Armanino LLP Welcomes You To Today's Webinar:

Preparing for Audit & IPO: Stock Plans

The presentation will begin in a few moments

Participants will receive an email within 3 business days with access to their certificate of completion.

About the Presenters

Matthew A. Perreault, Partner, Armanino

Matt heads the SEC and Technology Audit Practice. With his more than twenty years of experience, Matt has supported more than 50 technology sector transactions.

Matt has industry experience as Controller and VP of Finance and prior to Armanino he served in the technology practice at Ernst & Young in Boston, Palo Alto, and San Jose.

He is a recognized subject matter expert and frequently consults in the areas of revenue recognition, business combinations and equity accounting.

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About the Presenters

Scott Schwartz, Senior Manager, Armanino

Scott leads the Equity Management Solutions practice at Armanino. Scott has worked in the legal and financial industries, providing financial and consulting services to public and private companies, as well as entrepreneurs.

- Extensive experience in Equity Compensation and Valuations
- Scott works with finance executives on their stock-based compensation and other equity transactions.
- He has completed various specialized training in business valuations, fraud, equity compensation administration and more

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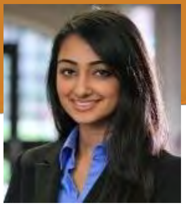
Learning Objectives

During today's webinar, participants will:

- List steps to prepare for the audit of your equity sections
- Recognize many of the risks and penalties involved in stock option accounting
- Identify equity award modifications
- Review accounting standard updates

Presentation Overview



- Audit Preparations
- Interacting with auditors
- Modifications
- IPO-Specific readiness
- Accounting Guidance updates and proposed updates

Stock Option Administration Overview

- Across the organization and with outside providers
- Balance low cost solutions vs. risk management
- Process transactions in the moment – Timing is Key

"You're not going to be a hero for getting stock option reporting right, but you will get a lot of grief for getting it wrong."

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Process – Case Study

Background

Company has granted awards to non-employee consultants throughout the start-up phase.

Facts

The company terminates / disregards the award due to consultant's lack of service. Consultant claims was not properly notified.

Issues

What type of agreements do we have with non-employees? What do the agreements say about separation? Requires BOD/Comp Committee resolutions and internal process management.

Results

Consultant came to the forefront when company went public. Company settled with consultant by granting fully vested stock.

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Preparing for Audit: Administration Practices

Understand & Manage your Stock Option Plan

- Understand the stock option plan
  - Read the plan document

- Provide management input to comp committee/BOD
  - Compensation consultants may be needed
  - Cost of administration
  - Challenges of managing various types of grants

Have you read it?

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Process and Procedures

- Documentation/Qualitative review
  - Valuations
  - Issuing grants
  - Exercises
  - Terminations
  - Modifications
  - Quarter-end/Year-end accounting and reporting

Valuation – Common Knowledge

- Valuation by qualified person
- Serve tax and audit purposes
- Reasonable projections
- Frequency
  - Annually (minimum for grants)
  - Major events

Ensure your 409A valuation will comply with the IRS "safe harbor" guidelines.

Engage your audit firm to sign off on the valuation report prior to granting options.

Documentation of Your Controls: Grants & Exercises

1. Document that you actually have a documented process.
2. Demonstrate check of offer letters to board minutes.
3. Provide reconciliation to BOD minutes to stock ledger reports to ensure all grants are included.
4. Document communication of grants to participants
   - Require recipient acceptance of award
   - Demonstrate the follow-up process

Much of the actual grant process can be automated through online systems.

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ISO/NSO Grants

	ISO	NQSO
Strike price	Minimum FMV 110% of FMV if owns 10%	Minimum FMV
Limitation	Max of $100,000 can become exercisable in any 1 year	N/A
Grantee	Employee (U.S. Citizen)	Employee and non employees
Taxed to employee	AMT in year of exercise unless sold. Capital gains if held for 2 years from grant and 1 from exercise	Ordinary income tax at time of exercise
Tax deduction for corporation	No tax deduction	Tax deduction at exercise

Document process and calculations confirm ISO shares are appropriate.

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Preparing for Audit: Accounting

Would it help to have an audit checklist?

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Audit Checklist – Stock-Based Compensation

(This list is not exhaustive, but addresses common topics related to stock-based compensation.)

Documents for Company to provide

- Stock plans and any amendments during the year
- Board minutes during the year (if first audit, all board minutes)
- Sample grant documents
- Grant documents for unique and/or large grants
- Employment contracts (if applicable)
- Support and methodology for fair value inputs
- 409A Valuations
- Technical Memo include general practice along with odd transactions
- Description of any unique events in the year (i.e. modifications, business combinations, repurchases, etc.)

