Stock & Option Solutions

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 using a term in a "non-standard" way and
2. companies not understanding the difference between the two accrual methods (and sometimes selecting 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. I've started to refer to this approach as "tranche-by-tranche" accrual since FIN 28 was superseded by the FASB codification and all those other terms can be incorrect or misleading.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, known as "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 I've encountered many companies that are 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. So if your grant has the first tranche with 50% of the shares vesting over 2 years and the next two tranches, each with 25% of the shares vest over the following 6-month periods, the first tranche would be allocated 66% of the expense, even though it contains only 50% of the shares, since of the three years of vesting, it has two years. This results in even expense over the three year vest period.

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" accrues expense based on the number of shares in the tranche so if you have 50% of the shares in the first 1-year tranche and 33% in the next and 17% in the next, 50% of the expense will be booked over the first year, 33% over the second and 17% over the third.

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 your vest base date occurs before your grant date.
   This is a common practice for some new hire grants. Vesting commences on the hire

date, but the grant date occurs some time later when the grant is approved by the board. 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.

2. If your 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. Maybe we should all just grant awards that vest perfectly evenly over time, starting on the grant date? Yes, I'm sure I can convince all the boards to do that right away...

Which method is right for you? It depends on the attributes of your grant. For some companies you may need to use Ratable for some grants and not for others.

Questions? Did I leave you confused? Drop me an email at edodge@sos-team.com. I'm happy to discuss further.

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Elizabeth is the Vice President of Product Management for Stock & Option Solutions, Inc. (SOS). Her responsibilities include monitoring new developments in the equity compensation arena, performing market research, and solving clients' stock plan accounting challenges. .

Elizabeth regularly speaks on industry trends and product development at client and industry events including NASPP and NCEO webcasts, GEO and NASPP Chapter meetings, and the NASPP Annual Conference. She was also selected to speak at the West Coast FASB Roundtable on FAS 123(R) and co-authors the chapter on accounting for equity compensation in The Stock Options Book, by Alisa Baker. She became a Certified Equity Professional in 1999 and continues to volunteer for the Certified Equity Professional Institute as well as serving on the CEPI Curriculum Committee. She is also the president of the Silicon Valley Chapter of the NASPP and serves on the Board of Directors of the NCEO.

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.