

# 13<sup>TH</sup> ANNUAL CEP AND SILICON VALLEY NASPP SYMPOSIUM

MARCH 28, 2017

SANTA CLARA UNIVERSITY • CERTIFIED EQUITY PROFESSIONAL INSTITUTE • SILICON VALLEY CHAPTER-NASPP



## There's the Windup...Here's the Pitch...It's an Audit!

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# Developing and Performing SOX Controls

- Why Is this Important?
- Several reasons
  - Due to ASC 718 requirements, equity compensation is a “high risk area”
  - COSO requirements
  - CEO/CFO certification of financials
  - Demonstrates Avoidance of fraud
  - “Blueprint” of administration
  - Reducing Errors
  - Promotes best practice and governance



# Types of Audit Items / Agenda

- Administrative
- Taxation
- Financial Reporting



# ADMINISTRATIVE



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# Examples of Controls

Area of Risk	Control	Control Activity	Frequency
Plan Review	Plans are reviewed by designated equity personnel to ensure compliance	<ul style="list-style-type: none"> <li>• Review plan for expiration</li> <li>• Check for cancels from "rollover" plans, add to new share pool</li> <li>• Share reserve reconciliation</li> <li>• Grant Recipient eligibility</li> <li>• Confirm that no grant exceeds plan limits</li> </ul>	Annually
Grants	Grants are processed accurately by proper delegated authority	<ul style="list-style-type: none"> <li>• Compare Equity system generated report to HR List</li> <li>• Compare control totals to Comp Committee Meeting Minutes</li> <li>• Confirm vesting terms if not "standard"</li> <li>• Document when communication to employees occurred</li> </ul>	Quarterly
Exercises	Exercises are processed accurately and timely	<ul style="list-style-type: none"> <li>• Secondary review of all exercises to ensure transactions are processed correctly per broker instructions</li> <li>• Comparing stock prices to prices fed into in equity system</li> <li>• Reconcile exercise proceeds to proceeds received</li> </ul>	Quarterly

# Examples of Controls

Area of Risk	Control	Control Activity	Frequency
Terminations	Forfeiture of grants are processed accurately and timely	Compare terms from HRIS to Equity System	Quarterly
ESPP	ESPP purchases are processed accurately and timely  Only delegated authority can approve ESPP purchases	<ul style="list-style-type: none"> <li>Compare contributions from Payroll to Equity System.</li> <li>Provide copies of purchase detail report and sign off sheets.</li> </ul>	Quarterly
Shares Outstanding	Roll forward accurate	<p>Compare reconciliation to Transfer Agent and / or Cap Table</p> <p>Rerun "Plan Summary" or Rollforward report from last period, move missed shares into current period</p> <p>Reconciliation of Par Value and APIC GL's</p>	Quarterly
Data Security	Only Delegated personnel has read/write access to equity database	Review team members and access level of equity system database.	Annually



# Spreadsheet Controls

- **Version Control**
  - Use standard naming conventions
  - Maintain historical files no longer available for update in a separate drive
  - Version notes on a separate tab
- **Security and Integrity of Data**
  - Locking or protecting cells
  - Show auditors file last update date
  - Save PDFs
- **Sheet Protection or Validation**
- **Documentation**
  - Notes pages within workbook document the procedures for each spreadsheet
  - Assists with knowledge transfer
- **Overall Review**
  - Checklist with all procedures



# How to Prepare Effectively for an Audit

- Create audit packages per category/transaction
  - Grants
  - Exercises
  - ESPP
- Referencing documentation
  - Tick marks
  - Recalculation of formulas
- Roll forward
- Establish checklists





# How to Prepare Effectively for an Audit

- **Establish process**
  - Single point of contact in department
  - Understand deadlines and what is needed
  - Work with internal group
- **Ask Questions if you don't understand what is being asked**
  - Ask for the business purpose of the request
  - Not "give me a report with expense for shares outstanding"
  - But "I'm trying to prove the DTA Balance"
- **Be confident**
  - Remember you are the SME



# Example of Referencing

## From/To

### Provided by Compensation

Dear Stock Administrator

Please grant the following RSUs from Stock Plan XYZ <sup>2/</sup> to the following individuals as approved Comp Committee. Grant date is 4/1/16. <sup>2/</sup>

Participant Name	Employee ID	Options/Awards Granted
Employee A	1	46,494
Employee B	2	75,107
Employee C	3	7,153
Employee D	4	7,153
Employee E	5	53,648
Employee F	6	42,918
Employee G	7	7,153
<b>Total</b>		<b>239,626 rx <sup>2/</sup></b>

