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SOS *Educational* Webcast: Demystifying and Determining DTA Balances

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Materials

http://www.sos-team.com/pdfs/dta_balances.pdf

Agenda

Intro to Deferred Tax Asset (DTA) & Tax Accounting

Approaches

Complications

General Concepts – Deferred Tax Asset

For certain types of equity instruments, a tax deduction is expected in future

- Non-Qualified Option = Tax Deduction at Exercise
- Restricted Stock/Unit = Tax Deduction at Release

Deferred Tax Asset ("DTA")

- Accounting way to anticipate future tax deduction
- Accrued over time instead of being "booked" all at once when event actually occurs
- Booked as expense is accrued (i.e., over vesting or service period)
- ASC 718/FAS 123(R) expense *times* applicable corporate tax rate
- DTA not booked for ISO/ESPP (more later)

General Concepts

ASC Topic 718 (formerly FAS 123(R))

- Requires that:
  - Record deferred tax asset (DTA) as expense is booked
  - Reconcile at time of tax deduction (or lack thereof)
  - Excess tax benefits be recognized as an addition to paid-in capital, NOT as a reduction in income tax expense
  - Unrealized tax benefit recognized as income tax expense
    - **Unless there** are excess tax benefits from previous equity awards in paid-in capital to which it can be offset (run it through APIC pool)

General Concepts – Deferred Tax Asset (cont'd)

Example of journal entries for expense and deferred tax asset (both booked over "requisite service period"):

- Expense for NQ = $10,000
- Vesting annually over 4 years, straight-line accrual used ($10,000 / 4 years = $2,500 per year of expense)
- 40% statutory tax rate for that country
- Debits/credits for each year of service period:

Debit: Compensation Expense	2,500	
Credit: Additional Paid-in Capital		2,500
Debit: Deferred Tax Asset	1,000	
Credit: Deferred Tax Benefit (part of Income Tax Expense)		1,000

Note: Expense should be reduced by estimated forfeiture rate up until shares vest.

General Concepts

Translation

- Deferred Tax Asset <> Actual Tax Deduction
- If windfall/excess = increase to APIC
- If shortfall/deficiency =
  - Reduction to APIC pool (if sufficient) or
  - Potential tax expense (if APIC pool not available to offset)

A – D = if positive, excess (good)

= if negative, deficiency (bad)

Actual - DTA

Journal Entry Oversimplification

Very generally speaking, when tax deduction occurs, you will make three entries to your General Ledger:

- Decrease taxes payable
  - Company receives a tax deduction
- Reverse previously booked DTA (if any)
  - No longer “anticipated” – DTA should be reversed
- Post difference (“plug”) to “APIC” or to Income Tax Expense

Forfeitures & Expirations

Forfeiture

- Cancellation BEFORE vesting
  - *DTA is reversed*
    - Tax deduction no longer outstanding
  - No windfall/shortfall calculation performed

Expiration

- Cancellation AFTER vesting
  - DTA is reversed
  - Windfall/shortfall calculation performed – DTA compares to $0 tax benefit received by participant

Why Now?

Auditors have been auditing:

- Expense reports (for DTA set-up)
- APIC report (for DTA reversals)
- Were they wrong all these years?

Perhaps no single period movement or single year entry was significant, or but now the DTA BALANCE is a material amount?

- So now requires proof?

PROVING YOUR BALANCE

Shares Outstanding by Tranche Approach

Begins with shares outstanding report with one row per vesting tranche

- With vest date and number of shares outstanding
- Not all systems have a report like this!

Vested Tranches

- Can be assumed all expense recognized
  - Requirement of accounting standard
- However, some shares may have been exercised
- DTA balance = fair value per share * shares outstanding * corp tax rate

Unvested Tranches

- Expense amortization still in progress or has not yet started
- To determine amount of expense booked to date = Net to date expense retrieved from expense report for tranche * corp tax rate
  - Not all systems have/show expense at tranche-level
  - Include "haircut" for forfeiture

DTA Booked Less DTA Reversed Approach

Approach begins with expense report

- Provides net to date expense for grant * corp tax rate = ***Total DTA Booked***
- Includes expense in progress
- Includes haircut for forfeitures (as it should)

Tax accounting / APIC report

- Provides ***Total DTA Reversed*** for exercises, releases, expirations, etc.
- Sometimes Exercise, Release, Expiration reports used instead

