Stock & Option Solutions

ACCOUNTING ANSWERS: DTA BALANCE PROOF
THE DEVIL'S IN THE DETAILS

Have you ever gotten this question from your tax or accounting team: "Can you give me the expense booked for all the *outstanding* stock options?"

If not, start getting ready for it since it's coming up for more and more and more companies at the end of their fiscal year. This is the tax accountant's way of asking for the data they need to "prove out" or "confirm" the Deferred Tax Asset (DTA) balance in your General Ledger.

Some systems don't have a report that readily provides this number, but it is something you can do in a spreadsheet[1], generally bringing in data from two to three standard system reports.

A Refresher on DTAs and DTA Balances:

DTAs are booked for non-qualified grants that give rise to a future tax deduction (at exercise, release, etc.) in anticipation of that tax deduction. The DTA is booked based on the expense amortized multiplied by the applicable corporate tax rate. Then, when the tax deduction-triggering event occurs, the DTA previously booked is reversed and a tax benefit/windfall or deficiency/shortfall is calculated by comparing the DTA booked to the actual tax deduction received. When options expire vested but unexercised, the DTA is also reversed and a tax deficiency is calculated (since no tax deduction was received).

Data You Will Need:

1. Shares Outstanding
   In our opinion, the *best* way to perform this calculation is at the vesting tranche level, so that you can use the full fair value for any outstanding shares that are vested, and expense booked to date for any tranches that aren't yet vested (either zero or partial expense with forfeiture haircut for those with expense in progress).
   The issue here is that many systems don't have a report with shares outstanding by tranche, or you have multiple tranches (in the same grant) with the same vest date, which can make it challenging to link data from your shares outstanding report to your expense report. In that case instead of starting with shares outstanding, you can perform the analysis at the grant-level and bring shares outstanding in as a "cross-check" rather than as the basis for your calculations. See the second approach, below, for more details.
2. Fair Value per Share
3. Cumulative Expense To Date
   Remember that for tranches where expense recognition is in progress, this should be haircut by your estimated forfeiture rate. This should also be adjusted for reversal of expense for actual forfeitures.

[1] SOS has also developed an application that can prove your DTA balance in a few minutes. See this webpage http://marketing.sos-team.com/l/14822/2014-11-20/47ff31 for more information.

4. Exercised / Released / Expired Shares
   You won't need this data if you are using the tranche-level approach, described in #1, above, since starting with the "share outstanding" as the basis for your calculation already "reverses" the DTA for shares that were exercised, released, or expired and are therefore no longer outstanding.

Shares Outstanding by Tranche Approach:

This approach begins with a shares outstanding report which provides one row per vesting tranche for each grant with the vest date and the number of shares outstanding for the tranche.

If the tranche is vested (determined by comparing vest date to the DTA Balance "As Of" date) then it can be assumed all expense has been recognized for the tranche (a requirement of ASC 718). However, some of the shares may have been exercised or released. Therefore the DTA balance is computed as fair value per share multiplied by shares outstanding. If the tranche is unvested at the time of the As Of date, then expense recognition for the tranche is either still in progress or has not yet started. Therefore to determine the amount of expense that has been booked to date, the net to date expense should be retrieved from the expense report. (To Date Expense less any Adjustments for actual forfeitures). This is the DTA for the unvested tranches.

DTA Booked Less DTA Reversed Approach

This approach instead begins with the expense report which should provide the net to date expense for the grant (the detail can be summarized into one row per grant via a pivot table) this is the total DTA booked for the Grant. A tax accounting / APIC report then provides the total DTA reversed for exercises, releases, expirations, etc. This detail can also be summarized into one row per grant via a pivot table. This provides the total DTA reversed for the grant. DTA booked minus DTA reversed = DTA balance. A lookup to a shares outstanding report pulls in the shares outstanding for each grant as confirmation. The report is audited to look for any grants with shares outstanding > 0 and DTA balance <> 0 and vice versa.

Complexities

Though this is not a complete list, here are a few of the hurdles you may have to overcome when calculating your DTA Balance:

Pre-123R/ASC 718 Options

Remember that DTAs are booked for *recognized expense* so if you were disclosing expense for options rather than booking it, prior to your company's adoption of FAS 123R/ASC 718, either no DTA should be assumed, or only part of the expense for that tranche should have DTA booked. You can pro-rate the expense based on the amount of the vesting that occurred after the adoption of FAS 123R/ASC 718. Yes, you *do* still have to think about these 'straddle' grants even after the amortization of their expense is complete, since some of them may still be outstanding up to ten years after you adopted the standard.

ISOs / 423-Qualified ESPPs

Actually this one is a get-out-of-jail-free card, not a wrinkle. No DTA is booked for ISOs or Section 423-qualified ESPPs, so you can leave these grants out of your analysis. However, unless your spreadsheets are getting so huge as to be unwieldy, I recommend leaving the ISOs in and setting the DTA balance to zero for them; this makes for an easier tie out.

Grants to Non-US Participants

Depending on your company, your subsidiary structure and the type of awards you grant, many non-US jurisdictions do not provide a tax deduction on exercise/release and therefore no DTA should be booked and no DTA balance calculated.

Option Exchanges/Modified Grants

If your company has engaged in a large grant modification, such as an option exchange, you may have what we at SOS call "orphaned" expense -- expense booked prior to the modification that your system does not consider when calculating the tax benefit/windfall or deficiency/shortfall. The DTA booked prior to the exchange should be considered along with the expense booked post-exchange to come up with the total DTA that should be reversed at the time of exercise/release. This can often be "added in" to the fair value per share by calculating "orphaned expense per share" at the time of the modification.

Section 162(m)

This section of the IRS Code may limit the tax deductibility of compensation in excess of $1 million to some of your top execs. Stock options, gratefully, are exempt as long as certain requirements are met. However, time-based RSUs are generally not exempt, so you may not want to calculate a DTA, or perhaps not a full DTA, for RSUs granted to those at your company subject to 162(m).

True Up at Vest

If you are using the True Up at Vest approach for your expense amortization, then you will have situations where shares outstanding are zero (since the grant has been cancelled) but there is still DTA on the books for that grant, since the reversal of expense does not occur until the vest date of the tranche. You can sum the expense that remains on your expense report for grants with shares no longer outstanding to prove this part of the balance.

Early Exercises

Grants that were exercised before vesting are treated differently. Instead of booking a DTA, you book a Deferred Tax Liability (DTL), since the tax deduction has already occurred and then you reverse the DTL as the expense is amortized.

Grants Outside Your System

In some cases you may be calculating and amortizing expense for 'special' grants outside your stock plan system. Then the DTA recalculation becomes much more challenging, especially if for non-employee grants, where you have a different fair value for each vesting tranche.

Some grants we've seen being expensed outside systems:

1. Non-employee grants
2. Modified grants
3. Performance options
4. Performance RSUs with "specialized" requirements (delayed service-inception dates, or "reverse FIN 28" amortization)
5. Performance grants with goals not set on grant date

For more information on DTA balances and SOS's solutions around them please see our website at http://marketing.sos-team.com/l/14822/2014-11-20/47ff31 or email info@sos-team.com.

About Stock & Option Solutions

Stock & Option Solutions is a leading provider of top-tier stock plan management and consulting services for companies offering equity compensation and benefit programs to its employees. Since 1999, hundreds of organizations, from private start-ups to Fortune 500 companies, have relied on Stock & Option Solutions' expertise for strategic planning, methodologies and skilled resources to build and support the most effective stock plan programs possible.