

Tender offer valuations are considered a Type I modification under ASC 718 and can be confusing to even the most seasoned equity accounting professional, let alone someone whose specialty is not accounting. However, once you break the subject down into bite-sized pieces, it becomes an easier meal to digest. In this article we will examine each of the pieces of the fair value needed to calculate the post-tender offer valuation for expensing purposes. For purposes of this discussion, we will assume that a company has outstanding underwater options that they want to cancel and issue new at-the-money options to employees.

The Appetizer: Unamortized Expense from the Tendered Option

In the era of expensing for a Type I modification under ASC 718, companies are obligated to recognize all of the originally calculated expense once they issue an option. If the company decides to offer employees a chance to tender their underwater options, any expense not yet recognized for unvested underwater options doesn't magically disappear at cancellation. It has to be recognized, even though the underwater option will be cancelled and no longer outstanding. This "leftover" isn't destined to be shoved to the back of the fridge and forgotten. It will become part of the new valuation for the newly issued option.

The Main Course: Incremental Expense

An evaluation needs to be done to see if the newly issued option will be worth more than the tendered option at the time of the modification. It requires determining the appropriate "before" and "after" expected terms which will drive the volatility and risk-free interest rate inputs to the Black-Scholes calculations we all have seen on the menu repeatedly. There are a few different entrees to choose from when it comes to determining the appropriate "before" expected term. You should read the menu carefully to make sure you know exactly what you're getting. The "after" expected term is simply what you would normally order when faced with a new option.

So, let's say that the Black-Scholes value of the underwater option just before the modification is \$2 and the Black-Scholes value of the new option will be \$3. The difference (\$1 per share) is the incremental expense that must be recognized over the service period of the new option.

Dessert: Number of Shares in the New Option

The cherry on the top of the valuation is the number of shares in the new option. All of the valuation inputs are known, so all that is left is to add them up and divide by the number of shares in the new option. (And possibly sit back and enjoy a cup of coffee or after dinner glass of port while you do!)

The new valuation is equal to:

$$\frac{\text{Unamortized Expense (tendered option) + Incremental Expense}}{\text{Number of Shares in the New Option}}$$

Or, to make this easier to swallow:

Appetizer + Main Course
Dessert

Tender offer valuations are not the tough to digest meal that many believe them to be. Breaking them down to the basics (Unamortized Expense of the tendered option, Incremental Expense and the shares in the new option) makes them more palatable. When you next encounter these on a menu, don't be afraid they will leave you with heartburn!