

# ISSUES & INSIGHTS

## Evaluating the Hidden Costs in Stock Option Accounting Solutions

*Daily management of a stock option plan can be challenging from an administrative and accounting perspective. In the following article, Armanino McKenna Senior Manager Scott Schimberg details some of the hidden costs and pitfalls of the most common stock option accounting solutions and makes recommendations for more contemporary tools to streamline the process.*

When a company is small or in startup mode, stock option plans are relatively easy to manage since there are few transactions. But reach a modest amount of growth and you've got a challenge on your hands. A stock option plan requires companies to track several types of transactions; granting of stock options, recording cancellations, and exercises. Companies must also manage the option pool, calculate ASC(718) expense and prepare required disclosures for financial statements.

Companies manage the stock option transactions and administrative tasks in many different ways. For instance, small companies find they can manage stock plans using a manual spreadsheet, such as an Excel workbook. As companies grow, the process of managing stock option plans becomes more complex and the financial decision-makers eventually default to one of four options:

1. Continue with Excel. 2. Outsource to an individual consultant. 3. Deploy



a software solution. 4. Outsource the entire process to an administrative firm.

Financial decision-makers responsible for stock option accounting most often say they either inherited their current solution or they went with the lowest cost solution at the time of implementation. And yet, most also admit the solution they inherited or implemented cheaply doesn't meet their current or future requirements to properly manage their stock option plan. Using antiquated or incomplete solutions is risky because if you run afoul of the SEC or other regulators, it can be a very expensive problem. Litigation is possible, as are fines and other sanctions that cause companies pain.

Each of the solutions noted above carry hidden costs and risks that can

be significantly reduced by increasing your awareness of the costs and risks and implementing a solution that meets anticipated growth.

### **Excel Workbook**

Typically an Excel workbook includes several complex worksheets, usually managed by the Controller or CFO, and primarily used to calculate the ASC(718) expense. Often coupled with this solution is a paralegal at the company's outside legal firm managing the cap table, providing monthly or quarterly reports that need to be regularly reconciled to the Excel workbook.

Access to the stock compensation data is limited to a select few individuals in the finance department. Questions from Human Resources related to shares vested and exercises for participants or terminations typically require

# ISSUES & INSIGHTS

---

review and input from both legal and finance.

Most companies start with the Excel workbook because the cost to implement appears to be low. Accountants say they like the Excel solution because they understand Excel, they can control the file, modify the file when needed, and explain the calculations to auditors. What are usually underestimated are the hidden costs of using Excel. These include the costs of the

more complex calculations kick in. These include tracking and calculating forfeiture rates and the need to break the participants into meaningful groups by employee class (executive, manager, staff and manufacturing), each of which can have significant differences in forfeiture rates.

Even more complex calculations are required when a company modifies a stock option through repricing or changing the vesting schedule. All of

to the Excel workbook solution with the additional cost of a consultant to perform the ASC(718) calculations in Excel, manage the Excel workbook, and prepare the quarterly or annual footnote. The consultant helps the company by saving the senior level accountant from having to expend valuable time to calculate the expense and usually improves the efficiency of building the Excel workbook. Another significant hidden cost of utilizing an individual consultant is turnover, when the consultant goes onto something new the company has to recruit and train a new consultant to take over the Excel workbook. In addition, the unnecessary interaction with Human Resources remains since the access to the stock option information remains with a select few individuals.

Some consultants will utilize a software package instead of an Excel spreadsheet. The consultant may be generally knowledgeable about software, but few have spent extensive time to become certified in the software, or can efficiently and accurately implement and maintain the data. The further hidden cost is the time the consultant passes on to the company to learn the software while on the job.

The company controller or CFO is still usually involved to make sure they understand the option transactions at a high level and feel comfortable with the expense calculations and footnotes.

There is an advantage to utilizing a consultant, getting a technical resource



paralegal fees, unnecessary interactions with Human Resources confirming termination close out reports, and employees asking for vesting schedules. Recurring reconciliation of the Excel file to the company's capital table, complex calculations of the ASC(718) and the variation in vesting schedules; not to mention, a senior level person's time to calculate the quarterly expense can be a time consuming process. Additional hidden costs come when

these calculations typically take a senior level person at a private company to calculate and using Excel makes a significantly complex workbook that needs to be explained to auditors. When the volume of transactions increase and the Excel file is overly complex many companies bring in a consultant to manage the Excel file.

## **Individual Consultants**

In most cases this solution is similar

# ISSUES & INSIGHTS

---

that typically has a strong understanding of the stock option accounting requirements and can provide significant guidance and help with both the ASC(718) expense calculations and the footnote preparation. Outsourcing this function to a firm versus an individual consultant can significantly reduce the cost associated with turnover because a consulting firm usually has multiple resources that can provide the service allowing consistency and eliminating the recruiting costs.

## **New Software Solutions**

In recent years, a handful of software packages have emerged to help companies manage their stock option plans. The range of software covers basic capital table management and reporting for simple time vested options to more complex solutions that can manage the entire capital table, including performance grants as well as complex international tax mobility issues related to grants.

The software packages are typically implemented and managed by the accounting department with an emphasis on calculating the ASC(718) expense. These packages typically solve the issue of a technical resource to calculate the ASC(718) expense, while the better software packages provide a significant amount of reporting to make equity compensation footnotes significantly easier to prepare.

A few of the not-so-obvious costs of these software packages include mismatched or poorly implemented

solutions. A system that is setup and configured incorrectly may not calculate the expenses or disclosure reports accurately. Unwinding and correcting calculation and reporting errors, and reimplementing the software can be very expensive and time consuming.

Another hidden cost is not deploying the software to essential users in finance, human resources and other departments, as well as participants. Some software solutions now have employee portals that give employees online access to their stock options via the internet.

## **Implementing Complete Outsourcing Solution**

A recent trend is to outsource the complete process, something known as Equity Compensation Outsourcing (ECO).

ECO is a solution whereby the complete process is outsourced not to an individual, but to a firm that deploys a software solution. This solution allows the company to access its data 24/7, which provides technical accounting support to manage the option plan, including reporting, ASC(718) expense calculations and footnote preparation, and answering auditors questions as well as calculating modifications.

The ECO firm typically works with human resources, finance teams and legal departments to ensure the company can gain the benefit of eliminating unnecessary internal communications for simple events like terminations. Some

ECO firms also deploy a participant portal that includes online grant acceptance and grant exercise processes.

The ECO annual expenses are usually predictable and easy to manage. The costs typically include an implementation fee, plus an annual support cost for managing the plan.

The best and least costly scenario is when an ECO provider delivers a solution that will allow a company to deploy a software application, couple the software with services and, as the company grows and heads towards an IPO, can bring the services in-house at any time and remain with a best-in-class software solution. An ideal software application is one that is scalable and can take a company from startup phase through maturity.

A stock option plan should not be an afterthought for a growing company because there is a tipping point at which complexity accelerates to unmanageable levels. If you thoroughly evaluate the process with which you manage your company's stock option plan, you will uncover time and cost savings opportunities; more importantly and more strategic, is the fact that you will significantly reduce the risk of delaying your IPO or liquidity event.

*If you need additional information regarding this article, contact Scott Schimberg, Senior Manager and an expert on stock option compensation and planning at 925.790.2600 or through email at [scott.schimberg@amllp.com](mailto:scott.schimberg@amllp.com).*