Non-Employee Accounting

Non-Employee Accounting Goes Awry?

We visited a client help them determine what their stock plan system could and couldn't do for them and propose workarounds and custom reports to fill the gaps. They were a rapidly expanding private company with their sights set on a not-too-distant IPO. Needless to say, they had all the "special features" in their stock plans that many private companies have (and many public companies that acquire private companies): early exercises, frequent accelerations at termination, a repricing with bifurcated accrual, and of course...non-employee grants by the dozen. (Of course, nonemployee grants exist at public companies too, we just find them to be far more common at private companies.)

We tackled a few their issues and then got around to the non-employee grants. They had been performing the accruals for these grants in a spreadsheet and wanted to know if we could write a custom report to take the manual effort and the pain out of the quarter-end process. We immediately advised them that the system they were using already had the functionality built-in. Delighted with the discovery, they had us enter a test grant and compare to the accruals they'd been performing manually. The manual calculations were miles away from the system's calculations. Unfortunately, we moved onto the next project before we had a chance to assess WHY the numbers were so wildly different. (Most likely, the system calculations were probably correct, since it had been in the system since 2003 and had been audited many times.)

We have other clients using spreadsheets that look very similar to the one in use at that first company. At one client, we finally got a chance to dig into the spreadsheet to see what made it tick and discovered...wait for it... that it was doing the non-employee accounting incorrectly and significantly understating the expense.

We were/are concerned that this spreadsheet or ones very similar were/probably still are in use at companies across the country and that some auditors may not be digging into the details to see if the calculations are actually correct. Hopefully for most of these companies the number of non-employee grants is small and the amounts are immaterial. However, for those companies with a significant number of non-employee grants, please read on to understand the problem and how to solve it.

Refresher on Non-Employee Accounting (FASB ASC Topic 505 & EITF 96-18)

As you may remember, non-employee grants are valued using the same basic methodology as regular employee grants: for options you use an option-pricing model, for RSUs you use the fair market value. However, unlike employee options, the measurement date is not the grant date. The measurement date is, in fact, the vest date. Until the shares vest, they are re-measured (re-valued) each reporting period and the expense marked up or marked down accordingly. Also, per EITF 96-18 (which has been superseded by FASB ASC 505/718) the accrual is to be performed using a FIN 28 approach (aka multiple or tranche-by-tranche). There is some debate now as to whether you can make a policy election to use straight-line instead, but most of the spreadsheets and equity databases we've seen are using the FIN 28 approach. **Note**: Since this article was published, the FASB released some proposed accounting guidance in March 2017 that will simplify the accounting for non-employee grants and eliminate this mark to market valuation. See our Accounting Update-March 2017 and SOS Comment Letter to the FASB for more details.

Let's consider a very simple example, an RSU granted on 1/1/11 with two tranches of 100 shares each vesting over 6 months (final vesting on 12/31/11). At the end of the first quarter on 3/31/11, the market value of the stock is $0.50. Since 50% of the service period for the first tranche is completed (three out of six months) the expense for the first tranche is computed as 100 shares * 50% of service period * market value of $0.50 = $25 of fair value. The second tranche has a life of one year, so 25% of its expense should be accrued: 100 shares *25% of service period * $0.50 of fair value = $12.50 of fair value.

Tranche #	Expense Begin Date	Vest Date	Shares	Service Period Completed	Fair Value	To Date Expense
1	1/1/2011	6/30/2011	100	50%	$0.50	$25.00
2	1/1/2011	12/31/2011	100	25%	$0.50	$12.50

On 6/30/11, the market value is now $1. The first tranche has completed its vesting so its expense is finalized and trued up by calculating the total expense for the tranche and then subtracting any expense previously accrued: To Date Expense: 100 shares * 100% service period * market value of $1.00 = $100 of fair value minus prior expense of $25 = current period expense $75.

The second tranche has not yet completed vesting but is also trued up by calculating the total expense for the tranche and then subtracting any expense previously accrued: To Date Expense: 100 shares * 50% service period * market value of $1.00 = $50 of fair value minus prior expense of $12.50 = current period expense: $37.50.