Activity

Questions:

- What type of participant is the grantee?
    - Employee, nonemployee director, nonemployee

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Documents to Provide

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Documents to Provide *(cont.)*

- Support and methodology for fair value inputs
- 409A Valuations
- Technical Memo include general practice along with odd transactions
- Description of any unique events in the year (e.g. modifications, business combinations, repurchases, etc.)

Stock-Based Expense

Stock Based compensation Memo describing the following:

- Accounting for various classes of participants
  - Employees
  - Non-Employee Directors
  - Non-Employees/Consultants
- Expense
- Forfeiture percentage
  - Experience Groups
- Modifications

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Calculations and Disclosures

- Supporting schedules
- Sources of data
- Recalculations as necessary
- Highlighting unique events

Financial Statement Disclosures (summary)

- Weighted average valuation assumptions
- Unrecognized stock comp expense and weighted average period of years
- Stock option activity (reconciliation of options available to be granted and outstanding)
- Shares, weighted average exercise price, weighted average remaining life, Aggregate Intrinsic Value for:
  - Vested and expected to vest
  - Exercisable

Know how to calculate these numbers and be prepared for your auditor to ask you. They will more than likely state they are not testing the equity system.

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Financial Statement Disclosures (summary)

- Aggregate intrinsic values of options exercised
- Grant date fair value of options vested
- Options outstanding and exercisable
- Stock-based expense
- Equity Roll-forward

Make sure you understand how to properly extract the data from the system you are using. The setting may impact the output.

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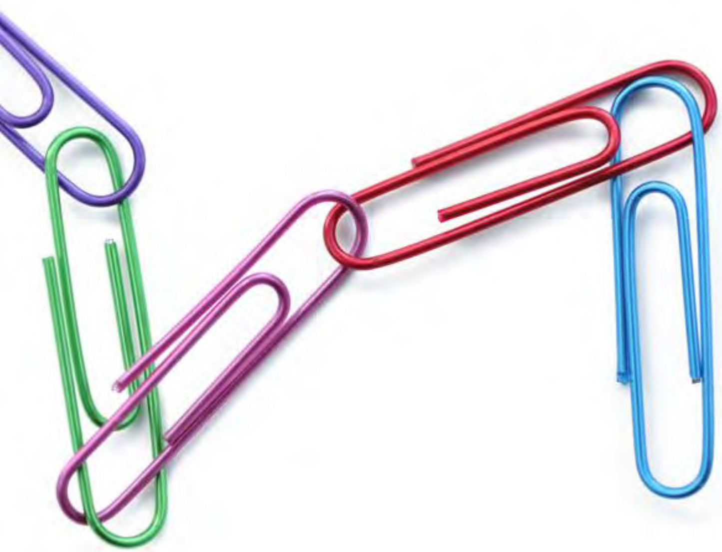
Interactions with Auditors

- Process
  - Defined, Defendable, Documented
- Calculations
  - Understand them
  - Provide detailed support
- Preference
  - Get Auditor insights
- Team approach
  - Bring in third-party provider as needed

Connect with Auditors before the Audit & S-1



- During Valuation Process
  - Before Board approval
- Modifications
  - Before undergoing
  - Post-modification calculations
- Cheap Stock Charges
  - Calculations
  - Financial statement/disclosure impact
- Change or implementing new accounting policies

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GUIDANCE UPDATE

Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (ASU 2014-12)

Background

- No specific guidance on how to treat a performance target that could be achieved after the requisite period
- Amendments require that such performance targets be treated as a performance condition

Highlights

- Target should **not** be reflected in estimating the grant-date fair value of award
- Cost should be recognized in the period when the achievement of target is probable (or occurs)

- **Example**:
  - Company grants stock options with 4-year service condition. The options will only vest upon a change in control within 10 years of grant date. Employees can terminate after 4 years and still vest.
  - CIC in year 5 and didn't become probable until year 5
  - Grant date FV is $100k (not affected by probability of CIC)
  - $100k comp expense is recognized in year 5

Effective Date and Application

- All entities: December 15, 2015
- Earlier adoption permitted
- Prospective application – all awards after effective date
- Retrospective application – all awards with targets outstanding as of period presented in financial statements

Preparing for Audit: Modifications

Definition of a Modification

- Change in the terms or conditions of an award
- Treated as an exchange of original award for new award
- Recognize compensation expense depending on modification type

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Examples of Modifications

- Obvious:
  - Re-pricing of awards
  - Exchange of awards in a business combination
  - Reclassification of an award

