THE CASE FOR BEST OF BREED IN SHARE-BASED COMPENSATION

WHITEPAPER

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I. EXECUTIVE SUMMARY

Corporations who issue shares to their employees have need of many products and services to administer and account for their plans. Some vendors deal with the administrative needs of employees, others handle the reporting concerns of corporations. And some claim to do both. This paper outlines these products and services, and contends that the optimal combination is one best of breed vendor for employees and a second for corporate financial reporting, both complemented by the appropriate service providers. The subset of data that flows between the two is limited, thereby minimizing any integration issues.

II. BACKGROUND

Prior to 2006, corporations were not required to reduce their earnings for shares of equity granted to employees. Since the adoption of ASC 718 (FAS 123R) in 2006, corporations have been required to expense share-based compensation, so that shareholders can better understand the dilution of earnings. So with the stroke of a pen, corporations went from negligible financial reporting to extremely complex accounting and tax calculations that require high profile disclosures.

To meet these new requirements, corporations naturally turned to their stock administrators and brokers, who were the source of the transactions needed to begin the calculations. These transactions, which can be quite voluminous, were crunched on spreadsheets, which begat additional spreadsheets to accomplish the needed allocations and loads into legacy reporting systems. Each spreadsheet was manually reconciled back to the source documents, as well as other spreadsheets in various departments. The spreadsheets were typically maintained by a small number of staff, so that the corporation was very exposed to employee turnover. The result was a broken process that remained a workaround outside of the financial reporting supply chain, and which struggled to meet the controls required by Sarbanes-Oxley.

The stock administrators responded with new reports designed to correct these deficiencies. They have, however, been unable to tame the financial reporting jungle that grows within large complex organizations, and the offline workarounds have continued.

III. WHY THE INDUSTRY HAS FAILED

The reason for this failure is simple. The purpose of a stock administrator is to satisfy employees, a full time job. The purpose of a corporate financial reporting system is to satisfy management, auditors, investors, tax inspectors, the SEC and various industry regulators. Stock administrators are concerned with historical transactions. Corporate accountants need to project into the future. Stock administrators have many one-on-one exchanges with employees. Accounting and tax departments need to roll-up large numbers of transactions and then allocate the results in many different ways. Stock administrators are not accounting or tax experts, so they do not have the deep domain knowledge required to deal with a dynamic regulatory environment. While stock administrators are the source of certain transactions, this should not drive the financial reporting process.

A brief example shows why.

Assume that you have built a great Stock Administration system that can handle every aspect of performance management. The system can precisely compute the number of shares owed to the employee and communicate the results in a timely fashion - <u>after</u> the targets have been achieved. However, you later discover that the accountants must estimate the likelihood of success well <u>before</u> the outcome is known - and adjust the amortization schedules accordingly as the estimates change, including forfeiture rates. Furthermore, the adjusted expense must be allocated by department (for budgets) by account (for journal entries) and by legal entity (for tax accounting), and rolled up into the 10-k for all the world to see. Each allocation changes with the movement of employees every quarter. Now assume that the FASB makes <u>one</u> change to the accounting standard, so that going forward any awards with a graded vesting feature must be amortized on an accelerated basis. (This is actually the only method allowed under IFRS, while GAAP allows either straight line or accelerated.) The amortization schedules will have to be re-computed, including estimates of performance and forfeiture. Catch-up adjustments will have to be recorded for the general ledger, budgets and tax. Disclosures regarding the impact of the accounting change may have to be made. We have travelled a long way from communicating the achievement of a performance target to a single employee in a private conversation.

IV. THE PLAYERS

A. Meet the Stock Administrators

Stock administrators stand between the corporate human resources department and the employee. They keep track of shares owed to the employees, transfers, terminations, vestings, exercises, releases, employee data, and plan documentation. They also assist in the communication and administration of the plan, including the achievement of performance targets and accelerated vesting. Stock administrators service their clients with a combination of personal services and websites that support many levels of communication with the employees.

B. The Brokers Show Them the Money

When an employee exercises an option or sells shares on a regulated stock market, he/she sets a number of transactions in motion, which are typically handled by a broker. The broker holds the cash, clears the trade and handles the reporting that the employee needs for tax purposes. This is a specialized financial services function that is licensed and heavily regulated. Accordingly, it is not normally available within the corporation. Like the Stock Administrators, Brokers provide a personalized service to employees.

