

# Accounting for Executive Compensation

## The Basics

The exchange of services for equity creates an accounting expense that must be recognized in the income statement. ASC topic 718 (formerly SFAS 123R) is the rule that governs expensing of all stock-based compensation. The expense realized is based on a “fair value” determined at the date of grant. This fair value is then amortized over the “requisite service period” which is typically the vesting period.

### What are the key terms in ASC Topic 718?

**Fair Value**—The value attributed to a compensation award. For equity awards, this is the amount expensed over the vesting period.

**Liability Award**—An award where the participant can demand cash or the employer can choose between cash and stock and establishes a pattern of paying in cash (examples: cash performance units, Stock Appreciation Rights payable in cash).

### What are the basic rules of ASC Topic 718?

#### *Fair Value Awards*

The fair value is defined differently for different types of awards:

- For restricted stock with time-based vesting, the fair value equals the stock price on grant date.
- For stock options or stock-based stock appreciation rights with time-based vesting, the fair value is generally estimated using a Black-Scholes or similar model.
- For awards with vesting tied to performance, the determination of fair value depends on the metric:
  - If the metric is a “market condition” (i.e., tied to stock price or shareholder return), the market condition is incorporated into the estimate of the fair value, often using a Monte Carlo simulation. The fair value is expensed over the vesting period and not adjusted for performance.
  - If the metric is a “performance condition” (e.g., EPS performance), the fair value per share is calculated excluding the performance condition. The fair value is expensed over the vesting period and the number of shares expensed is adjusted based on the estimated number of shares to vest.

#### *Liability Awards*

- For non-liability awards, the fair value of the award is estimated at the grant date and is expensed over the vesting period.
- For liability awards, a liability equal to the aggregate fair value is booked with the fair value adjusted each quarter based on current conditions (i.e., variable accounting) until the award is paid.
- The number of shares expensed is reduced for estimated forfeitures during the vesting period; the estimate is adjusted for actual forfeitures during the vesting period.

## The Details

### Summary of Accounting for Key Long-Term Incentive Vehicles

Vehicle	Paid in Stock	Paid in Cash
Stock Options	Fixed expense calculated at grant date using valuation model (e.g., Black-Scholes) and accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	N/A
Stock Appreciation Rights	Fixed expense calculated at grant date using valuation model (e.g., Black-Scholes) and accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly until exercise as fair value changes; mark to fair value accounting
Restricted Stock (time-based)	Fixed expense based on share price at grant date accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly throughout vesting period as stock price changes; mark to fair value accounting
Performance Plan (market condition)	Fixed expense calculated at grant date taking into account the market condition and accrued over performance period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period. No reversal of previously recognized expense for awards where performance has eliminated payout.	Expense adjusted quarterly throughout performance period as performance changes; mark to fair value accounting
Performance Plan (non-market condition)	Expense estimated at grant date and accrued over performance period. Expense adjusted quarterly for changes in the number of shares (but not stock price). Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly throughout performance period as performance changes; mark to fair value accounting

**Note:** if company has ability to pay award in cash or stock, company and its auditors will need to determine whether to account for it as stock or cash award based on past history.