Please let me know if you have any questions

Sincerely

Judy Brown

Director of Compensation

1/



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# Example of Referencing

## From/To

Grant Plan Number - Name (Type)	Participant Name	Employee ID	Grant Type Code	Grant ID	Grant Date	Options/Awards Granted	Grant Price	FMV at Grant	Aggregate Grant Price
1/ Stock Plan XYZ	Employee A	1	RSU	29	1/ 04/01/2016	46,494	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee B	2	RSU	27	1/ 04/01/2016	75,107	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee C	3	RSU	24	1/ 04/01/2016	7,153	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee D	4	RSU	25	1/ 04/01/2016	7,153	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee E	5	RSU	28	1/ 04/01/2016	53,648	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee F	6	RSU	30	1/ 04/01/2016	42,918	\$0.0000	\$0.0000	\$0.00
1/ Stock Plan XYZ	Employee G	7	RSU	26	1/ 04/01/2016	7,153	\$0.0000	\$0.0000	\$0.00
<b>Stock Plan XYZ</b>						<b>1/ 239626 rx</b>			<b>\$0.00</b>
<b>Totals For All Grant Plans:</b>						<b>239,626</b>			<b>\$0.00</b>

**Report Last Executed:** 07/15/2016 9:22:04 PM GMT-04:00  
**Current User:** LaddonJ\_EOS4  
**Parameters:** Company 123  
 For Grant Date From 4/1/2016 to 4/1/2016



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2/

naspp SILICON VALLEY CHAPTER

# Reconciling Timing of Exercises with Cash

- If an exercise occurs at the end of a reporting period, the cash proceeds/tax amounts from the exercise will likely not be in your Company's bank account during said reporting period
- An accrual is your best option
- Compare actual exercises from your system against the cash you have received from your service provider
- Accrue the "timing difference" amount in order to true-up the accounts for the reporting periods
- Note: your Company will need to decide whether you want to recognize exercises when they are initiated or when the cash is received



# TAX



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# Tax Audits

- IRS more determined than ever to recover lost revenue
- Must be prepared to provide documentation on tax reporting/withholding practices
- Common areas for audit
  - Section 162M
  - Mobility
  - 100k Federal Tax Deposit rules
  - Forms 3921/3922
  - Qualifying/Disqualifying Disposition
  - W-2s
  - 1099-MISC for non-employees



# Ticking & Tying Tax

- Document process for obtaining “correct” tax rates from Payroll or other sources
  - Especially key that this is performed prior to large release transactions, non-US or non-qualified ESPP purchase
- Mobility
  - How are location changes tracked and used by tax?
    - Country and state
  - How are taxes pro-rated, if applicable
- 3921/3922
  - ISO Exercises
  - ESPP Purchase
    - Unless not deposited into a brokerage account
  - Sample/test forms match stock plan system



# Ticking & Tying Tax

- **Section 162(m)**

- Does not apply to time-based options/SARs
- \$1M Limit on Tax Deductibility
  - Covered employees
    - CEO and three highest compensated (other than CFO)
    - Employed on last day of tax year
    - Covered by proxy disclosure
- Ensure that performance grants meet requirements
  - Objective (not subjective), pre-established performance goals
  - Compensation committee composed of two or more outside directors
  - Shareholder approved, prior to payout
  - Goals achieved certified in writing by comp committee
  - Plan must specify maximum shares granted during specified period
- Ensure that time-based RSUs do not exceed the plan share limit

- **\$100K IRS Deposit Threshold**

- Document each time during the year that threshold was exceeded
- Ask payroll to document submission timing





# Ticking & Tying Tax

## ● Exercises, Releases

- Confirm tax \$ amounts received from broker(s) tie to system calculations
- Confirm tax \$ amounts submitted to IRS via payroll deposit
- RSUs with deferrals or Retirement Eligible, confirm that FICA collected on Vest Date/RE date

## ● Dispositions

- Document process for tracking dispositions
  - Broker reports is best practice (don't allow participants to transfer shares to another broker)
  - Surveys for shares transferred, former employees
  - Sample/test DDs and QDs were reported on W-2s

## ● W-2s

- Sample and test W-2 amounts match Stock Plan System
- Codes are correct (V for NQ exercises, but NOT for other transactions)
- RSU releases, ISO and ESPP DDs AND ESPP QDs!

## ● Tie Out Taxes at Employee Level Monthly?

- Increase frequency as year-end approaches
- Split out recon to transaction type to tie to payroll W-2 reporting



# Deferred Tax Asset

- **Reconcile APIC / Tax Accounting Report to Transaction Reports**
  - Confirm jurisdictions, review mobility if material
  - NQ Exercises – Exercise Report
  - NQ Expirations – Only VESTED, Cancelled Report
  - RSU Releases – Release Report
  - ISO DDs – DD Report
- **Add expense to DTA Rollforward**
  - Group by Country (sometimes type, if not using a special report)
- **Reverse DTA from Transactions**
- **Prove DTA Balance**
  - Expense booked for outstanding shares
- **Getting rid of the APIC Pool due to ASU 2016-09**



# ASU 2016-09 Updates for Tax

- When the estimated DTA recorded for SBC exceeds the actual tax deduction taken with the award, the excess tax benefit is recorded to the Windfall Pool (a part of APIC)
- Under the update, the Windfall Pool is eliminated
  - Need perfect back up for the existing pool
- The tax benefits or deficits are now to be recorded on the Income Statement as a part of Income Tax Expense
- This will increase volatility on the Income Statement given the fact that Income Tax Expense will fluctuate regularly as there is no cushion anymore
- Hence, more scrutiny on tax accounting since no buffer of APIC pool – impacts P&L directly!



