Straight-line or "Ratable" Expensing Method

Definitions & Issues

One of the most confusing aspects to recognizing expense for equity compensation stems from two factors:

1. a popular stock plan software uses a term in a "non-standard" way and
2. companies often don't understand the difference between the two accrual methods (and when to select an inappropriate method)

Many accountants commonly use the term "Ratable" to refer to the "FIN 28" method of recognizing expense for equity awards. That method, also known as "accelerated" or "multiple", recognizes expense for each tranche of each grant starting on the grant date and finishing on the vest date for that tranche. This approach can also be referred to as "tranche-by-tranche" accrual since FIN 28 was superseded by the FASB codification and all of those other terms can now be incorrect or misleading.

One popular stock plan software, which shall remain nameless, uses the term "ratable" differently. For companies using a straight-line accrual approach (aka "Single" in the software), they have a choice to run expense reports using a "Straight-line" or "Ratable" method. Very few companies seem to understand how these methods differ and we've encountered many companies using a method that is not appropriate for the attributes of their grants.

"Straight-line" is just that. The total expense for the grant is recognized evenly from grant date to the final vest date, with no regard to how many shares are in each tranche or when the vesting commences. Total expense is allocated to each tranche based on the number of days of vesting in that tranche. Assume your grant has three tranches: Tranche 1 with 50% of the shares vesting over 2 years; Tranche 2 with 25% of the shares vesting over 6 months; and Tranche 3 with the final 25% of the shares vesting over another 6 months. In this scenario, the first tranche would be allocated 66% of the expense under the straight-line method, even though it contains only 50% of the shares. This is because straight-line results in even expense over the 3 years and the Tranche 1 takes up 2 of the 3 years.

Another quirk of this method is that if you have a tranche that vests immediately (or immediately after a previous tranche) it has zero days so is allocated $0 expense.

"Ratable", on the other hand, accrues expense based on the number of shares in the tranche. So, if you have 50% of the grant shares in the first 1-year tranche and 33% in the second 1-year tranche and 17% in the final 1-year tranche, 50% of the expense will be booked over the first year, 33% over the second year and 17% over the third year.

Each approach has its pros and cons; and, if your vesting is even over time, each approach should give you very close to the same numbers.

However, in at least a couple of instances, straight-line will *not* ensure that you are compliant with the requirements of ASC Topic 718:

1. **If the vest commencement (vest base date) occurs before the grant date.**
   This is a common practice for some new hire grants. Vesting commences (aka "vest commencement date" or "vest base date") on the hire date, but the grant date occurs some time later when the grant is approved by the Board of Directors (BOD), Compensation Committee or equivalent committee responsible for approving equity grants. In this case, the full expense for the

first tranche should be recognized from the grant date to the vest date for that tranche - generally a shorter period than the subsequent tranches. Because the straight-line method does not use individual vest dates for its calculation, the expense will generally not be recognized in full by the vest date (which is a requirement of ASC 718). This is often an immaterial difference, but if your grant date is long after your vest base date, the numbers can add up and possibly become material.

2. **If the vesting is front-loaded.**
   This is less common, but still occurs in some cases. As stated above, ASC 718 requires that all expense for a vest tranche must be recognized by the time the shares are vested. If more of the grant vests earlier in the life of the grant, but the recognition of expense is spread evenly over time, the requirements of the standard have not been met.

Some practitioners also argue that Ratable is not appropriate if vesting is uneven over time since the standard offers the choice of only two methods for recognition: a) straight-line and b) graded (tranche-by-tranche); but the standard also attempts to have even recognition of expense over the vest period. So, using straight-line accrual and kicking expense up at the vest date also seems to make little sense.

Which method is right for you? It depends on the vesting schedules of your grants as set by the equity plan document, the Compensation Committee/BOD and ultimately the equity award agreement. For some companies, you may need to use Ratable for some grants and not for others.

Questions or comments? Please email us at xtra@sos-team.com

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