

Global Commercial Bank Taps Equity Methods for Valuation, Expensing and Tax Reporting of Complex Equity Awards

- *Fortune 100 financial services company issuing equity compensation to 25,000 employees*
- *Variety of complex award types, including: liability awards, performance awards, and cash awards*
- *Tiered retirement eligibility provisions (very unique)*
- *Data integrity issues that require significant adjustments to be made to administration data*
- *Complex valuation assumption development needs*

BACKGROUND AND CONTEXT

Our client is a Fortune 100 financial services firm with a global presence.

This firm grants a variety of equity compensation awards to over 25,000 employees. These awards generally include plain vanilla stock options and restricted stock, as well as cash-settled RSUs, cash awards, and performance awards. The plans also contain tiered retirement eligibility provisions, which means multiple retirement eligibility thresholds exist which cause only portions of an award to be accelerated.

In addition to complex award types and provisions, this client leverages Equity Methods to perform Black-Scholes valuations for its stock option grants. While the application of Black-Scholes is simple and straightforward, compliant development of the expected term and volatility inputs require much effort. With regard to expected term, effort must be taken to identify non-representative grants in the historical data and exclude them from the analysis.

Finally, Equity Methods has engineered numerous data adjustment processes. Due to reasons not even known to client personnel, certain data stored in the administration system are not accurate for accounting purposes. As such, Equity Methods performed specific, targeted adjustments to the data to ensure accurate financial reporting.

SPECIFIC REPORTING CHALLENGES AND EQUITY METHODS SOLUTION

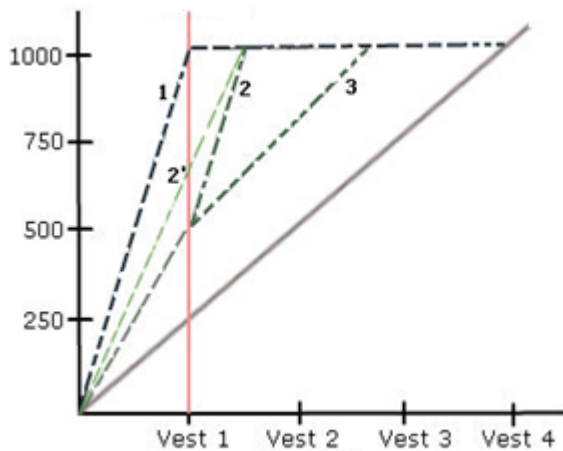
As noted, this firm faces a number of equity compensation challenges that necessitate a technology-enabled solution that is highly customizable. Equity Methods' industry-unique use of SAS technology allows such customization through a modular-based approach toward process engineering.

The first key challenge concerns the retirement eligibility provisions in the stock plans. Each plan (NQ, RSUs, performance-based awards) possesses different provisions. In all cases, the provisions are tiered, which means that unlike most firms' retirement eligibility rules, there is not a single threshold, which once achieved, causes all then-unvested awards to be earned. Tiered provisions result in a partial acceleration upon a milestone being reached. This distinction is non-trivial: with tiered provisions, it is not possible to simply amortize the entire award through the retirement eligibility date. Instead, partial acceleration records must be triggered at the retirement eligibility date and the remainder of the award will continue vesting thereafter. In short, the result is a "kinked" expense amortization line over time.

Consider the following example of an award, with four years of equal vesting and three distinct targets:

- Retirement Age Milestone 1 plus a 1-year award holding period results in 50% of the then-unvested shares accelerating
- Retirement Age Milestone 2 plus a 1-year award holding period results in 100% of the then-unvested shares accelerating
- Retirement Age Milestone 3 (without any award holding period) results in 100% of the then-unvested shares accelerating

Interestingly, note how it is possible to hit (and be affected by) more than one of these provisions in the course of just one award's vesting life. As previously mentioned, each provision results in a partial acceleration. Line 1 simply shows an individual who hits the first milestone before Vest 1 while not hitting the second milestone until after that date. Lines 2 and 3 represent individuals who will be at the second milestone in year two and year three of the grant, respectively, with 2' being a potential acceleration option and 3' not being an option due to the provision requiring a 50% acceleration, or 500 shares, at Vest 1 that would consequently cause disallowed under-expensing. Finally, imagine a line labeled 4 that would go from 500 shares at Vest 1 to the upper corner depicting an individual of 55 years at Vest 1, but who does not become 60 years of age until after vesting has ended.



The second challenge faced by this client concerns the use of relatively unique award types. In addition to plain vanilla options and restricted units, this firm grants cash-settled units, cash-denominated units, and performance grants.

Performance Awards. Recent Performance Awards have been structured to contain two tranches:

- Tranche 1: performance period in year 1, service required through end of year 2
- Tranche 2: performance period in year 2, service required through end of year 3

A performance multiplier is assigned each period that ranges between 0% and 200% of the target quantity granted. However, because these awards are cash denominated (not tied to the share price), a discount factor is also applied to present value the future cash quantity each reporting period. Off-cycle grants are not uncommon, and require special treatment with regard to the recognition of a pro-rata portion of expense immediately upon grant.

Cash-Denominated Grants. Cash-denominated grants without performance conditions are also issued. As described above, a discount factor is applied each period to compute the present value of the future cash quantity. Because the denomination of the award is in cash, there is no consideration of the share price.

Cash-Settled Grants. Finally, these are traditional liability share-based awards, whereby the payout is in cash, but the quantity to be paid out is based on the share price at settlement. As such, the fair value is marked-to-market each period based on the closing stock price.

The third challenge in this client's financial reporting process relates to generally pervasive data integrity issues. Similar to many of Equity Methods' clients, this firm has a rather large administration database and has gone through multiple system conversions—the net effect being sporadically erroneous data. One specific issue concerns incorrectly specified vesting schedules, whereby numerous awards were literally assigned the wrong vesting schedule. While this client's administrator was not able to correct the problem, Equity Methods engineered its process to build vesting schedules for all awards based upon certain rules and criteria provided by its client. This enables the client to possess assurance that inaccurate vesting schedules are not undermining their financial reporting process.

One important feature of Equity Methods' process is the integration of rigorous valuation work. Whereas previously multiple groups within and outside the company shared work related to valuation, expensing and tax accounting, all this work now falls under the Equity Methods umbrella. Annually, Equity Methods performs a study to develop an expected term and forfeiture rate assumption. Monthly, Equity Methods refreshes the volatility, interest rate and dividend yield, since these inputs must be refreshed for each individual grant. This client has realized significant time and risk savings from engaging Equity Methods to handle all aspects of their equity compensation financial reporting process.

A few other minor issues have also arisen, such as Type III modifications in response to certain divestitures and assumed awards (subject to ASC 805) through the course of certain acquisitions. Equity Methods' process also seamlessly handles these situations.

CONCLUDING REMARKS

Consistent with its objective, Equity Methods engineered a truly customized, and yet automated and locked-down, process, to manage all valuation and accounting aspects of this client's equity compensation compliance process. The unique nature of this firm's plan (in size, data, and award complexity) precluded a simple off-the-shelf software bundle, instead necessitating Equity Methods' modular technology-enabled solutions. Furthermore, Equity Methods' unique staffing approach (valuation and accounting professionals with more than 115 cumulative years in equity compensation accounting) enabled this solution to be developed in less than four months.