

November 1, 2021
(Originally April 29, 2005)

ACCOUNTING FOR STOCK COMPENSATION UNDER FASB ASC TOPIC 718

Overview

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718, Stock Compensation (formerly, FASB Statement 123R), requires generally that all equity awards granted to employees and nonemployees be accounted for at “fair value.” This fair value is measured at grant for stock-settled awards, and at subsequent exercise or settlement for cash-settled awards. Fair value is equal to the underlying value of the stock for “full-value” awards such as restricted stock and performance shares, and estimated using an option-pricing model with traditional inputs for “appreciation” awards such as stock options and stock appreciation rights. Compensation cost equal to these fair values is recognized net-of-tax over the vesting or performance period only for awards that vest, but there are important exceptions for awards with “stock price” or “intrinsic value” performance criteria. Subsequent modifications to outstanding awards result in incremental compensation cost if fair value is increased as a result of the modification. Thus, a value-for-value stock option repricing or exchange of awards in conjunction with an equity restructuring does not result in additional compensation cost. There are special provisions for nonpublic companies that are intended to ease compliance with accounting for stock compensation.

FASB ASC Topic 718 (Topic 718) is in substantial convergence with the International Accounting Standard Board’s (IASB) final standard on Share-based Payment, except for transactions with nonemployees and nonpublic companies, and minor technical differences in regard to employee stock purchase plans, modifications, liabilities, and income tax effects. Topic 718 creates a more “level playing field” for equity compensation design that has resulted in the increased prevalence of full-value and performance-vesting awards, and a corresponding decline in plain-vanilla, tax qualified, and reload stock options, and employee purchase plans. This paper summarizes the most pertinent provisions of accounting for stock compensation under Topic 718 and other related FASB and Securities and Exchange Commission (SEC) Topics.

Scope

In General – Topic 718 applies to all share-based payment transactions with employees and nonemployees (referred to collectively as grantees) in which a company acquires goods or services by issuing company stock, or by incurring liabilities that are based on the fair value of the company’s stock or are settled by issuing company stock. Employees are defined by reference to common law and federal payroll tax principles, and include certain “leased” employees and nonemployee directors elected by the company’s shareholders. Nonemployees include independent contractors, advisory board members, and employees and nonemployees of an equity method investment. Topic 718 does not include stock compensation issued to a lender or investor in a financing transaction, but does include stock compensation granted as part of a contract accounted for under ASC Topic 606 dealing with revenue from contracts with customers.

Employee Stock Ownership Plans (ESOPs) – FASB ASC Subtopic 718-40 provides guidance for share-based payment transactions with tax-qualified ESOPs. The FASB may reconsider accounting for ESOPs in a later phase of the share-based payment project.

Employee Stock Purchase Plans (ESPPs) – FASB ASC Subtopic 718-50 provides guidance for share-based payment transactions with ESPPs. Subtopic 718-50 does not recognize compensation cost for ESPPs that are nondiscriminatory, incorporate no option features (such as a purchase price “look-back” provision), and provide for purchase discounts of 5 percent or less. If the above criteria are not satisfied, the ESPP is deemed compensatory and compensation cost is calculated using option valuation techniques and accrued over the purchase period. For ESPPs with a purchase price look-back provision, compensation cost is calculated under a complex methodology that assumes the award is composed of (1) a non-dividend-paying share of stock equal in value to the purchase discount, and (2) an at-the-money stock option equal in value to the discounted purchase price.

Equity versus Liability Awards

Equity Awards – A share-based payment arrangement is classified as equity if the written or substantive terms of the award call for settlement solely in company stock. Examples of equity awards are stock options, ESPPs, and stock-settled stock appreciation rights (SARs), restricted shares/share units, and performance shares/share units. Equity awards are not reclassified as liabilities merely because the company occasionally settles awards for cash, withholds shares to satisfy *maximum individual statutory* federal, state, and payroll tax withholding requirements applicable to each tax jurisdiction, or permits a “valid” broker-assisted cashless exercise. However, equity awards may be reclassified as liabilities if the above conditions are not met (refer to *Liability Awards* below). In addition, the stock-for-tax withholding exception referred to above applies only to equity awards granted to employees (that is, stock-for-tax withholding on nonemployee equity awards is not permissible.) Companies should report stock-for-tax withholding transactions as a financing activity on the statement of cash flows because the substance of the transaction is a repurchase of shares from employees.

Liability Awards – A share-based payment arrangement is classified as a liability if (1) the written or substantive terms of the award call for settlement in cash or other assets, (2) the award provides for a puttable or callable repurchase provision that is based on other than fair value or can occur less than 6 months after option exercise or share vesting, or (3) the award is indexed to a factor other than a service, performance, or market condition (refer to *Vesting Conditions* below). Examples of liability awards are cash-settled SARs and restricted/performance share units. Cash-denominated awards such as performance units are not accounted for as share-based payments, unless the awards are in some way based on or settled in the company’s stock. As noted above, equity awards may be reclassified as liability awards if the company exhibits a pattern of cash settlement, withholds shares for taxes in excess of maximum individual statutory rates, or permits an “invalid” broker-assisted cashless exercise.