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	To Date Expense	Prior Expense	Current Period Expense
1	1/1/2011	6/30/2011	100%	$1	$100	$25.00	$75.00
2	1/1/2011	12/31/2011	50%	$1	$50	$12.50	$37.50

On 9/30/11, the market value is now $1.50. The first tranche has no expense since its fair value was finalized on the 6/30/11 vest date and the service period is complete. The second tranche has not yet completed vesting so is trued up by calculating the total expense for the tranche and then subtracting any expense previously accrued: To Date Expense: 100 shares * 75% service period * market value of $1.50 = $112.50 of fair value minus prior expense of $50 = current period expense: $62.50.

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	To Date Expense	Prior Expense	Current Period Expense
1	1/1/2011	6/30/2011	100%	$1.00	$ 100.00	$100	-
2	1/1/2011	12/31/2011	75%	$1.50	$ 112.50	$50	$ 62.50

And finally, on 12/31/11, the market value is $2. The second tranche's vesting is now complete and the expense can be finalized. To Date Expense: 100 shares * 100% service period * market value of $2 = $200 of fair value minus prior expense of $112.50 = current period expense: $87.50.

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	To Date Expense	Prior Expense	Current Period Expense
1	1/1/2011	6/30/2011	100%	$1.00	$ 100.00	$100	-
2	1/1/2011	12/31/2011	100%	$2.00	$ 200.00	$112.50	$ 87.50

The Problem with Spreadsheets

So, if this is the "right" way to compute non-employee expense, what are those spreadsheets doing wrong?

Based on our analysis, the spreadsheets are not marking up the expense in ALL the unvested tranches, but only applying the new fair value to the shares that have not had expense accrued in the past. They calculate only based on the current period expense, without calculating a "to date" expense and subtracting out the prior expense - leaving any shares with any expense previously booked without a true up and leaving the grant under expensed.

The first quarter provides the same results as when the correct method is used, however in the second quarter:

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	Current Period Expense
1	1/1/2011	6/30/2011	50%	$1	$ 50.00
2	1/1/2011	12/31/2011	25%	$1	$ 25.00

And the third quarter:

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	Current Period Expense
1	1/1/2011	6/30/2011	0%	$1.50	-
2	1/1/2011	12/31/2011	25%	$1.50	$ 37.50

And the fourth quarter:

Tranche #	Expense Begin Date	Vest Date	Service Period Completed	Fair Value	Current Period Expense
1	1/1/2011	6/30/2011	0%	$1	-
2	1/1/2011	12/31/2011	25%	$2	$ 12.50

...expense is consistently under-accrued. The total expense for the grant reaches only $162.50 over the entire service period.

However, if the first tranche has 100 shares worth $1 each and the second tranche has 100 shares worth $2 each, it seems obvious that the accruals should reach $300, as they do with the methodology described earlier in the article.

Conclusion

So, if this is wrong at so many companies, why haven't the auditors caught it?

Remember that the auditors have only so much time to review/audit every piece of your accounting. Do they dig into every calculation in detail? They know the ABCs of accounting from A to Z, while we stock plan professionals have the privilege of focusing on only a small slice of the accounting world and delving into the minutia that the auditors never see. Further, the auditors have likely seen dozens of spreadsheets that look very much alike. They check to ensure that a new fair value is being used or calculated and that the tranches are accrued using a FIN 28 approach. Other than that, they may stop there...

So, what steps should you take? First, check your spreadsheet; perhaps yours IS doing the calculations correctly. Are the new fair values being used for all the shares in each unvested tranche, or only for the portion that accrued expense during the most recent reporting period?

Second, analyze materiality; if you have only a couple of non-employee grants for a relatively small number of shares, chances are the amounts are immaterial.

Third, if needed, adjust your spreadsheet calculations (or see if your system can do this calculation for you, several CAN) and then compare the historic accruals to the corrected accruals. Again, chances are the changes are immaterial and you could take an adjustment in the current quarter to true expense up appropriately.

If you have further questions on non-employee accounting, please feel free to contact the SOS team.

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