

Equity Methods Solves Accounting and Financial Reporting Conundrum for Fortune 50 Technology Leader

- *Global Technology Company Issuing Equity Compensation to 150,000 Employees*
- *20,000 Plan Participants Receive Awards Containing Both a Market and Performance Condition*
- *M&A Accounting on Assumed Options from Three Acquisitions*

BACKGROUND AND CONTEXT

Our client is a Fortune 50 global provider of technology products, software, solutions and services to individual consumers, small- and medium-sized businesses and large enterprises, including customers in the government, health and education sectors.

This firm grants a variety of equity compensation awards to over 150,000 employees, whereby 20,000 of those individuals receive awards containing interdependent performance conditions (two separate metrics) and a market condition. The market condition (relative total shareholder return) serves to modify the payouts created by the two performance conditions. This firm has also recently undergone three acquisitions, and in each case assumed the options of the acquiree (under FAS 141R / ASC 805).

The majority of this case study will focus on the performance-based awards, because this firm is unique insofar as it grants performance awards deeper in its organization than any other firm in the world. Needless to say, numerous complexities also arise from the non-performance-based awards, M&A accounting on assumed awards, data/systems issues stemming from the size of the plan, and multinational nature of the plan.

SPECIFIC AWARD TERMS AND EQUITY METHODS SOLUTION

As noted, performance-based awards contain two separate performance conditions and one market condition. For expense recognition purposes, this requires two multipliers (one for each performance condition), and for diluted EPS calculation purposes, three multipliers are used.¹ Furthermore, each award contains three tranches whereby performance targets are individually set for each of the three tranches at the beginning of years one, two, and three, respectively. This has two implications:

- Each tranche has a separate grant date under ASC 718.
- Each tranche will receive different multipliers for the performance conditions.

Interestingly, although the payout resulting from the performance conditions is known at the end of each fiscal year (e.g., at the end of year one, the outcome on tranche one is known), there is no payout made to the employee. This is so for two reasons:

¹ Under FAS 128 (ASC 260), awards with performance or market conditions are considered contingently issuable shares. The multiplier assumed for calculation purposes is based off a test that examines what the payout would be if the end of the current period actually was the end of the performance period. Thus, a changing multiplier is used for a market condition and the two multipliers used for the two performance conditions may be different than those assumed for expense recognition purposes.

- The requisite service period is three years, and so the employee has yet to earn the tranche.
- The performance condition payout outcome will ultimately be modified by the market condition, which runs for the full three-year period.²

A graphical depiction of the award is provided in Appendix A.

Based on this, there are a total of 18 different multipliers being tracked and monitored at any point in time (two per tranche; three tranches per grant; three overlapping grants outstanding). However, this firm also issues off-cycle grants to new employees and new hires. Off-cycle grants do have the same performance conditions (and thus the same performance multipliers), however, they receive different valuations because they have different grant dates and the Monte Carlo valuation of the market condition yields a different value. A separate Monte Carlo simulation must be performed on each grant date.³

This provides a convenient segue into how Equity Methods' process must actually create vesting schedules because awards are tracked only at the grant level within the administrative system. Thus, Equity Methods receives data at the grant level and explodes it into the tranche level. However, due to off-cycle grants, this is not simple a process of building in two additional rows per grant (for a total of three) and dividing the total award quantity by three. Based on the timing of an off-cycle grant, the award may be structured to include one, two, or three tranches. Equity Methods must build the vesting schedule of each award according to predefined logic in order to ensure accurate amortization.

Another complicating factor is the timing of the company's large annual grant. The grant is legally issued in November of each year, although the accounting grant date is not established until December or January when the Board certifies the performance condition. Based on paragraph A79 of FAS 123R, the service inception date cannot precede the grant date, and thus amortization does not begin until the formal grant date. However, the legal grant date is specified as November, and thus manipulation is needed to ensure that expensing does not begin until the accounting grant date occurs. (As a practical matter, a grant date fair value cannot be established until that date arrives.)