- Commonly Overlooked:
  - Accelerated Vesting
  - Extended time to Exercise
  - Changing award type or performance conditions
  - Reclassification of an award

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Fair Value Implications

- Always as of the modification date
- Equity awards
  - Probability of vesting
  - Comparing fair value of original and modified award
- Liability Awards
  - Recognize fair value using modified terms

Modification Accounting

- Pre- and Post Calculations
- Document the accounting treatment
- Discuss with audit team
- Document calculations with supporting detail
- Typically applicable in an M&A transaction

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Types of Modifications

- Analyze each award's probability of vesting before and after modification

	Type I: Probable to Probable	Type II: Probable to Improbable	Type III: Improbable to Probable	Type IV: Improbable to Improbable
Expense	Incremental fair value between new award and original	Incremental fair value between new award and original	Fair value of new award only	Fair value of new award only
Minimum Expense	Grant date fair value (original)	Grant date fair value (original)*	No minimum	No minimum
Expense Timing	Vested - Immediately Unvested - over service period	Unvested - over service period when probable	Vested - Immediately Unvested - over service period	Unvested - over service period when probable

* As long as original target is achieved

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M&A Consideration: Replacement Awards

Obligation to replace acquiree's awards?

- If No, Post-combination Compensation Cost
- If Yes, Further Analysis

Further Analysis:

- Purchase consideration = Value of entire award immediately before x % of service period complete
- Post-Transaction Expense = Value of entire award immediately after minus Purchase Consideration
- Potential incremental expense = excess of (Post-Transaction Expense x % of service period complete) over Purchase Consideration

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Other Considerations

- Accelerations
  - If Change of Control Provisions, no modification expensing, but accelerated expense to Acquiree pre-transaction
  - If no COCs, modification accounting post-transaction on acquirer's books
- Tax Impact of awards

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Preparing for IPO: Additional Steps

Equity Management Process - Summary

Establish today what we've discussed previously:

- Defined roles and responsibilities
- Written procedures
  - Issuing and administering the plan
  - Modifications
- Open communications between stakeholders

= Cleaner and Accurate Data for IPO Reporting

the older the plan, more likely data cleanliness issues

Equity Compensation Expense

- Highly scrutinized
- History back to 2006 for opening balance
- Modifications and "Unique" Grants
- Large grants and key employees
- Quarterly Expense Calculations *(if not monthly)*

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Valuation Considerations

- Complex Valuations
  - Get them started early
  - Multiple review steps
- Common Stock Valuations – Timing is important
  - Quarterly Valuations within 12-18 months out from filing
  - Financings
  - Significant Company events
- Cheap Stock Analysis

Equity Compensation Tax Issues

- Private – Minimal Tax Transactions
- S-1/Public
  - DTA Tracking by grant
  - Modifications impacting DTAs
  - 162m Limitation
  - Mobile Employees
  - R&D Cost Sharing

Earnings Per Share

- Basic
  - Weighted common shares outstanding
  - Net of weighted unvested early exercised shares
- Diluted
  - Basic EPS
  - Dilutive Issuances
  - SBC – Unrecognized Expense
  - Tax Benefit
  - Proceeds

Administration Changes

- Change in Award Type
  - Shift to NSO or RSUs
  - Performance awards – Be aware of added administration
- Discontinue Early Exercise
- Tracking Modifications
- ESPP rollout

Proposed Accounting Standard Changes

- **Private company**
  - SAB 107 Simplified Method for grants with performance and service conditions
    - If not probable at GD, could use Contractual Term
  - One-time change in accounting principle to measure liability awards at intrinsic value if currently using fair value
  - Align public and private classification guidance (equity vs. liability) for put and call rights that are contingent on events within employee control
    - Consider probability of occurrence to determine classification

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Proposed Accounting Standard Changes (cont.)

- Changes to IFRS 2
  - The accounting for the effects of vesting conditions on the measurement of a cash-settled share-based payment
  - The classification of share-based payment transactions with net settlement features; and
  - The accounting for a modification to the terms and conditions of a share-based payment that changes the classification of the transaction from cash-settled to equity-settled.

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In Conclusion…

During this webinar, we've covered:

- Taking a proactive approach at each step of equity management process
- Preparing for Audit and IPO
- Seeking help before year-end or S-1 undertaking
- Avoiding management of the plan with Excel

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You're Invited!

Armanino Cloud Solutions Networking Event.

Join Armanino for a cocktail party at CalCPA as we present some of our biggest Cloud success stories and enjoy an evening of networking.

Tuesday March 3rd 4-7pm

Email: Mary.Tressel@armaninoLLP.com

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