# FINANCIAL REPORTING



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# Period Close Process

## ● New Options

- Audit market values (used for volatility) against external source
- Check for new non-employee grants
- All assumptions with source data in one XLS
  - Expected term, volatility, interest rate
- Report from system with assumptions for each grant
- Summary tab proving they match
- Assumptions memo (should be the same as last quarter?)
- Data audit / check to confirm fair values for all new grants (all grants too)

## ● Forfeiture Rate

- s/b annual or non-existent now
- If not, document process for updating and applying to expense

## ● Performance Payouts

- Document process for current %, include in assumptions memo



# Period Close Process

## ● Existing Grants

- Check for modifications (review board minutes!)
  - Include details in your SBC XLS
  - Type I – Probable to Probable
    - Often already vested (extension of exercise grace period)
    - Incremental Expense – Before / After Fair Value
  - Type III – Improbable to Probable
    - Unvested accelerated at termination
    - Performance goal changed to something attainable
    - Reverse expense for unvested shares under old fair value, calculate new fair value
- Check for status changes
- Check for dept / cost center changes



# Period Close Process

- Rerun last quarter's report – match to e-copy from last quarter
  - At reporting level, not just total – dept or cost center
- Flux Analysis / Completeness Test
  - Prove all grants that should be expensing ARE
    - Unvested Shares = Ongoing Expense
  - Prove that grants that should have completed expense HAVE
    - No unvested shares = no current expense
  - Common categories for variance:
    - New grants (0 expense last period, partial expense this period)
    - Grants fully vested last period (expense last period, 0 expense this period)
    - Terminations last period (expense last period negative, 0 this period)
    - Terminations this period (expense last period positive, negative this period)
    - Final vest in prior period (expense ended last period)
    - Final vest in current period (expense less this period than last)
    - Changes to forfeiture rate
    - Modifications



# Financial Period Close Process

- Prove  $Q1+Q2+Q3+Q4 = YTD$ 
  - One tab per quarter, one YTD report, sumifs or pivot tables
  - Tie to JE for year for SBC
- Don't filter reports
  - Run one expense report and slice and dice
  - Filtering can lead to...
    - Grants/expense missed
    - Grants/expense double-counted





# Disclosures

- One XLS with Summary Page with Disclosure Items
- Detailed reports on supporting tabs

SBC Disclosures as of January 31, 2017		Supporting Tab		
additional future period expense to be recognized over the remaining service periods through fiscal 2021	\$ 264.9			
<b>9. Common Stock</b>				
Common Outstanding	38,156,688	3		
2008 Equity Incentive Plan:				
Restricted stock units and options outstanding	44,560,246	4		
Shares available for grant	579,833	4		
Amended and Restated 2008 Stock Purchase and Option Plan (from prior acquisition):				
Options outstanding	53,455	5		
Undesignated	1,742,363	6		
Total Common Reserved	121,843,312	6		
Total Common Issued or Reserved for Issuance	160,000,000	3		
<b>10. Stock Option Plans</b>				
Reserved under the 2008 Plan	579,833	4		
The following tables summarize stock option activity and related information:				
		5, 7, 8		
	Shares Available for Grant	Variance		
		Options Outstanding		
		Weighted Average Exercise Price		
		Wtd Avg Rem Contractual Term		
Balance - January 31, 2016	336,697	24,835,286	\$ 4.60	
Additional shares reserved	10,001,250			
Restricted stock activity, net	-10,195,214			
Granted	-370,480	370,480	\$ 17.85	
Exercised		-1,157,625	\$ 3.10	
Canceled	808,463	-808,463	\$ 10.74	
Plan Shares Expired	-882			

# Diluted EPS

- Tie Absolute Outstanding to Outstanding Report
- Tie Unamortized Expense to Expense Report (before forfeitures)
- Average Market Value During Period – calc from Value report
- Tie Weighted Average Options/Awards Outstanding to Outstanding Report
- Keep in mind specific instruments – like RSAs – that are not included in the basic EPS calculation, but are included in Dilutive Shares calcs



# Fun Auditor Requests

- **Prove that the report calculations haven't changed**
  - Rerun the report for last period and tie to the e-copy of the report
- **Recompute every single number in every report that is used in recording the compensation expense or the financial reporting disclosures**
  - Includes recomputing/supporting vested shares, actual exercises, grant info, etc.
  - Then why do we have a system instead of a spreadsheet?
  - Recalculate a couple of sample grants instead of every one
- **How do we know you didn't alter the numbers on the reports?**
  - Save to PDF
  - Have the auditors download (not run, but download) the reports from the systems themselves



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