FASB ASC Section 718-10-35 (Section 718-10-35) provides that an award granted for past or future grantee services remains subject to the measurement and recognition provisions of Topic 718 for the entire existence of the award, unless the award is subsequently modified when the award is vested and the grantee is no longer providing goods or services. The only exception is in the rare instance a nonemployee award contains a convertible debt or equity feature. In that case, the award would be subject to other applicable accounting rules upon vesting. Section 718-10-35 provides that, solely for purposes of that Section, a modification does not include changes to grantees’ outstanding award terms in connection with an equity restructuring provided (1) there is no increase to the awards’ fair value, *or* the ratio of intrinsic value to exercise price is preserved (that is, the equity holder is “made whole”), *or* the modification is not done in contemplation of the restructuring, *and* (2) all equity holders are treated similarly.

Section 718-10-35 further provides that a cash settlement feature of a stock option or SAR that can be exercised only upon the occurrence of a contingent event that is outside the grantee’s control (such as a change-in-control or initial public offering) does not result in liability classification until it becomes probable the event will occur. If and when a contingent event becomes probable of occurrence, the reclassification is accounted for as a modification from an equity to liability award. This guidance is consistent with required treatment for other equity awards, such as restricted stock and performance shares (or stock-settled share units).

Compensation Cost for Equity Awards

In General – Compensation cost is based on the award’s fair value at grant, less the amount (if any) paid by the award recipient, with a corresponding credit to equity (generally, paid-in capital). The date of grant occurs when there is a mutual understanding of the award’s key terms and conditions, the company becomes contingently obligated to issue equity or transfer assets, and all necessary approvals are obtained. That is, the grantee begins to benefit from, or be adversely affected by, subsequent changes in stock price. FASB ASC Section 718-10-25 provides that a mutual understanding of the award’s key terms and conditions is presumed to exist on the relevant approval date, provided those key terms and conditions are not negotiable by the grantee and are communicated to recipients within a “relatively short time period.”

Full-Value Awards – Compensation cost for full-value awards such as restricted stock and performance shares (or share units payable solely in stock) is based on the market value of the underlying stock at the date of grant. Dividends or dividend equivalents (if any) paid during the vesting or performance period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited and the dividends are not repaid. Compensation cost for a dividend-paying company that grants non-dividend-paying awards is reduced by the present value of estimated forgone dividends over the vesting period.

Appreciation Awards – Compensation cost for appreciation awards such as stock options or stock-settled SARs is estimated at grant date using an option-pricing model taking into account at a minimum the six traditional inputs identified below, assuming observable market prices are not available (refer to *Option-Pricing Model Inputs* below). Permissible option-pricing techniques include a “lattice” model such as a binomial model, a “closed form” model such as the Black-Scholes-Merton formula, and a “Monte Carlo” simulation technique. Topic 718 does not explicitly mandate a specific option-pricing model, but states that a lattice model “more fully reflects the substantive characteristics” of grantee stock options and should be used if it produces a better estimate of fair value.

The SEC staff in Section 718-10-S99 acknowledges that fair value estimates cannot predict actual future events and provides comfort to companies that, so long as the estimates are made in good faith, they will not be subsequently questioned no matter what the actual outcome. The SEC staff will not object to a company's choice of option-pricing model provided it meets Topic 718's three-pronged requirements that the valuation technique (1) is consistent with the fair value measurement objective, (2) is based on established principles of financial economic theory, and (3) reflects all substantive characteristics of the award. So long as fair value estimates are prepared by a person with “requisite expertise,” it is not a requirement that companies must hire an outside third party to assist in the valuation. Further, it is permissible to use different valuation techniques for awards with different characteristics, and to change valuation techniques without being considered a change in accounting principle (although the SEC staff does not expect companies to frequently switch between valuation techniques). Appropriate disclosure of any change in valuation technique should be made in financial statement footnotes (refer to *Footnote Disclosures* below).

Option-Pricing Model Inputs – Topic 718 provides extensive guidance for companies when selecting option-pricing model inputs, and states that estimates should be reasonable, supportable, and determined in a consistent manner from period to period. The FASB and SEC staff guidance is briefly summarized below:

Current stock price:	• Market value of underlying stock at measurement date (grant date for equity awards, and end of each reporting period until settlement for liability awards)
Exercise price of option:	• At-the-money, premium, or discount exercise price inputs (for indexed exercise prices, refer to <i>Compensation Cost for Other Design Features</i> below)
Expected term of option:	• Based on contractual term, vesting period (expected term must at least include the vesting period), expected early exercise and post-vesting employment termination behavior, expected volatility, black-out periods, and grantee age, length of service, and location demographics;

