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Stock options: do you have a problem?

How to tell if you have equity-based compensation issues—and how to fix them

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Mistakes in tracking and accounting for equity-based compensation are a common cause of restatements and other finance troubles. Think this isn't your problem? We have plenty of sobering examples of companies in denial right up to the moment when they experience a painful accounting breakdown. This guide walks you through the issues we see regularly at public and private Silicon Valley companies—and tells you how to set yourself up for smooth sailing.

Step 1: Confront the issue—are you in denial?

Equity-based compensation in Silicon Valley is as common as free drinks in Las Vegas. And perhaps because it's so unremarkable, many companies—public and private—treat it with the breezy inattention of a tipsy gambler ordering another round.

Why the risky behavior? Companies often don't realize how complex the accounting for equity-based compensation can be, or they don't understand what's on the line if it isn't done correctly. Errors in equity-based compensation can cost a company money, reputation, time, and employee morale.

- For companies headed toward an IPO or acquisition, issues with stock awards can cause unnecessary delays and reduce their valuation.
- Correcting problems is a time-consuming hassle. Modifying equity systems to reflect the appropriate records and accounting can involve a lot of manual work and extensive checks and balances: Were the stock records updated correctly? How did they impact the accounting? Was there an impact on incentive stock option status?
- The finance team will have to perform a materiality assessment, which could result in a need to restate financial statements from prior periods.
- You can expect increased scrutiny from your auditors and more substantive testing in this area going forward.
- If your company must amend awards previously made, your employees may have concerns, even if the change has little to no financial impact on them.

About now you may be thinking: "Our equity compensation accounting is just fine!" "This doesn't apply to my company." "My attorney takes care of all of my stock administration, so our records are in good shape." "The auditors have reviewed our stock-based compensation and there haven't been any issues so far." Or maybe, "We have a great equity accounting system that does all the work for us."

We've heard it all at RoseRyan—from companies that aren't fully aware of accounting requirements, have incomplete or broken internal processes, or rely on equity systems with parameters and limitations they don't really understand. Is it possible you're in denial? Let's take a look at the facts.

Step 2: Awareness—admit you could have a problem

When companies think of equity-related restatements, they often think of stock-option backdating, a fraudulent activity. But while those incidents are widely publicized, equity-related restatements more often stem from honest mistakes—and they're more common than you might think.

Earlier this year, the *Wall Street Journal* reported that since 2004, more than 30 percent of companies with recent IPOs have restated their financial statements—and equity-based compensation and executive pay accounted for more than 10 percent of the restatements. RoseRyan often assists clients with equity-based

compensation, and in our experience, 9 out of 10 companies have some issue with their underlying stock data that affects their stock-based compensation expense.

The U.S. Securities and Exchange Commission (SEC) spotted this trend years ago. Scott Taub, former deputy chief accountant at the SEC, sounded the alarm about increasing restatements in a 2006 speech. He noted that the number of restatements by U.S. public companies rose from 116 in 1997 to 1,195 in 2005. In an effort to understand the underlying issues, the SEC looked at disclosures accompanying restatements over the previous three years. Its findings "suggest that well over half of the errors that resulted in restatements were caused by ordinary books and records deficiencies or by simple misapplications of the accounting standards," Taub said.

Another common cause that's particular to equity compensation, we've found, is that many companies don't fully understand the reporting functionality of their equity software, which can lead to mistakes that result in inaccurate recording of stock-based compensation expense.

Step 3: Understanding—know the issues

The best way to deal with an equity compensation issue is to prevent it. Following is a set of best practices—for public companies, private companies, or both—based on our extensive stock-based compensation experience. And to show you why they're necessary, we've included some real-life examples of what can go wrong when they're not followed—and what can go right when they are.

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Communicate awards to employees pronto

Most companies consider the grant date of stock options or other equity awards to be the date they were authorized by the board of directors. But if you don't notify recipients of the awards promptly, the board approval date may not be the grant date for accounting purposes. Technically, the grant date is when the employer and employee have a mutual understanding of the award's key terms and conditions.

You don't have to notify an employee on the day of the board meeting—the Financial Accounting Standards Board (FASB) allows companies to use the board approval date as long as the employee receives notice within a relatively short period and cannot negotiate changes to the award. "Relatively short" means "that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices." Yes, it is subjective, and it depends on your company's communication standards (whether you rely on email, hard-copy letters, and so on). We recommend developing a communications protocol and consistently applying it. Communications should be in writing and employees in foreign countries should be considered separately—distance, time differences, and variations in access to technology may cause delays.