C. The Tax Men Handle Payroll

When an employee moves from one country to another, he/she leaves a trail of tax issues that need to be addressed when the shares are released or exercised. For example, what country gets to tax the employee's gain? What is the proper amount of withholding? In most cases, tax treaties need to be consulted to determine the answer. This is complicated by the fact that someone has to track the days spent in-country, often many years after the employee has moved on. There are a number of tax consultancy firms, including the Big Four, that provide this service, which is driven by the individual residency issues of the employee.

D. Corporate Accountants - In the Thicket

The corporate accountants (or their consultants) are required to value the awards based on future projections of share prices (easy for people who can predict the future, but somewhat more difficult for the rest of us). Forfeiture rates must also be predicted, reducing the expense during the current amortization period. When the shares ultimately find their way into the hands of the employees, the financial statements must be trued-up to reflect the actual cost of the award to the shareholders. In the meantime, the amortization period can be accelerated for the achievement of performance targets or retirement eligibility. Add in multiple tranches which vest at different times and you have many dependent variables, any combination of which can change the impact on the financial statements.

Meanwhile, below the line, the tax people (or their consultants) must set up deferred tax assets that correspond with the country where the deduction will ultimately be claimed. The tax accounts must also be true-ed up when the final deduction is claimed.

The calculations of the accountants and the tax departments will both impact the earnings per share and the related disclosures in the financial statements, compiled by the financial reporting staff.

All of this is typically accomplished within the corporation on spreadsheets, which crunch large volumes of transactions taken from the Stock Administrators, Brokers, Valuation Specialists and other internal sources. This data is then rolled-up and allocated in different ways for accounting and tax purposes. These spreadsheets require many reconciliations and a great deal of manual effort to maintain. There are several software vendors who provide some or all of these calculations, but this remains a complex accounting exercise that requires management oversight.

As anyone engaged in this business can attest, the level of scrutiny in financial reporting has increased dramatically in the past few years, as have the penalties, career and otherwise, for failure. This trend continues today with the PCAOB focused on the internal controls around the process of making estimates. This can be expected to roll downhill to accountants and tax departments, who will need to explain how they make the projections that form the basis of their share-based compensation expense.

For a more detailed description of the these accounting and tax functions, see white paper entitled "An Accounting View of Share-based Compensation" at http://www.armtechnology.com.

E. Integrators Approach The Final Frontier

Corporate legacy systems such as the general ledger, the tax provision and tax return, budgeting, management reporting and external reporting all consume data produced by the players noted above. Most of the time these legacy systems are manually loaded. True integration with the share-based compensation supply chain is rare, partially because of the heavy reliance on spreadsheets to house the calculations, roll-ups and allocations. There are large numbers of accounting and system consultants who specialize in the integration of systems and improving the financial reporting supply chain. However, there is only so much they can do with spreadsheets and their real value comes in linking structured databases.

F. Valuation Specialists Look Into the Future

As noted above, valuing the award based on future stock prices can be a challenge. There are many service providers who are familiar with the valuation techniques that are acceptable for accounting purposes, including Black-Scholes and Monte Carlo simulations. Given the vagaries of predicting stock prices, (and the potential liability for misstating the financial statements) corporations will often outsource this task to specialists, who provide this as a service.

V. THE OPTIMAL COMBINATION

So, what is the optimal combination of vendor systems and service providers?

The answer begins with a simple observation. The needs of employees are quite different from those of the corporation. Employees want a personal service delivered via an easy to use website. They want an honest broker. Corporations need systems that crunch large volumes of data, perform accurate calculations and push the results out to a number of legacy systems - all in an automated and transparent process that satisfies the requirements of Sarbanes-Oxley.

If we draw a bright line between the employee and corporate needs, the picture becomes much clearer, as illustrated below.

EMPLOYEE NEEDS	**CORPORATE NEEDS**
A.Stock Admin B.Broker C.Payroll	D.Financial Reporting E.Legacy Systems F.Valuation

So how does this apply to the market?

On the employee side of the house, there are efficiencies to be achieved by using a single system for both Stock Administration and Brokerage, which share a great deal of transactional data. Employee issues related to tax residency and payroll, essentially a stand alone professional service, are handled on a consulting basis.

On the corporate side, Financial Reporting can be systematized with the appropriate product, limiting the dependence on spreadsheets and opening up the possibility of integration with the Legacy Systems. The ideal Financial Reporting system will handle all types of awards with no off-line workarounds and have enough flexibility to directly feed all legacy management and external reporting systems. Valuation is handled as a service that produces the award values needed for Financial Reporting as a single data input.

