

A Five Step Framework to Create Auditable Stock Option Records and Comply with FAS 123R

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In the past few years, there has been a perfect storm of stock option administration and accounting challenges starting with Sarbanes-Oxley in 2002, FAS 123R in 2004, stock option backdating scandals in 2006, and the final IRC Sec. 409A regulations in 2007. Most importantly, the new Financial Accounting Standard (FAS) 123R moved equity compensation expense for most companies from a pro forma footnote to a line item in the income statement.

In light of the current environment, auditors are using much higher standards and CFOs are struggling to integrate stock option administration, tax and accounting reporting, and good corporate governance practices. During the first audit season under the new FAS 123R regulations, many companies found themselves with insufficient record keeping that made calculating stock option related expenses difficult, time consuming, and subject to error. Transactions were not recorded properly nor well documented and there was no audit trail to follow.

CFOs and stock plan administrators now realize that in order to satisfy the higher levels of scrutiny and comply with the new stock option expensing requirements, they can no longer rely on error-prone, manual spreadsheets. Instead, they are looking to implement automated FAS 123R solutions capable of simplifying the process while providing critical information faster and with greater accuracy and accountability. More specifically, financial executives now require systems that enable all participants to rely on the same set of consolidated records and be capable of combining stock plan administration, stock option expensing, and corporate governance management.

A Five Step Framework to Impress Auditors and Ensure FAS 123R Compliance

Today, financial executives are looking to gain a greater understanding of how FAS 123R applies to them. Instead of continuing with a manual approach that is subject to potential errors and increased scrutiny, organizations should consider these five steps to simplify FAS 123R compliance and satisfy their auditors:

1. Organize Legal Documents: Before anything else, organizations should start by ensuring they are properly recording and documenting the legal actions of the Board, the company, and each employee as they relate to option grants, exercises, and cancellations. Because your option records and equity compensation expense reports will later reflect these actions and the supporting documents, you want to avoid any inconsistencies that may show up in an audit. The recent stock option scandals announced in 2006 uncovered examples of option grants that pre-dated Board meetings or Board meetings that were allegedly held but never documented. This led to incorrect financial statements and tax reporting errors. Such problems could have been avoided if these companies had properly integrated their legal documentation with their stock option records. Companies can avoid these types of problems by properly recording, retaining, and managing the legal documentation at each step in the process.

2. Centralize Records: Organizations should also consider consolidating all transactions that relate to stock option administration, valuation and expensing, and legal compliance in a single, integrated system. This is particularly important as stock option data tends to come

from a number of different areas within a company, typically in documents most commonly related to legal, finance, and human resources. When each department retains and manages its own collection of information, it can lead to errors, inconsistencies, and missing documentation as well as duplicate effort and wasted time. As an example, imagine a situation where the HR department is using one date for an employee termination and the related option cancellation while the finance department is using a different date as they determine when to stop expensing the option. Duplicate data entry creates these types of problems. Consequently, organizations need to create a single, consolidated repository for all legal documents and data related to stock option records available to all members of the equity compensation team.

3. Automate Transactions: The next consideration involves automating your organization's stock option administration and equity compensation expensing as these activities typically involve large numbers of transactions. On the administration side, you need to record information related to the date of hire, the option grant, the vesting schedule, and any exercises and cancellations. On the option expensing side, you need to record how the valuation inputs were determined for each grant date, expense the fair value every period, and later true-up when the option is cancelled. Every time you record a transaction, there is the potential for error. Over the course of hundreds of transactions and many years, the risk of error increases. The best way to reduce the level of risk and potential errors is to let your computer do the work. When you automate, you know you are tracking, calculating, and reporting similar transactions the same way, every time. Also, automating the tracking and reporting will save time. Finally, an automated system will create an audit trail showing who made the changes and when. Based on this higher level of reliability, auditors are more comfortable with automated systems and typically can sample fewer records which will save audit time and expense.

