What Nonpublic Companies Need to Know About Accounting for Stock-Based Compensation

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Kei Morita

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Kei Morita, Audit Principal, CPA, CFE
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Key Takeaways

- New guidance makes it easier for private companies to account for share based awards, but there are still many complex issues to consider.
- The timing or the amount of periodic SBC expense may differ depending on vesting conditions or performance conditions.
- Private companies will usually require an audit just prior to a Series A or B round. That means making sure they are GAAP compliant about their SBC accounting.
- It can be very costly and time-consuming for private companies to become compliant if they have not kept clean records of their SBC awards since business inception.

With the war for talent at a fever pitch these days, stock-based compensation (SBC) is one of the most effective ways for private companies to attract and retain valued workers. It's also a very effective way for early stage companies and other private entities to preserve cash flow while allowing key employees to share in the company's growth. But the SBC accounting rules and calculations can be very complex.

While the FASB and the Private Company Council (PCC) issued guidance late last year to make it somewhat easier for private companies to account for share based awards, many challenges still remain. If you're a CFO, controller, treasurer, HR director, or other stakeholder in a privately held company, it is critical for your company to follow the SBC accounting rules correctly. The regulations, timing, and mathematic calculations can be complex. You may want to enlist the help of an outside specialist to guide you through the process so you don't have costly and embarrassing fixes to make down the road.

When private companies must treat employee SBC awards as an expense

Prior to obtaining outside financing, many technology startups and other early stage companies simply ignore the accounting for SBC awards. But, as companies raise larger funding rounds -- typically in the Series A or B round – they will typically need to be audited and must become GAAP compliant.

However, even with substantial financial backing, most private/early-stage companies do not have adequate resources to handle complex GAAP accounting and financial reporting for SBC awards. That can be problematic since larger investors typically want a third party to sign off on the accuracy of the startup's financials. They want assurance that the company is not doing anything fraudulent or failing to follow GAAP guidance.

Also, being careless with SBC in your company's early years can make it very costly and time-consuming to change from non-GAAP to GAAP standards as you prepare for an IPO, sale, or other exit.

Below I've prepared a primer on things to consider with SBC accounting, no matter where your company is in its evolution. There are six major areas to consider:

1) ASC 718. Any U.S. entity (following GAAP) that provides SBC to its employees, contractors, advisors, legal service providers, etc., is required to account for SBC in accordance with Accounting Standards Codification (ASC) Topic 718 ***(Compensation – Stock Compensation)***. Common types of SBC subject to ASC 718 include stock options, restricted stock units (or RSUs), stock appreciation rights (SARs), and phantom stock plans. Similar awards with certain characteristics may require an in-depth analysis to determine whether they need to be accounted for as SBC under ASC 718. Such awards may include profits interest (with certain characteristics, to be discussed further below), profit-sharing arrangements, and cash-deferred compensation plans.

- **Incentive Stock Options –** Generally speaking, an ISO is a stock option that can only be granted to an employee, and that does not result in any employee income (or employer deduction) at exercise, unless there is a "disqualifying disposition" or a sale of the underlying purchased shares within one year of acquisition. An employee who's been granted an ISO has the option, but not the obligation, to purchase vested shares of the company's underlying equity (e.g., common stock) at a predetermined price, or strike price within a set timeframe -- typically 10 years from the grant date.
- **Non-Qualified Stock Options –** An NSO is a stock option that does not meet the ISO requirements (see above), and if exercised, the employee, vendor or director holding them will have compensation income equal to (and the employer is entitled to a deduction for) the difference between the fair value of the stock at the time of exercise and the exercise price.
- **Restricted stock –** A restricted stock arrangement is one in which an employee is granted stock that is subject to a vesting requirement and is nontransferable at the time of grant. While the stock is restricted, the employee may have dividend and voting rights (or the dividends may be reinvested or paid at vesting).