The optimal combination of products and services is illustrated below:

EMPLOYEE NEEDS		**CORPORATE NEEDS**	
A.Stock Admin B.Broker	C.Payroll	D.Financial Reporting E.Legacy Systems	F.Valuation
Single Product	***Service***	***Single Product***	***Service***

This configuration delivers an integrated solution to meet employee requirements (supplemented with a payroll consulting service), and real process improvements for the corporation (supplemented with a valuation service).

VI. DATA FLOWS: EMPLOYEE, CORPORATE, AND SHARED

As noted above, the optimal combination of products leverages the natural split in function between employee and corporate needs. This also applies to data flows, which follow a similar split. Certain data inputs are required exclusively by Stock Administration systems for employees, others relate exclusively to Financial Reporting for corporations. Shared data input is the limited subset of information that comes from the Stock Administration system and is consumed by the Financial Reporting system.

STOCK ADMIN / BROKERAGE	SHARED	FINANCIAL REPORTING
Name	Employee ID	Fair value of grant
Address	Grant name	Amortization period/method
Residency	Strike price	Forfeiture rate
Payroll withholding	Share settlements	Accounts
Rights upon termination	Vesting	Performance targets for book
Performance management		Mapping to legal entity (tax)
Wealth management		Mapping to accounts (j entries)
Relocation		Mapping to department (budgets)
Employee onboarding		Time spent in-country
Communication of new grants		Deductible/non-deductible countries
Plan interpretations		True-ups
Exercises		Permanent & temporary differences
Money transfers		Period lock
Share transfers		Mark-to-market
		Sarbanes-Oxley compliant

The table above reflects the fact that most of the data inputs are unique to either Stock Administration / Brokerage or Financial Reporting and further underscores the singularity of employee and corporate needs. The overlap between the two, Shared data inputs, is quite limited.

Since the Shared data is maintained in a structured database, it can be readily exported from the Stock Administration system to the Financial Reporting system, another structured database. The Shared data itself is basic: employee IDs, grant name and strike price are initially loaded as part of the set-up, and then updated for changes. Share transactions are monthly or quarterly loads that reflect the grants (usually once a year) and the transactions for the period (vestings, forfeitures and distributions).

Compare this to the transfer of data from a stand-alone Stock Administrator or Broker to a system that does both Stock Administration and Financial Reporting, a common configuration in the industry. Here, all of the Stock Administration data must be transferred to achieve a duplication of Stock Administration functions before the Financial Reporting can begin. The result is two Stock Administration systems (only one of which is used) and one inadequate Financial Reporting system.

VII. THE DREAM OF AN ALL-IN-ONE SOLUTION

Many corporate buyers pursue the dream of an All-in-One solution, where a single product supported by a single vendor meets the needs of all users, including Brokerage, Stock Administration, Payroll, Financial Reporting for book and tax, Valuation and Integration with legacy systems. Having "one neck to wring" also has great appeal for buyers seeking higher levels of customer service.

The downside, of course, is that these diverse functions require many different support departments; i.e. the Brokers cannot help out with Financial Reporting. In reality, there is not "one neck", but many.

As any software product moves through its life-cycle, it becomes older, more resistant to change, more cranky - like everybody. By definition, All-in-One solutions are large, sprawling affairs. The All-in-One solutions are more susceptible to hardening of their software arteries simply because they have more of them.

The result is that the All-in-One system becomes unresponsive to the changing needs of its users. In the case of share-based compensation, Financial Reporting changes are met with new "services", off-line workarounds which the vendor must provide behind the scenes to keep up. Within the corporation, any number of spreadsheets hang off of the platform, but are not a part of it. This slows everything down because the data can only move as fast as the slowest process. Thus, a single workaround represents a failure. And there are a lot of workarounds, both inside and outside of the corporation.

Compare this with a best of breed Financial Reporting engine that is built to handle changes to the accounting and tax regime. Here, the system can be configured to accommodate such changes without expensive customization, and accountants and tax professionals can achieve a sustainable level of independence, a very different dream.

VIII. SUMMARY

The new requirement to expense share-based compensation has created many reporting issues for corporations, specifically around accounting and tax. Thus far, the solutions have remained in off-line workarounds that resist automation and integration with legacy systems. This is due to the fact that vendors (and their clients) have tried to extend Stock Administration systems beyond their capabilities to meet complex corporate financial reporting needs. The optimal combination is a best-of-breed product specifically designed to meet the Stock Administration needs of employees and a second one for corporate Financial reporting.

About the Author

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