	<p>expected term is a direct input in a closed-form model, and is inferred based on the output of a lattice model</p> <ul style="list-style-type: none"> • The SEC staff in Section 718-10-S99 provides additional guidance for companies when estimating an option's expected term. In general, companies are not allowed to consider additional term reductions for nonhedgability, nontransferability, or forfeitures, and the option term cannot be shorter than the vesting period. Companies are permitted to use historical stock option exercise experience to estimate expected term (with as few as one or two relatively homogenous grantee groupings) if it represents the best estimate of future exercise patterns. • The SEC staff in Section 718-10-S99 provides a "simplified method" to estimate expected term for "plain-vanilla" stock options that is calculated as the vesting period plus the original contractual option term divided by two. The SEC will continue to accept use of the simplified method on an interim basis, provided a company concludes that its own historical option exercise experience does not provide a reasonable basis for estimating expected term • Accounting Standards Update (ASU) 2016-09 provides that nonpublic companies are permitted to make an entity-wide accounting policy election to use the simplified method for awards with a service-vesting condition, awards with a performance-vesting condition that is probable of attainment, and awards with a performance-vesting condition that is not probable of attainment but there is an explicit service period. For awards with a performance-vesting condition that is not probable of attainment and no explicit service period, companies are to use the maximum contractual term. The election applies solely to stock options that are granted at-the-money, have limited post-termination exercise terms of no more than 90 days, are subject to anti-sale and hedging provisions, and do not have market vesting conditions
Risk-free interest rate(s):	<ul style="list-style-type: none"> • Implied yield(s) on U.S. Treasury zero-coupon issues, using yield curve over contractual option term for lattice models and current yield with remaining term equal to expected option term for closed-form models (special guidance is provided for jurisdictions outside the U.S.)
Expected stock price volatility:	<ul style="list-style-type: none"> • Generally based on historical price observations commensurate with contractual term for lattice models or expected term for closed-form models, as adjusted for supportable future expectations; other factors to consider in estimating volatility include, "mean reversion" tendencies, "implied" volatility of traded options or convertible debt (if any), "term structure" of expected volatility (if using a lattice model), and expected volatility of similar companies (for newly public or nonpublic companies) • Nonpublic companies may use the historical volatility of an appropriate industry index in certain situations (refer to <i>Compensation Cost for Nonpublic Companies</i> below) • The SEC staff in Section 718-10-S99 provides extensive guidance on how companies should estimate expected volatility, particularly in regard to historical and implied volatility. In general, historical volatility should be measured on an unweighted basis over a period equal to or longer than the expected option term for closed-form models or contractual option term for lattice models based on daily, weekly, or monthly stock price observations. Future events should be considered to the extent other marketplace participants would likely consider them, and prior periods may be excluded in rare circumstances. Implied volatility is based on the market prices of a company's traded options or other financial instruments with option-like features, and can be derived by entering the market price of the traded option into a closed-form model and solving for the volatility input. The SEC staff believes that companies with actively traded options or similar financial instruments generally should consider implied volatility, and even place greater or exclusive reliance on it, taking into consideration (1) volume of market activity, (2) synchronization of variables, and (3) similarity of exercise prices and option terms. Section 718-10-S99 also provides guidance for companies that wish to place exclusive reliance on either historical or implied volatility, and for newly public companies. Appropriate disclosure of the method used to estimate expected volatility should be made in the Management's Discussion and Analysis (MD&A) section of public filings
Expected dividends on stock:	<ul style="list-style-type: none"> • May be input as either an expected yield or dollar amount, taking into account supportable future expectations based on publicly available information (no single method of estimating fair value is specified for dividend-paying stock options and SARs)

When selecting option-pricing model inputs, the FASB instructs companies to use an *average* of the range of estimates when no amount within the range is more or less likely to occur, and cautions companies that unadjusted historical data may not be appropriate if future expectations are reasonably expected to differ from past experience.

Not Possible to Estimate Fair Value – In the rare event that a company determines it is not possible to reasonably estimate fair value at grant date, Topic 718 requires equity awards to be accounted for at intrinsic value until award settlement (that is, variable intrinsic value accounting), even if fair value can be reasonably estimated at a subsequent date.

Compensation Cost for Liability Awards

Topic 718 requires liability awards to be calculated at fair value using the same methodology as for equity awards, except that fair value is remeasured at the end of each reporting period until award exercise or settlement (that is, variable fair value accounting), and the corresponding credit is a liability as opposed to equity. Thus, compensation cost for full-value awards is remeasured each period based on the market value of the underlying stock until award vesting or settlement. Likewise, compensation cost for appreciation awards is remeasured each reporting period using an option-pricing model until final measurement at intrinsic value upon award exercise or settlement. Topic 718 does not explicitly address dividend equivalents that are paid on liability awards, but accountants opine that all dividend equivalents paid on liability award should be accounted for as additional compensation cost, consistent with the requirements of FASB ASC Topic 480 (Distinguishing Liabilities from Equity).