When the restrictions lapse, the employee has compensation income equal to the value of the stock (less any amount he or she has paid for the stock) under IRC Section 83. Alternatively, the employee may be entitled to make a "Section 83(b) election" and be taxed based on the value of the restricted stock at the time of grant. This enables the employee to convert subsequent appreciation from ordinary income to capital gains.

- **Stock appreciation rights (SARs) –** SARS give an employee the right to receive the value of stock appreciation, payable in shares or in cash, without having to tender an exercise price. Sometimes, SAR plans cap the appreciation to which the employee is entitled.
- **Phantom stock –** Under a phantom stock plan, an employee is granted a hypothetical number of units of stock that are convertible into cash or common stock of the company after a period of time. Similar to SARs, the form of phantom stock plans can come with cash-settlement or stock-settlement features. Typically, though, phantom stock plans are structured as cash-settled awards.

NOTE: SBC awards that only vest when a liquidity event occurs -- such as an IPO or change in control –may be easier to account for than other types of SBC awards because typically, there is no SBC expense recognized until such event actually takes place (which I will cover below). However, entities are still required to make required disclosures about such awards under ASC 718.

2) Know the difference between Stock Compensation (718) and General Compensation (710). To determine which accounting guidance to apply, you need to analyze carefully whether the value of your awards is based, at least in part, on the price of your shares or other equity instruments or if the awards require settlement by issuing your equity shares or other equity instruments. If the awards meet one of these conditions, they must be accounted for under ASC 718; otherwise, they are likely subject to other guidance, such as ASC 710. The accounting and disclosure requirements in ASC 718 are quite different from those in ASC 710.

3) Profits interest awards. This type of compensation, similar to a cash bonus, has become more popular in recent years, particularly among venture capital-backed or private equity-backed companies. A profits interest award is essentially a right to receive any residual profits after distributions to other equity holders. Significant accounting challenges arise in accounting for profits interests, including whether they ought to be accounted for under ASC 718 or ASC 710. If the awards must be accounted for as SBC under ASC 718, there are additional complexities around the valuations of profits interests and the timing of when their value should be recorded as an expense in the financial statements.

4) Equity-classified awards vs. liability-classified awards. When SBC awards are within the scope of ASC 718, the company needs to determine whether the SBC awards are considered equity-classified or liability-classified awards. Under ASC 718, SBC awards with certain characteristics are classified as liabilities. For example, SBC awards that will be settled in cash or settled in stock that can be redeemed within six months after exercise are considered **liability-classified awards**. For nonpublic entities, liability-classified awards must be revalued at fair value or intrinsic value every time GAAP-based financial statements are prepared --

until the awards are settled or expire.

Accounting for **equity-classified awards** is based on the grant-date fair value. Unlike liability-classified awards, equity-classified awards are not subject to revaluation (unless the awards are subsequently modified), even if the company's value increases significantly.

5) Vesting considerations. SBC awards typically include one, or a combination of, the following vesting conditions:

- Service conditions (e.g., employment service),
- Performance conditions (e.g., sales/EBITDA target, IPO, or change in control, etc.), or
- Market conditions (e.g., stock price target, multiple on invested capital, internal rate of return thresholds, etc.).

*NOTE: **Service conditions** or **performance conditions** are not factored into estimates of fair value or intrinsic value, but **market conditions** do need to be reflected in the valuation process.*

For SBC awards with market conditions, the probability of satisfying such conditions affects the grant-date fair value of the awards. Regardless of whether market conditions are met, the grant-date fair value needs to be recognized as SBC expense when other conditions, such as service conditions or performance conditions, are satisfied for accounting purposes.

*A periodic SBC expense for awards with performance conditions is recognized only when the achievement of such conditions becomes probable. In practice, a "probable" threshold, while not specifically defined under GAAP, has roughly a 70% to 75% likelihood of occurring. However, if the performance condition relates to an IPO or change in control, **the achievement of such conditions is not considered "probable"** until an actual liquidity event takes place. This means that no compensation cost would be recorded until the moment the IPO or change in control occurs.*

6) Option pricing models. Many SBC awards are structured in the form of options. The fair value of options with service or performance conditions may be measured using a Black Scholes Merton (BSM) model. SBC awards with market conditions are often measured using more complex methods, such as ***Monte Carlo*** or ***Lattice simulations***.