What happens if you're lax? One of our life sciences clients was asked by their auditor to provide support for when they communicated awards to their employees. The company had been focused on raising another

round of preferred stock financing for their next clinical trials and had delayed communicating the grants to employees for a couple of months. The audit firm concluded that the grant date was the date of communication. Result: higher stock-based compensation charges. The firm deemed the value of the common stock to have been higher at the grant date, as evidenced by the preferred stock financing, than it was at the board approval date. On top of that, updates to the equity system took more than a week and delayed the audit.

Put a neon sign on nonemployee awards

Stock-based awards to employees and nonemployees are accounted for differently. Generally, employee awards are measured at fair value at the grant date and expensed over the service, or vesting, period. For nonemployees, share options are remeasured until the shares vest. The fair value for nonemployee awards is generally higher than the fair value for employee awards, because the calculation is based on the contractual term of the award (generally 10 years), versus the expected term of the award for employees (generally 4 to 6 years). A longer term results in a higher expense. No big deal, right? Sure, if you've properly identified all nonemployee awards.

When we see accounting issues around nonemployee awards, it's usually because the company didn't identify the recipient as a nonemployee. This can happen in a number of ways: the stock administrator receives a list of option grants and assumes that all the individuals are employees; the equity administrator doesn't check all the boxes and set up modules in the system to identify both the individual and the grant as nonemployee; or the accounting department doesn't know that there are any nonemployee awards, so they don't think to ask for nonemployee stock-based compensation expense reports. No matter what the cause, the result is an understatement of expense.

Make sure performance-based awards are on everyone's radar

We're seeing a trend toward making the vesting of stock awards contingent upon achievement of specified performance metrics, especially for the executive team. Performance-based awards are great tools for both retaining employees and motivating goal-driven behavior. But there is accounting risk here.

With performance-based awards, companies must assess the probability of achieving the metrics at each reporting date and adjust the expense accordingly. This often doesn't happen. Maybe the board minutes lay out the performance goals associated with an award, but the stock administrator gets only a spreadsheet of grants to administer, with no indication that vesting is contingent. Or maybe the stock administrator is aware of the performance targets, but doesn't flag performance-based grants in the equity system, so the accounting team doesn't know they exist.

One of our clients faced the latter situation. At the end of a two-year period, they had not met the goals for a large performance-based stock option, so the stock administrator changed the award to vest in zero shares. As a result, the stock-based compensation expense for the quarter dropped significantly. The existence of that contingency was news to the accounting department, which then faced the questions, "During which quarter in the last two years did the probability of achievement diminish, and was stock-based compensation expense overstated in any prior period?" Ouch.

Make sure your stock administrator knows which equity awards are contingent on performance targets, so that they vest only what should be vested. And make sure the accounting team knows too, so that they can evaluate probability and account for the awards correctly—and avoid restatements.

Tie your 409A valuations to major grant dates

For private companies, the rule of thumb is to obtain a 409A valuation of your stock at least once a year, and in conjunction with major events such as financings or an IPO. But when do you get the annual valuation done? At December 31, right? Sure, if you grant most of your equity awards around that time. But what if you do your major annual employee grant in June? Get the 409A then.

Here's why: One of our clients had a 409A valuation as of December 31, 2010, with the common stock valued at $1.25 per share. The following June, the board approved a major grant to executives and employees. As most private companies would, our client granted the stock options with an exercise price of $1.25, which they believed represented the fair value of their common stock as of the grant date. Six months later, they got 409A valuation as of December 31, 2011, and found that the value of their stock had increased significantly—to $3—based on several design wins and other economic factors. Therefore, the company had to assess the value of the common stock during the course of the year, noting the dates of significant events. They determined that the value of their stock in June was $2. Now they had a big problem. Not only did they face additional stock-based compensation expense and time-consuming updates to their equity system, but the revaluation also called into question whether the awards could still be considered incentive stock options and whether there were additional tax consequences to employees. And all this was discovered in preparation for the year-end audit, which was significantly delayed as a result.

The lesson: Plan ahead and time your 409A valuations around your grants. Also consider whether you would benefit from performing an additional 409A valuation during the year.