Compensation Cost for Nonpublic Companies

Equity Awards – Topic 718 requires nonpublic companies to value equity awards using the same grant-date fair value methodology that applies for public companies, unless it is not possible to calculate a reasonable fair value because of the inability to estimate expected volatility. In that case, nonpublic companies are instructed to calculate fair value using the historical volatility of an appropriate industry index (as opposed to a broad market index such as the *S&P 500*) as an input to the option-pricing model, and to appropriately disclose that index and how it was selected (referred to as the “calculated value” method). If a nonpublic company subsequently becomes public, the SEC staff in Section 718-10-S99 provides that stock options valued under the calculated value method prior to becoming public should continue to be valued under that method after becoming public, unless the awards are subsequently modified, repurchased, or canceled. This methodology should be applied consistently to both employee and nonemployee awards.

Nonpublic companies must estimate the expected term of stock options in the same manner as public companies. ASU 2016-09 provides that nonpublic companies are permitted to make an entity-wide accounting policy election to use the simplified method discussed above for awards with a service condition, awards with a performance condition that is probable of attainment, and awards with a performance condition that is not probable of attainment but there is an explicit service period. For awards with a performance-vesting condition that is not probable of attainment and no explicit service period, companies are to use the maximum contractual term. Expected term under the simplified method is calculated as the midpoint between the vesting date and the maximum contractual term. The election applies solely to stock options that are granted at-the-money, have limited post-termination exercise terms of no more than 90 days, are subject to anti-sale and hedging provisions, and do not have market vesting conditions. If a nonpublic company uses the simplified method to calculate the expected exercise term for employee awards, it must also do so for nonemployee awards. However, ASU 2018-07 provides that nonpublic companies are permitted on an award-by-award basis to elect to use the maximum contractual exercise term in lieu of the otherwise required expected exercise term for awards granted to nonemployees.

ASU 2021-07 provides that nonpublic companies are permitted to make an election to use a simplified method for determining the current price of its underlying share for the purposes of determining the fair value of an equity award granted to employees and nonemployees. The standard outlines factors of a reasonable valuation method, similar to existing fair value measurement standards within ASC 820-10-55-3. Additionally, it allows the use of any of the following three valuation safe harbors described in the “presumption of reasonableness” under Treasury Regulation Section 1.409A-1(b)(5)(iv)(B):

- A valuation determined by an independent appraisal within the 12 months preceding the grant date
- A valuation based on a formula that, if used as part of a non-lapse restriction with respect to the shares, would be considered the fair market value of the shares
- A valuation made reasonably and in good faith that is evidenced by a written report that considers the relevant factors with respect to the illiquid stock of a start-up corporation, as defined in the regulations

Under ASU 2021-07, the valuation is not considered reasonable if it was calculated more than 12 months earlier than the date it is being used, or if the valuation fails to reflect material information available after the date of the calculation. The election is made on a measurement-date-by-measurement-date basis and is required to be disclosed in the financial statement’s footnotes.

Liability Awards – Topic 718 allows nonpublic companies to make an accounting policy decision as to whether to measure all liability awards at “preferable” fair value (or calculated value if it is not possible to estimate expected volatility) or intrinsic value until award settlement. Because the fair value method is regarded as preferable, once companies begin using it they generally may not revert to the intrinsic value method. Notwithstanding the previous sentence, ASU 2016-09 provides companies with an additional one-time accounting policy election to switch from measuring liability awards at fair value to intrinsic value. If a nonpublic company subsequently becomes public, the SEC staff in Section 718-10-S99 provides that equity compensation liabilities valued under the intrinsic value method prior to becoming public should be measured at fair value subsequent to becoming public. ASU 2018-07 provides that nonpublic companies are required to change measurement of all liability awards granted to nonemployees from fair value to intrinsic value if awards to employees are measured that way.

Compensation Cost for Other Design Features

Topic 718 provides extensive guidance on the treatment of other shared-based payment design features, which is briefly summarized below:

Mature Shares – There is no concept of “old-and-cold” or “mature” shares under Topic 718, other than for determining liability award classification for puttable or callable repurchase provisions that can occur less than 6 months after option exercise or share vesting. Thus, “immaculate exercises” or “pyramiding” in connection with stock-for-stock exercises do not adversely affect the measurement or recognition of compensation cost.

Reload Stock Options – The “reload” feature is not directly considered when estimating grant-date fair value, although the feature may be indirectly considered via a shorter expected term assumption because reloads are designed to encourage early option exercise. Rather, each reload grant is accounted for as a separate award resulting in incremental compensation cost for each reload grant.

