Fortune 500 Life Sciences Leader Enlists Equity Methods to Account for Option Exchange Awards Program

- *Represents one of the largest option exchange programs over past five years*
- *Resolves pre-exchange and post-exchange data for accurate, custom financial reporting*

BACKGROUND AND SPECIFIC REPORTING CHALLENGES

Our client is a Fortune 500 life sciences company (referred to as LiSiCo to protect client confidentiality) that completed one of the largest option exchange programs conducted in the past five years.

LiSiCo conducted a value-for-value underwater option exchange (options for restricted stock) within the last five years. The vesting on the new restricted stock was extended, thus requiring an accounting policy decision on whether to use the Bifurcated Method or Pooled Method. For context, in the May 2005 FASB Resource Group Meeting, the FASB discussed two approaches for establishing the attribution period post-modification for the unamortized component of the original grant-date fair value:

- Pooled Method: unamortized component of the grant-date fair value is amortized over the modified (extended) vesting period and the incremental cost, if any, over the modified vesting period; or
- Bifurcated Method: unamortized component of the grant-date fair value is amortized over the original vesting period and the incremental cost, if any, over the modified vesting period.

Adherence to the floor provision is straightforward under the Bifurcated Method because compensation expense continues to follow the original vesting schedule, such that a cancellation occurring after the original vesting date but prior to the modified vesting date is classified as a post-vesting cancellation and not a pre-vesting forfeiture. This ensures expense is only reversed on grants that are canceled sufficiently early such that they would not have vested even under the original vesting terms. LiSiCo elected to follow the Bifurcated Method. Both methods are challenging to implement; complicating the Bifurcated Method is the fact that stock administration data are updated to reflect only the modified award terms so as not to confuse plan participants. The problem this poses is that the accounting rules require consideration and reference of both the original and modified award terms. To accomplish this, a process must be utilized that adjusts the stock plan data (outside the stock plan database) to reflect the original vesting schedule.

EQUITY METHODS SOLUTION

As noted, the central problem concerning the financial reporting for awards subject to an exchange program is that the reporting requires consideration of pre-exchange data whereas plan participants are only interested in the post-exchange data (it would be confusing and misleading to continue to show participants pre-exchange data). And, because stock plan administration systems are generally designed from a participant perspective, financial reporting processes tied to those systems lack the ability to seamlessly, *and yet selectively*, reference the pre-exchange data. This is not to insinuate that companies actually delete the pre-exchange grants from their administration systems; however, even maintaining the original grants in a parent-child fashion within the

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administration system will cause off-the-shelf financial reporting processes linked within or linked to that system to struggle in correctly referencing both the pre-exchange and post-exchange award characteristics in the appropriate manner.

Equity Methods' solution is to construct an adjusted dataset (called the "EM Adjusted Dataset"). The EM Adjusted Dataset mimics selective characteristics of both the pre-exchange and post-exchange grants in order to achieve the correct financial reporting values. For example, given the floor provision as it relates to vesting extensions, the EM Adjusted Dataset will reflect the original vesting schedule. On the other hand, the EM Adjusted Dataset will reflect the post-exchange strike price. Most importantly, note how this does not require any revision to the core administration data: the EM Adjusted Dataset is developed by Equity Methods based on the core administration data but is never appended back into the administration system. This ensures the administration data and the processes associated with the entry and maintenance of this data are never affected.

Concluding Remarks

Equity Methods is a full-service firm, possessing deep experience in plan design, equity award valuation, and financial reporting. Equity Methods' custom-tailored process for handling exchanged awards combines the appropriate characteristics from pre-exchange and post-exchange data to form a dataset useful for financial reporting purposes. This combined dataset flows seamlessly through Equity Methods' algorithms to generate correct financial statement values. Furthermore, the staged and controlled process of formulating the EM Adjusted Dataset enables straightforward tie-out to the core administration data and audit of the downstream financial reports.

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