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Be obsessive about looking for modifications

Some modifications are obvious (say, repricing a stock option); some modifications are less so (say, allowing a consultant to keep their options after you hire them as an employee). Keep an eye out not only for board decisions, but also for management decisions, material transactions, or liquidity events. The rule is, *any* change to the award or the award holder's status should trigger consideration of accounting modifications.

Common modifications include repricing, acceleration of vesting upon termination, exchange of options for restricted stock units, extension of the exercise period for vested awards following termination, and retention of an award with a change in employment status.

Identifying that you have a modification is just the first challenge; the accounting can be tricky as well. How you account for the modification will depend on the type of modification. Variations include measuring the incremental value only, accelerating the expense, or valuing the new award and reversing the value associated with the original award. You also need to be sure you're entering the modification in your equity system in a way that captures the appropriate modification accounting.

Here's how this can work smoothly: A software company engaged us to help them implement the accounting for stock-based compensation. During our review of the supporting documentation, we identified several modifications in the board minutes and noted several others arising from changes in employment status. We documented the modifications and accounting in a memo, reperformed the fair value calculations, and ensured that the stock-based compensation expense reported by the equity system was correct. Several months later, when the company engaged their auditors, the equity records were audit worthy and the auditors were able to use the memos in their work papers, resulting in a clean audit and saving the company time and money.

Remember: special arrangements need special accounting

Creativity abounds. Companies often get crafty with special arrangements for highly valued employees. That's OK—but remember, special arrangements require special attention. When companies provide loans to employees for the exercise of stock options, those might not be accounted for as loans. And how do you account for a bonus plan that pays based on an increase in value of the stock underlying the option? Or a cash bonus paid each year around the vest date of restricted stock units, allowing employees to pay the tax on vesting? Key considerations: Is the arrangement allowable under the equity incentive plan? Does it require board approval? Is the arrangement accounted for separately or is it tied to the equity award?

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Be on intimate terms with your estimated forfeiture calculation

When recording stock-based compensation expense, you have to estimate the number of awards that ultimately will not vest (most often due to employee termination) and reduce the expense accordingly. You also have to adjust and true up these estimates over time. For any company, estimating the forfeiture rate means truly understanding the equity system's calculation.

Does your system use a flat rate or an annual rate? Is the system applying the forfeiture rate to each vesting tranche or to the whole award? Does the system true up at vest or at termination? Understanding your system's calculations will help you estimate the forfeiture rate more accurately and tell you how often that rate should be trued up.

We've seen the forfeiture rate wreak havoc with stock-based compensation expense. For example, a company estimates a forfeiture rate and puts it into the system, and auditors seem OK with it—in the first year. Then in year two, there's a big hiccup in the stock-based compensation expense. In most cases, we see the expense spike as awards granted in the previous year hit their first 12-month vesting date and the system trues up the expense. No one expects you to be psychic, but a significant change in your stock compensation may be evidence of an error in the calculation, which can lead to restatement.

Record, review, reconcile, repeat

You've heard the phrase "garbage in, garbage out." Your stock-based compensation expense is only as good as the data in the system. And the more significant that expense is to your overall financials, the bigger the risk posed by faulty underlying data. We've seen it all—missing grants, duplicate employees, incorrect hire dates, incorrect vesting, missing employee terminations, updates to the common stock fair value not reflected in individual awards, and so on.

A classic example: A new client assured us that the stock data in their equity system was in tip-top shape, as the company's attorneys had maintained it; we were engaged only to provide fair value calculations and expense for the awards. A few weeks later the audit firm asked why several people were still vesting when payroll records showed they'd left the company long ago. Turns out the company had neglected to inform their attorneys of employee terminations. All stock-based compensation expense was overstated as a result.

This brings to mind another truism: the more things you have to remember, the more opportunities you have to forget. So while accounting for stock-based compensation may not require a psychic, it's really helpful to be obsessive-compulsive. Check your data—again and again.

Step 4: Get help

Still think none of these situations applies to you? Good for you. But if you have an inkling of doubt, know you're in trouble and aren't sure how to get out, realize you don't have the staff time or expertise to deal with the details, or just want the comfort of an expert review, RoseRyan can help. Contact Maureen Ryan at mryan@roseryan.com to find out what we can do to ensure that your equity-based compensation processes and system are in perfect health.

About Kelley Wall: Kelley Wall, a CPA with more than 15 years' experience in finance and accounting, regularly advises clients on equity-based compensation issues. She joined RoseRyan in 2005 and leads the firm's growing Technical Accounting Group.