Clawback Provisions – Contingent features such as “clawback provisions” that may cause the recapture of equity compensation profits are not considered when estimating grant-date fair value. Rather, such features are accounted for *only if and when* the contingent event occurs by recognizing a credit to income equal to the lesser of the consideration recovered or previously recognized compensation cost. Clawback provisions that are triggered by objectively determinable events (such as a financial restatement) should not cause a delay in the grant date, but clawback provisions that are triggered solely by discretion could result in a delayed measurement date until there is a mutual understanding of the key terms and conditions of the award.

Indexed and Step Exercise Prices – The guidance for valuation of stock options with an “indexed” (exercise price varies with a market index) or “stepped” (exercise price increases by constant percentage) exercise price requires a leap of statistical faith. Indexed stock options may be valued by substituting “cross-volatility” (the relationship between the volatility of the company’s stock and the volatility of the index stocks) for the company’s volatility, and by substituting the dividend yield on the index stocks for the risk-free interest rate assumption. Stepped exercise price stock options may be valued using lattice models adapted for such features, or by deducting from the risk-free interest rate the annual percentage increase in exercise price.

Tandem and Combination Awards – A tandem award consists of two or more grant types in which the exercise or vesting of one cancels the other(s). A combination award also consists of two or more grant types, but each award can be separately exercised. Valuation complexities with these types of arrangements can arise when there are differing grant types, such as equity versus liability awards and appreciation versus full-value awards.

Restrictions After Vesting – Restrictions on vested shares such as stock ownership guidelines or mandatory holding periods should have “little or no effect” on grant-date fair value for actively traded stocks.

Noncompete Agreements – Depending on the facts and circumstances, certain legally enforceable noncompete provisions may be substantive service conditions requiring the recognition of compensation cost over that period (even if the awards are fully vested at grant).

Book Value Plans – Book value share purchase plans are generally treated as liability awards for public companies (because they are generally indexed to something other than the company’s stock price), and as equity awards for nonpublic companies (with compensation cost recognized for any discount from book value).

Share-Based Payments to Customers – Some companies grant share-based payments to their customers to incentivize additional payments from those customers. Companies are required to account for these share-based payments under ASC Topic 606 as a reduction of revenue, similar to other sales incentives such as coupons and rebates. ASU 2019-08 provides that the amount recorded as a reduction in revenue be measured based on the grant-date fair value provisions of Topic 718.

Vesting Conditions

In General – Topic 718 distinguishes between service, performance, and market conditions for purposes of determining (1) the fair value of an award, (2) the period over which compensation cost is recognized (refer to *Recognizing Compensation Cost* below), and (3) whether previously recognized compensation cost can be reversed if an award fails to vest. If a vesting condition is something other than a service, performance, or market condition (Topic 718 uses as an example vesting or exercise price indexed to the value of a commodity), the share-based payment arrangement is classified as a liability award taking into consideration the non-service/performance/market condition(s) in the estimate of fair value.

Service and Performance Conditions – A service condition is defined solely by reference to an grantee rendering services to the company, including accelerated vesting conditions in event of death, disability, or termination without cause. A performance condition is dependent on both the grantee rendering services and the attainment (by the grantee or company) of a specified performance target(s) defined solely by reference to the company’s operations, either on an absolute basis or relative to other companies (including events such as an initial public offering or change in control). Service and performance conditions that affect vesting are not considered when estimating grant date fair value. Rather, previously recognized compensation cost is reversed if the service or performance conditions are not satisfied and the award is forfeited. Conversely, service and performance conditions that affect factors other than vesting (such as exercise price, number of shares, or contractual term) are considered when estimating grant date fair value by considering each possible outcome. For example, if the number of shares may double or the exercise price be halved based on a performance condition, the fair value of the award is estimated for each possible outcome and initially accrued based on the most probable outcome (refer to *Recognizing Compensation Cost* below).

Market Conditions – A market condition is defined as a condition affecting exercise price, exercisability, or any other factor used in estimating fair value that relates to the attainment of a specified stock price or amount of intrinsic value (including, presumably, total shareholder return), either on an absolute basis or relative to other companies. Market conditions are always considered when estimating fair value. However, previously recognized compensation cost is not reversed if the grantee satisfies the requisite service period but the award is nevertheless forfeited because the market condition is never satisfied (refer to *Recognizing Compensation Cost* below). Conversely, previously recognized compensation cost is reversed if the grantee fails to satisfy the requisite service period, unless the market condition is satisfied prior to the award forfeiture.