DTA Booked minus DTA Reversed = DTA Balance

- Pull in shares outstanding for each grant as confirmation
- Check report for any grants with shares outstanding > 0 and DTA balance = 0 and vice versa

Pros & Cons

	Pros	Cons
Shares Outstanding by Tranche Approach	• Starts with different data than used to book/reverse DTA – “different angle” • Built-in validation: number of shares outstanding basis. If shares outstanding = 0, DTA balance = 0.[1] • More granular = More accurate?	• Data sets can be large • Not all systems have reports needed • Linking tranches can be challenging if vest dates not unique within grants • Vest schedule adjustments may also result in vest dates <> source data to expense report
DTA Booked Less DTA Reversed Approach	• Smaller data set • Data easier to get • Less problematic to link data	• Same data as used to create balance

[1]Not true if you use True Up at Vest. More later.

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Tips

Custom Reports are feasible

- Even if that is your long-term goal, **calculate** *it in a spreadsheet first!*
- Faster/less expensive to test your process
- Easier for auditors to review/test/understand
- Gives you something to compare to as a baseline

COMPLICATIONS

ISOs/ESPPs

NO DTA Booked for ISOs/Qualified ESPPs

Tax Accounting performed if/when **there** is a Disqualifying Disposition

Excess:

- If actual tax benefit greater than “estimated tax benefit”, excess treated as APIC and “estimated tax benefit” reduces tax expense, but only in year of disqualifying disposition
  - If actual > estimated
    - Excess tax benefit = APIC
    - Estimated tax benefit (expense * tax rate) = reduces tax expense

Deficiency:

- No DTA booked, so no real deficiency
- If actual tax benefit <= “estimated tax benefit”, no APIC and actual tax benefit reduces tax expense

Other Issues

Non-unique vest dates

- When a grant has same vest date for multiple tranches, linking data from one data source to another can be difficult
- Can assign unique IDs to each tranche on both reports

"Straddle grants"

- Grants made prior to adoption of ASC 718 / FAS 123(R)
- Only part of expense created a DTA entry
- Prorate based on "post R" shares

Size of data set

- Especially for monthly vesting, data can contain hundreds of thousands of rows
- May mean calculation should be performed in MS Access instead of a spreadsheet
- Definitely stand-alone computer which is not required for other work

Other Issues

Grants / individuals subject to 162(m) tax deductibility cap

Non-US Issues

- Many countries do not give rise to a tax deduction at settlement, so no DTA should be included
- Must know tax status "check the box" etc.
  - Check with your tax group
- Different tax rates for different countries

Option exchanges or repricings

- Many systems do not "capture" expense (and therefore DTA) booked prior to the option exchange or repricing

ISOs

- Some systems do not "split" ISO into a NQ grant when they exceed the $100 limit but keep them as one grant,
- Means a portion of the grant should give rise to the DTA balance

Other Issues

True up at Vest

- Maybe expense "still amortizing" that is part of your DTA even when shares are no longer outstanding

Grants being expensed outside your stock plan system:

- Non-employee grants
- Modified grants
- Performance options
- Performance RSUs with "specialized" requirements
  - Delayed service-inception dates
  - "Reverse FIN 28" amortization
- Performance grants with goals not set on grant date

Grant Type not on Source Reports

- Vlookup to pull from another place

Other Issues

Files can be large/contain sensitive data

- Use secure file transfer system if someone offsite is performing the initial calculations

Leading zeros on grant numbers

- Some exports will strip these out, others will not
- Export to CSV, change file extension to TXT, use Excel to open, specify TEXT for open number field to keep leading zeroes

Some systems have different data in same columns on tranche-level outstanding report

- May need to run the report separately for each grant type

Vest Schedule Changes not always reflected on reports used

Apples to Oranges (tranche to transaction)

Tranche – Expense/ Book DTA

Transaction – Reverse DTA

Exercise

Expiration

$100

$75

$100

$25

= Balance = $100 Incorrect!

Leapfrog's Story

Why now?

Process

- Onsite meeting with tax + stock plans + tax accounting consultant
- Decide on approach, review challenges

Special challenges

- System conversion
- Repricing
- Exports not always pretty
- Non-unique vest dates
- Some tranche-level fair values (for performance grants, FIN 28)
- Date formats
- Straddle grants

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