



Stock Appreciation Rights Fundamentals

Description

A stock appreciation right (SAR) entitles an employee to the appreciation in value of a specified number of shares of employer stock over an “exercise price” or “grant price” over a specified period of time.

Key Features

Base Price

The base price generally is equal to the underlying stock’s fair market value on the date of grant.

Vesting

Typically, a SAR will vest upon the completion of a time-based service requirement (e.g., 3- to 5-year graded service-based vesting). However, the right to exercise a vested SAR may be subject to satisfaction of a performance condition (e.g., EPS or ROE) or market condition (e.g., stock price change or total shareholder return vs. peers).

Exercise Period

Typically, a vested SAR may be exercised, in whole or in part, at any time during the period commencing on the date of vesting and ending on the SAR’s expiration date.

Settlement

Upon exercise, an SAR may be paid in cash (e.g., cash-settled SAR) or stock (e.g., stock-settled SAR) or a combination of the two. Value of cash or stock settlement based upon appreciation of underlying stock over base price.

Term

Generally, a SAR expires seven to ten years from the date of grant, after which time the SAR may no longer be exercised.

Shareholder Approval

- **NYSE and NASDAQ listing requirements**—An equity plan under which SARs may be granted must be approved by shareholders pursuant to stock exchange listing rules. No shareholder approval is required if SARs must be settled in cash.
- **162(m) requirements**—Shareholder approval of the material terms of a SAR grant is required for SARs to qualify as “performance-based” compensation for purposes of IRC Section 162(m) and, therefore, to not be subject to the \$1 million deduction cap applicable to nonperformance-based compensation. Note: Additional requirements must be satisfied for a SAR to qualify as “performance-based” compensation.

Federal Tax Considerations

To Employee

The following tax consequences assume the SAR is exempt from IRC Section 409A (see discussion below).

- **At grant.** No tax consequences.
- **At vesting.** No tax consequences.
- **At exercise.** “Spread” is taxable as ordinary income when paid. Spread is equal to the excess of share price on date of exercise over exercise price multiplied by number of shares subject to the exercised SAR.
- **At sale.** If shares received upon exercise of the SAR are later sold, then any gain or loss on the sale of shares (i.e., post-exercise share price appreciation or depreciation) is taxable as short- or long-term capital gain or loss, depending on how long the shares have been held.

To Employer

The following tax consequences assume the SAR is exempt from IRC Section 409A (see discussion below).

- **Deduction timing and amount.** The employer may take a tax deduction in the amount and at the time the employee realizes ordinary income upon option exercise of SAR.
- **162(m) implications.** IRC Section 162(m) denies deduction for compensation in excess of \$1 million paid to CEO and other top paid three executive officers (excluding CFO), unless “performance-based” (see discussion above regarding shareholder approval).

Accounting Treatment

Note: The following discussion ignores forfeiture rates and expected tax benefits

Stock-Settled SAR (*Time Vested*)

- The SAR’s grant date “fair value” is amortized over the SAR’s requisite service period (e.g., typically the vesting period).
- “Fair value” is determined using an option pricing model (e.g., Black-Scholes or binomial model).
- Any recognized compensation cost may not be reversed after requisite service has been rendered. In addition, no previously recognized compensation cost may be reversed if a vested SAR expires unexercised.
- Previously recognized compensation cost should be reversed if SAR is forfeited due to employee’s failure to satisfy service requirement.

Stock-Settled SAR (*Performance Condition*)

- Each reporting period, the number of SARs expected to vest is predetermined and the grant date “fair value” of these SARs is amortized over the remaining requisite period less amounts previously recognized.
- “Fair value” is determined using an option pricing model (e.g., Black-Scholes or binomial model).
- At the end of the requisite service period, compensation cost is trued up to equal the “fair value” of the SARs that actually vest.
- Previously recognized compensation cost for SARs that did not vest would be reversed.

Stock-Settled SAR (*Market Condition*)

- The SAR grant date “fair value” is amortized over the option’s requisite service period.
- “Fair value” may be determined using a Monte Carlo simulation or a binomial model, but generally not Black-Scholes.
- Irrespective of whether the market condition goals have been achieved, any recognized compensation cost may not be reversed after the requisite service period has been rendered.

Cash-Settled SAR (*Time Vested*)

- At the end of each reporting period, the SAR’s “fair value” is re-measured (e.g., marked-to-“fair value”) and amortized over the remaining requisite service period less amounts previously recognized.
- “Fair value” is determined using an option pricing model (e.g., Black-Scholes or binomial model).
- At the end of each reporting period after the requisite service period is completed, the SAR’s “fair value” would continue to be re-measured (e.g., marked-to-“fair value”) each reporting period until settlement and any increase/decrease in the “fair value” would be immediately recognized as a compensation cost or income.
- Upon settlement of the SAR, compensation cost is trued up to equal the SAR’s intrinsic value (i.e., spread) on the date of settlement.

Cash-Settled SAR (*Performance Condition*)

- At the end of each reporting period, the number of SARs that are expected to vest is re-determined and the “fair value” of these SARs would be re-measured (e.g., marked-to-“fair value”) and amortized over the remaining requisite period less amounts previously recognized.
- “Fair value” is determined using an option pricing model (e.g., Black-Scholes or binomial model).
- At the end of each reporting period after the requisite service period is completed, the SAR’s “fair value” would continue to be re-measured (e.g., marked-to-“fair value”) until settlement and any increase/decrease in the “fair value” would be immediately recognized as a compensation cost or income.
- At time of settlement, compensation cost is trued up to equal the amount of cash actually paid.
- Previously recognized compensation cost for SARs that did not vest would be reversed.

Cash-Settled SAR (*Market Condition*)

- At the end of each reporting period, the SAR’s “fair value” is re-measured (e.g., marked-to-“fair value”) and amortized over the remaining requisite service period less amounts previously recognized.
- “Fair value” may be determined using a Monte Carlo simulation or a binomial model, but not Black-Scholes.
- At the end of each reporting period after the requisite service period is completed, the SAR’s “fair value” would continue to be re-measured (e.g., marked-to-“fair value”) until settlement and any increase/decrease in the “fair value” would be immediately recognized as a compensation cost or income.
- Previously recognized compensation cost for SARs that did not vest would be reversed.

Impact on Earnings per Share

Basic EPS

Non-vested stock-settled SARs are not included in the computation of the denominator of basic EPS. Vested stock-settled SARs are included in the computation of the denominator of basic EPS.

Diluted EPS

Non-vested SARs that will be settled in stock (or could be settled in stock at the election of the company or employee) are included in the computation of the denominator of diluted EPS if the award is dilutive.