Recognizing Compensation Cost

Requisite Service Period – Topic 718 introduces the notion of “requisite service period” for determining the period over which compensation cost should be recognized. The requisite service period may be explicit, implicit, or derived, as follows:

Explicit:	• Explicitly stated in the award agreement
Implicit:	• May be inferred from service or performance conditions
Derived:	• Derived from valuation of a market condition when estimating fair value

Topic 718 provides complex guidance for determining the requisite service period, which can be deciphered as follows:

- If an equity award includes no substantive service, performance, or market conditions, the entire amount of measured compensation cost is recognized at grant date, such as an award granted to a retirement-eligible grantee that includes an explicit service period (for example, the award vests after 3 years of service) but provides for accelerated or continued vesting upon retirement
- Nonsubstantive explicit vesting provisions (or the acceleration of explicit vesting provisions) are ignored when estimating the requisite service period for deep “out-of-the-money” stock options that are deemed to have a market condition derived service period
- If a vesting condition requires the performance of future services, the initial estimate of the requisite service period is presumed to be the vesting period (unless there is clear evidence to the contrary), and cannot be a prior period
- If service condition vesting may be accelerated by a performance condition that is probable of attainment, the initial estimate of the requisite service period is based on the shorter performance period (otherwise, vesting is based on the service period)
- If vesting is based on *both* market *and* service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the *longest* measurement period
- If vesting is based on *either* market *or* service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the *shortest* measurement period
- If the terms of an equity award provide for a performance target that can be achieved after the requisite service period, the performance target is treated as a performance condition that affects vesting

Companies are to base initial accruals of compensation cost on the initial estimate of the requisite service period. If the initial estimate of the requisite service period is based on service or performance conditions, companies are to revise that estimate and recognize remaining compensation cost *prospectively* if subsequent information indicates a different measurement period is more appropriate. Conversely, if the initial estimate of the requisite

service period is based on market conditions, that estimate is generally not revised unless the market conditions are satisfied prior to the end of the initial measurement period.

Accrual of Compensation Cost – Compensation cost begins to be recognized on what is referred to as the “service inception date,” which is usually the grant date but in certain circumstances may precede or be subsequent to the date of grant (but can never be prior to receiving all necessary approvals, such as compensation committee or shareholder approval). The service inception date precedes the grant date if an authorized award contains either (1) no substantive future service conditions subsequent to grant date, or (2) market or performance conditions that if not satisfied during the service period preceding (and following, if applicable) the grant date results in forfeiture of the award. For example, if nonvested awards that cliff vest after 2 years are granted as consideration for the prior year annual incentive payment, compensation cost is recognized over the 3-year period beginning with the annual incentive plan year and including the 2-year vesting period. Compensation cost is recognized ratably over the requisite service period based on the number of awards that are expected to vest due to a service condition and/or the “probable outcome” of a performance condition, with *cumulative adjustments* in later periods to the extent actual forfeitures differ from prior period estimates. FASB ASC Topic 450 (Contingencies) defines probable as “the future event(s) are likely to occur,” which in practice is generally interpreted as in excess of a 70 percent likelihood of occurrence.

For awards with only a service condition, ASU 2016-09 provides that companies are permitted to make an entity-wide accounting policy election to either estimate forfeitures with subsequent true-up to actual experience, or recognize forfeitures as they occur. This election can be different for awards granted to employees and nonemployees. This election is not permitted for awards with performance conditions. For awards with only a service condition that is based on a “graded” (as opposed to “cliff”) vesting schedule, companies are to make a policy decision as to whether to recognize compensation cost ratably over the service period or on a more complex accelerated accrual basis that assumes each vesting tranche is a separate award. This policy decision is *not* dependent on how the company estimates fair value for the award (such as using tranche-specific option lives in a lattice model), and neither approach is regarded as preferable. This election is not permitted for awards with performance conditions, which are required to use the more complex accelerated accrual methodology that treats each vesting tranche as a separate award. Regardless of which method is chosen, the amount of compensation cost recognized at any date must at least equal the vested portion of the award.

Option Expires Unexercised – Previously recognized compensation cost is not reversed if a vested stock option or stock-settled SAR expires unexercised, such as when the award is “underwater.”

Award Modifications, Cancellations, and Settlements

Modifications – In general, modifications are relevant only in regard to equity awards because the final measure of compensation cost for liability awards does not occur until the awards are vested or exercised, regardless of whether the awards are modified or not. ASU 2017-09 defines a modification as a change to an award’s terms or conditions, other than a change that does not affect an award’s fair value (or calculated value or intrinsic value if applicable), service, performance, or market vesting conditions, and equity/liability classification. Examples of changes not considered to be modifications include changes that are administrative in nature (such as a change in company name, address, or plan name), or changes to an award’s net settlement provisions related to tax withholdings that do not affect the classification of the award. Examples of changes considered to be modifications include changes that affect fair value, vesting conditions, or equity/liability classification, such as changes to the number of shares, exercise price, transferability, or vesting/settlement provisions. Also included as modifications are certain “inducements” to encourage option exercises, and exchanges of awards in connection with a business combination (refer to *Business Combinations* below) or changes to award terms in connection with a nonreciprocal equity restructuring (such as a stock dividend, stock split, spinoff, rights offering, or large nonrecurring cash dividend).