Equity Methods' process also builds cancellation records according to termination data received from the global human resources information system. This process step is necessary due to the complexity of qualifying termination and retirement eligibility provisions, and how the effect of these provisions cannot be fully captured in the record-keeping system used by this firm. In the case of terminations, Equity Methods reads the termination date, termination reason, and termination action provided by the termination data, and via a predefined cross-referencing process, generates both a cancellation record and acceleration record. The table cross-referenced governs how the simultaneous pro-rata cancellation and acceleration is specified based on rules related to both the timing and type of termination. Just one example of the customized nature of this process, the pro-rata

² As an alternate example, consider tranche 3. Here, the performance conditions are not specified until the beginning of year three. However, this tranche is also affected by the market condition. At the end of year three, both the performance condition and market condition outcomes are known. The interesting nuance is the valuation of tranche three (and for this matter, tranche two): the valuation needs to reflect actual stock price performance over the elapsed period, since the same market condition governs all three tranches on the grant.

³ Discussed briefly later, but a topic of considerable complexity, a market condition period often starts before the accounting grant date on an award (e.g., the market condition may begin on January 1, but the grant date may not take place until March 1). In this case, the Monte Carlo simulation must combine actual performance between the market condition start date and award grant date with simulated performance between the award grant date and market condition ending date.

determination depends on the number of months of service rendered (e.g., as opposed to days) but requires that service be rendered through the last day of a month in order for that month to count.

Whereas qualifying termination events govern the pro-rata acceleration and cancellation upon an actual qualifying termination (death, disability, and actual retirement), retirement-eligibility provisions are accounted for ex ante to model how qualifying retirement rules could make the stated requisite service period non-substantive. In this firm's case, retirement-eligibility must be modeled on a tranche by tranche level. Specifically, a tranche is considered earned so long as one year of service on that tranche has been rendered. For a retirement-eligible employee, tranche one is considered earned after year one (i.e., remaining two years of required service are not binding) and tranche two is considered earned after year two (i.e., remaining one year of required service is not binding).

Finally, as fate would have it, this company elected to modify its performance-based awards by adjusting the targets. Before any programming or report customization, Equity Methods added significant value by helping to clarify the correct accounting treatment of the modification. Controversy existed as to whether it should be classified as a Type I (probable-to-probable) or Type III (improbable-to-probable) modification. This client was able to extract significant value from Equity Methods experience in addressing similar topics of accounting policy. The subsequent reporting adjustments needed to quantify incremental cost and incorporate it into the accrual stream were also non-trivial.

In summary, Equity Methods' process is fully customized to the types of awards issued by this client and the nature of the data stored in their administration system. The key process steps discussed here include:

- Automated export of data from client's equity administrative system.
- Built vesting schedules according to specific criteria because award data only exists at grant level within the administration system.
- Created different numbers of tranches for off-cycle grants based on pre-defined rules, and allocated quantities to each tranche based on those same rules.
- Created cancellation and acceleration records based on the timing and reason of each individual termination event; highly-complex process due to pro-rata provisions that vary by situation.
- Customized retirement eligibility treatment due to differing effect of provisions on each tranche.

Once again, this case study has focused on the specific processing and accounting issues related to this company's performance-based awards, however, a near equivalent degree of complexity stems from unrelated issues. A brief summary of financial reporting challenges not related to the performance-based awards is as follows:

- Deferred tax accounting: awards issued in over 50 countries, resulting in use of multiple tax rates based on the specific country in which awards are being issued.
- Purchase accounting under ASC 805 related to assumed awards in each of three recent acquisitions.
- Certain international awards are paid out in cash and thus classified as liabilities.
- Detailed push-down accounting policies to ensure expense is allocated appropriately to specific divisions and cost centers.
- Robust forecasting process to trend expense over the forward-looking three-year period, while also layering in the expected impact of future grants.

More holistically, Equity Methods automated a process that previously had been managed entirely through Excel spreadsheets. The current process is now fully technology-driven, thereby significantly reducing risk and freeing-up considerable time that had previously been lost performing inefficient spreadsheet procedures.

CONCLUDING REMARKS

Equity Methods is capable of successfully performing financial reporting for this Fortune 50 firm based on its unique blend of technical accounting, valuation, and technology experience. The solution required full customization from the ground up, as no other firm in the world has issued this specific type of award nor issued so broadly throughout the organization. Equity Methods combined its expertise in technical accounting with its programming acumen to deliver an end-to-end solution that manages risk and eliminates manual process steps.

APPENDIX A

