD NET EXPENSE: (\$6.79)  
 ADDITIONAL CURRENT PERIOD ADJUSTMENT: \$48.14  
 CURRENT PERIOD ADJUSTED NET EXPENSE: (\$48.83)

# SOS Accounting Applications

## Demo

LOG OUT

[Reports Menu](#) [Set Up Menu](#) [Export Reports](#)

Welcome to SOS Accounting

**Parameters**

Report Period Begin Date:  (In mm/dd/yyyy format)  
 Report Period End Date:  (In mm/dd/yyyy format)  
 Tax Rate:  (%)

**Reports**

- Termination True Up
- Tax Accounting
- Diluted EPS

**Execute Report**

## Why SOS is the Best!

- Experience You Can Trust
  - More than 750 clients in 12 years of business
  - Vast experience in M&A and data conversions
  - Comprehensive vendor exposure/experience
  - Seasoned Data experts
  - Unmatched participant communications
  - In-house accounting expertise

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## Why SOS is the Best

- Superior Quality
- Flexible Offerings
  - Focused expertise
  - Use of specialists where required
- Advanced Technology Solutions
- The SOS Network
  - Extensive Partnerships
  - Large number of equity compensation experts on staff

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