In regard to nonreciprocal equity restructurings, Topic 718 states that changes to the terms of an award in accordance with properly structured “antidilution provisions” generally should not result in additional

compensation cost, provided such provisions are *contractually mandated* and not entered into in contemplation of an equity restructuring. Conversely, antidilution provisions that are *discretionary* or entered into in contemplation of an equity restructuring could result in significant incremental compensation cost. In practice, companies likely will continue to rely on a methodology that does not increase the aggregate intrinsic value or reduce the ratio of exercise price to market price of the award, because to do otherwise may be problematic with rules dealing with incentive stock options (ISOs), nonqualified deferred compensation, and stock exchange listing standards.

At a minimum, compensation cost is *always* recognized for the original grant date fair value of the equity award, unless at the modification date the original service or performance conditions are not expected to be satisfied. In addition, compensation cost is recognized for any incremental fair value (or intrinsic value, if applicable) resulting from the modification, measured as the difference between the estimated fair value of the modified award and the original award at the modification date. Modifications that relax a service or performance (but not market) vesting condition that was not probable of attainment at the modification date result in a final measure of compensation cost equal to the fair value of the award at the modification date, as summarized below:

Modifications to Service and Performance Vesting Conditions	
<p>Type I Modifications Probable to Probable</p> <p style="text-align: center;">-- and --</p> <p>Type II Modifications Probable to Improbable (not likely to be common)</p>	<ul style="list-style-type: none"> • Awards <i>are</i> expected to vest under original service or performance conditions at modification date • Modification does <i>not</i> result in incremental compensation cost • Original grant date fair value is recognized as compensation cost if awards ultimately vest under original or modified conditions
<p>Type III Modifications Improbable to Probable (likely to be common)</p> <p style="text-align: center;">-- and --</p> <p>Type IV Modifications Improbable to Improbable</p>	<ul style="list-style-type: none"> • Awards are <i>not</i> expected to vest under original service or performance conditions at modification date • Modification results in final measure of compensation cost equal to fair value of award at modification date • Compensation cost recognized only if award vests under the modified vesting conditions (original vesting conditions are no longer relevant)

Cancellations – Cancellation of an award accompanied by the concurrent grant of a replacement award (or other valuable consideration) is accounted for as a modification. Cancellation of an award *not* accompanied by the concurrent grant of a replacement award is accounted for as a repurchase for no consideration. Accordingly, there is no reversal of previously recognized compensation cost, and any previously measured but unrecognized cost is accelerated at the cancellation date.

Settlements – The amount of cash or other assets paid to repurchase an equity award is accounted for as a reduction in equity, provided the repurchase amount does not exceed the fair value of the award at the repurchase date. Any excess of the repurchase price over the fair value of the award at repurchase is recognized as additional compensation cost. Settlement of a nonvested award results in the recognition of previously measured but unrecognized compensation cost.

Business Combinations

As stated above, Topic 718 requires that exchanges of equity or liability share-based payment awards in connection with a business combination should be accounted for as modifications. Accordingly, the acquirer should measure both the replacement awards granted by the acquirer and the replaced acquiree awards as of the acquisition date in accordance with Topic 718. FASB ASC Topic 805 (Business Combinations) provides that if an acquirer is not contractually obligated to replace outstanding acquiree awards but nevertheless chooses to do so, the fair value of the acquirer’s replacement awards is allocated entirely to postcombination compensation

cost. If an acquirer is contractually obligated by the purchase agreement (or otherwise) to replace outstanding acquiree awards, the fair value of the acquirer's replacement awards (regardless of whether equity or liability awards) is allocated between purchase price consideration and postcombination compensation cost, as described below.

The portion of the acquirer's replacement awards that is allocated to purchase price consideration is equal to the fair value of the replaced acquiree awards multiplied by the ratio of the precombination grantee service period to the greater of the "total service period" or the original service period of the replaced acquiree awards. The total service period is the sum of the requisite service period for the replaced acquiree awards completed prior to the acquisition date and any postcombination requisite service period for the acquirer's replacement awards, taking into consideration any explicit, implicit, and derived service periods in accordance with Topic 718.

The portion of the acquirer's nonvested replacement awards that is allocated to postcombination compensation cost is equal to the fair value of the acquirer's replacement awards less the portion attributable to precombination grantee services, including any excess of the fair value of the acquirer's replacement awards over the replaced acquiree awards. The portion of the acquirer's nonvested replacement awards attributable to precombination and postcombination grantee services should be recognized net of estimated forfeitures.

Events that occur subsequent to the acquisition date, such as forfeitures, modifications, changes in liability award fair value, or the ultimate outcome of performance awards, do not affect the purchase price. Rather, such events are recognized through adjustments to compensation cost and income tax expense in accordance with Topic 718 during the postcombination period.

Income Tax Effects

Topic 718 requires fair value (or calculated or intrinsic value) compensation cost to be recognized net-of-tax for share-based payments that normally give rise to tax deductions, such as nonqualified stock options. Conversely, compensation cost is not tax effected for awards that normally are not tax deductible, such as the exercise of an ISO without a related disqualifying disposition.