4. Determine Variables: Now that the new regulations require companies to include stock option-related compensation expense in the income statement, auditors are even more careful when reviewing how each variable used in the valuation model is determined. As a result, companies must be able to document that they followed a reasonable process to determine each variable. The key variables are fair market value, exercise price, volatility, expected term, interest and dividend rates, and forfeiture rates – with

even greater scrutiny being applied to volatility and expected term. In its published Questions & Answers dated Oct. 17, 2006, the Public Company Accounting Oversight Board (PCAOB) stated: "The expected term and expected volatility assumptions have the highest risk because they involve the greatest amounts of judgment and have a significant effect on the estimated fair value." Companies that are not able to demonstrate how they determined a variable as well as why it was changed or did not change for future grant dates will be subject to greater scrutiny. If the valuation and expensing variables are properly documented, based on a reasonable process, and supported by an integrated system, it will provide the auditors with greater confidence and raise fewer red flags.

5. Prepare Reports: The final and perhaps ultimate goal of stock option administration is to produce a clear and concise set of reports that provide the necessary information for a company's quarterly and annual financial statements. More specifically, your company will want to prepare a standard set of reports that it can use each quarter to generate the stock option-related expense items. Using the same system for generating stock plan administration and option valuation and expensing reports will help to avoid inconsistency and increase accuracy. To ensure a smooth audit, prepare the list of reports in advance and organize them in a format that is easy to review.

Take the Fear Out of FAS 123R Compliance

In the wake of the new FAS 123R regulations, auditors are requiring organizations to address the inherent risks associated with stock plan administration and equity compensation expense reporting. Therefore, companies will want to reconsider outdated methods and replace unreliable spreadsheets, ad hoc databases, and manual processes with cost-effective, automated systems that ensure real-time, accurate and auditable FAS 123R compliant financial reports.

Taking the time to evaluate and improve your current internal processes for administration, expensing, and reporting is the best way to ensure future compliance and expedite your next audit. With option expensing hitting the bottom line and a brighter spotlight on stock option granting practices, companies need to implement better systems that will ensure the most expedient and accurate processes for stock plan administration.

Framework for Auditable Option Records and FAS 123R Compliance

| Action | Problem | Solution | Description |
|-----------------------------------|--|---|---|
| 1 Organize Documents | Missing documents are the greatest source of potential future issues. | Collect all historical documents related to option grants and related stock records. Identify and note any missing documents. | <ul style="list-style-type: none"> ■ Board actions ■ Option agreements ■ Exercises / cancellations ■ Employee terminations ■ Common stock certificates |
| 2 Centralize Records | Multiple systems create data inconsistency and more work. | Create a single, consolidated digital repository for all legal documents and data related to stock option records and other related stock types, available to all members of the working group. | <ul style="list-style-type: none"> ■ All legal documents ■ Option records ■ All stock records ■ Complete capitalization tables ■ All supporting documents/spreadsheets |
| 3 Automate Transactions | Manual updates and calculations are a major source of errors and wasted time. | Implement a system that automates all transactions and calculations, and creates a complete audit trail of user changes and legal documents. | <ul style="list-style-type: none"> ■ Exercises ■ Cancellations ■ Employee terminations ■ Fully diluted capitalization tables ■ FAS 123R valuation/expensing ■ Audit trail of user changes ■ Signed documents |
| 4 Determine Variables | Determining FAS 123R variables is difficult for companies that are privately-held or have little historical data. | Use historical information, external sources, or seek outside assistance to determine FAS 123R variables. Attach supporting documents to each variable in order to support assumptions during an audit or to evaluate future changes. | <ul style="list-style-type: none"> ■ Standard variables required for Black-Scholes formula: <ul style="list-style-type: none"> ■ FMV and exercise price ■ Volatility ■ Expected term ■ Interest and dividend rates ■ Forfeiture rates for amortization schedules |
| 5 Calculate and Report | Scrambling to create last minute reports and complex calculations after the audit has begun creates errors and unnecessary stress. | Choose your valuation method and determine fair values on the date of each option grant. Prepare amortization schedules and review periodic reports in advance of the reporting cycle. | <ul style="list-style-type: none"> ■ Choose a valuation model (Black-Scholes or lattice) based on the historical data available ■ Determine the amortization method (straight-line or accelerated) ■ Generate amortization schedules (using expected forfeiture rate) ■ Review reports required by FAS 123R |



About the Author

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