- **The BSM model** incorporates certain assumptions and inputs, such as the current value of the underlying share, expected term, and expected volatility. For nonpublic entities, ASC 718 provides a number of practical expedients for reducing the cost and complexity of estimating the fair value of option awards. In 2021, the FASB issued an update to help private companies determine the current price of underlying shares for equity-classified share-based awards. The amendment under ASU 2021-07 provides nonpublic entities with an option to determine the current price of the underlying share, using a valuation method acceptable under IRC Section 409A that is determined by an independent valuation specialist within the preceding 12 months of the grant date.

- **Plain-vanilla.** Nonpublic entities are also allowed to determine the expected term of "plain-vanilla" SBC awards, using the simplified method that provides a midpoint between the end of the requisite service period (typically, the vesting period) and the contractual term of the SBC awards.
- **The Monte Carlo method** simulates a wide variety of potential scenarios involving an option award. The value derived from the Monte Carlo simulation represents the probability-weighted average of the pathways where the awards become exercisable and are anticipated to have future intrinsic value.
- **The Lattice model** is a technique that produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. A lattice method is used to value options with a discrete timeframe, in which a decision to exercise the option is required at all times, or at any time before and including maturity.

In practice, applying a Monte Carlo or lattice model can be challenging since both models require a significant amount of data and judgments, such as grantee exercise data, varying interest rates, and anticipated volatilities. I typically advise my private company clients to obtain the assistance of a valuation expert if it is necessary to use these models to value SBC awards.

When private companies procrastinate on SBC accounting

Depending on the number of shares granted, the frequency of such grants, and the terms and conditions set forth in each award, SBC accounting under ASC 718 gets tricky and often costly if an entity neglects its recordkeeping. As discussed above, many early-stage companies choose not to account for SBC in accordance with GAAP until they raise capital in a Series A or B offering and investors demand audited financial statements.

If a company has plenty of time to make its financial information GAAP compliant, then SBC accounting is doable and not that stressful. However, I've seen too many startups on the cusp of equity or debt financing, M&A transactions, or IPOs, forced to work round the clock to become GAAP compliant if they have not kept clean records of each SBC award since their inception. SBC accounting **cannot be done** without a complete set of SBC grant information, which includes the following data:

- Stock option ledger containing SBC activity from inception to date, including the number of shares granted, vested, exercised, and forfeited.
- Classification between employees and non-employees and ISO v. NSO.
- Vesting schedules by SBC award.
- A summary of vesting conditions, that is, service conditions, performance conditions, and or market conditions for each grant.
- Periodical equity valuation reports, such as 409A valuation, to support the value of the underlying shares of equity at each grant date.

- A list of comparable publicly held companies.

Startups may also want to consider some accounting implications that may arise if they plan to go public or be acquired by a publicly held company. Depending on the exit strategies, a company might need to change some accounting policies to comply with Securities and Exchange Commission (SEC) rules and regulations, which differ from the accounting rules applied by private companies. When a private company files an initial prospectus with the SEC to sell securities, it is considered a public entity under GAAP. As a result, the company must prepare financial statements using GAAP as a public company in connection with the filing.

Conclusion

If your company or a client's company offers (or is planning to offer) SBC awards to valued employees or contractors, don't let SBC accounting issues delay your financing or liquidity plans. Please do not hesitate to **contact us** to discuss SBC accounting or valuation methods.

Kei Morita, CPA, CFE, is a Principal in the Los Angeles, CA office of HCVT. Kei has extensive experience providing audit and assurance services to closely held private companies, mainly clients in the technology industry, including SaaS, FinTech, and software companies. Kei is a core member of HCVT's Technology Niche Practice.