If the deduction reported on the company's tax return is *more* than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise exceeds fair value at grant), the effect of the "excess tax benefit" is recognized as a decrease to income tax expense on the income statement and commingled with other income tax cash flows as an operating activity on the statement of cash flows. Excess tax benefits are recognized on the income statement regardless of whether the tax benefit reduces taxes payable in the current period (because of, for example, a net operating loss). If the deduction reported on the company's tax return is *less* than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise is less than fair value at grant), the effect of the tax deficiency is recognized as an increase to income tax expense on the income statement. The tax effects of exercised or vested awards are discrete items in the reporting period in which they occur, and they are not considered when determining the annual estimated effective tax rate.

Earnings per Share

FASB ASC Topic 260 (Earnings per Share) requires that share-based payments be treated as "potential common shares" in computing diluted earnings per share (EPS), based on the actual number of equity awards granted and still outstanding, unless doing so would be "antidilutive." Stock options and nonvested awards are included in diluted EPS using the "treasury stock method," which assumes that all awards are exercised or converted at the *beginning* of the reporting period (or at actual issuance, if later), and the proceeds received from such hypothetical exercise or conversion are applied to repurchase outstanding common stock at the *average* market price during the period. "Proceeds" resulting from the assumed exercise include not only the exercise price, but also any unrecognized compensation cost. Equity compensation that is subject to a performance or market condition (such as earnings or stock price goals) are treated as "contingently issuable shares" and are included

in diluted EPS via the treasury stock method *only if and when* the relevant performance criteria are currently being satisfied, assuming the end of the reporting period is the end of the performance period.

Footnote Disclosures

The objective of Topic 718’s footnote disclosure requirements is to enable financial statement users to understand the nature and terms of share-based payments, the method of estimating fair value, and the effect of compensation cost on the income and cash flow statements. To this end, Topic 718 sets forth the following “minimum disclosure requirements” and reminds companies that they may disclose supplemental information if it is useful to users and does not lessen the prominence and credibility of the minimum required disclosures:

- Description of general terms and substantive conditions of share-based payments, such as requisite service periods, vesting schedules, maximum contractual terms, number of shares authorized, and methods used for measuring compensation cost
- Description of the company’s policy (if any) for issuing shares upon option exercise or share unit conversion (and the source of those shares), and an estimate of the number of shares expected to be repurchased during the *following* annual period in connection with its equity compensation programs
- The following information for *each year* an income statement is presented:

Each Year for Which an Income Statement is Presented			
	Year 1	Year 2	Year 3
Expected volatility	} Must disclose the assumption input (or range of inputs), the method used to estimate the input, and the method used to estimate fair value; a nonpublic company that uses the calculated value method must disclose why it cannot estimate its own volatility, the industry sector index it selected, and the rationale for selecting it		
Expected dividends			
Expected exercise term			
Risk-free interest rates			
Discount for post-vesting restrictions (if any)			
Weighted-average grant-date fair value (or calculated or intrinsic value)			
Total intrinsic value of options exercised			
Total intrinsic value of share-based liabilities paid			
Total fair value of shares vested			
Total compensation cost recognized in income			
Total recognized tax benefit			
Total compensation cost capitalized			
Description of significant award modifications			
Total amount of cash received from option exercise	} If not separately disclosed elsewhere		
Total tax benefit realized from option exercise			
Total amount of cash paid to settle equity awards			

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

- The following information for the *most recent* fiscal year:

Most Recent Fiscal Year Stock Option Activity	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value except for nonpublic companies	Total Unrecognized Compensation Cost Related to Nonvested Awards	Weighted- Average Period Over Which Cost is Expected to be Recognized
Outstanding at beginning of year					--	--
Granted			--	--	--	--
Exercised			--	--	--	--

Forfeited or expired			--	--	--	--
Outstanding at end of year						
Vested and expected to vest (or nonvested awards if forfeitures are recognized as they occur)					--	--
Exercisable at end of year					--	--

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

Most Recent Fiscal Year Nonvested Share Activity	Number of Shares	Weighted-Average Grant-Date Fair Value (or Calculated or Intrinsic Value)	Total Unrecognized Compensation Cost Related to Nonvested Awards	Weighted-Average Period Over Which Cost is Expected to be Recognized
Nonvested at beginning of year			--	--
Granted			--	--
Vested			--	--
Forfeited			--	--
Nonvested at end of year				

-- Information should be disclosed separately for different types of awards to the extent it would increase understandability

The SEC staff In Section 718-10-S99 further provides that companies may disclose the amount of non-cash equity compensation cost included in specific line items in financial statements, footnotes, or within MD&A. In addition, companies may disclose non-GAAP financial measures such as net income excluding equity compensation cost within MD&A, provided they are accompanied with appropriate descriptive disclosures. However, pro forma presentations excluding equity compensation cost are prohibited.

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General questions about this summary can be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by email at tmhaines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com.