SHARE-BASED COMPENSATION UNDER ASC 718

The guidelines for valuing share-based payment transactions are outlined in Accounting Standards Codification (ASC) 718 (formerly SFAS No. 123(R)). ASC 718 states that costs resulting from all share-based payment transactions be recognized using fair value as the measurement objective, and requires a fair-valued based measurement method be utilized. VRC has valued various forms of share-based compensation including stock options, employee share purchase plans (ESPPs), restricted shares, and stock appreciation rights (SARs), for financial reporting requirements under ASC 718. Below is an overview of some of our most common share-based compensation valuations.

OPTIONS ON COMMON STOCK

Service Condition (Time Vesting) Awards

General Description: This is the most common vesting scheme, where employees and/or non-employees are granted options which then vest over a certain period of time, subject to continued employment with the company. If these options are granted at-the-money (where the strike price is equal to the fair value of the shares at the grant date), they are commonly referred to as plain vanilla. An example of a “plain vanilla” option is a grant which provides the opportunity to buy 100 shares of stock, each share worth $10 on the grant date, for $10 each; this right vests over 5 years, or 20 shares per year, and is available for 10 years from the grant date.

Methodologies: The Black-Scholes model is most commonly used for grants of this type. A lattice model or Monte Carlo analysis can be utilized if the grantor’s underlying shares have liquidity and there is a tracked history of option exercise behavior.

Valuation Complexities:

1) Expected volatility – this is straightforward for a public company with at least three years’ history of its equity traded with good volume in an active market. Where companies are newly public or privately-held, a peer group will need to be determined and utilized. Peer data needs to be adjusted for the leverage and capitalization of the subject company.

2) Expected term – this is straightforward for a public company with fully vested options and good empirical data from all trades of such, assuming at-the-money grants. Historical data is analyzed to determine exercise behavior of the grantee population. Where companies have changed their vesting schemes and/or contractual terms over time, or have little/no option grant history, or have issued in- or out-of-the-money options, different steps need to be taken to estimate expected term. The simplified method for plain vanilla options, described by the SEC in SAB Topic 14, is not a panacea for estimating expected terms.

3) Underlying share price – this is straightforward for a public company with equity trades at good volume in an active market. In a private company, a valuation must be undertaken utilizing the guidelines provided in the AICPA Practice Aid entitled “Valuation of Privately Held-Company Equity Securities Issued as Compensation.” Originally issued in 2004, the Practice Aid is currently being updated by the AICPA Cheap Stock Task Force, and is expected to be re-issued in the fall of 2010. The resulting per-share value should reflect a minority, non-marketable basis.

If the value of the enterprise is known, i.e., the company was recently acquired, then it should be allocated across the capital structure using one of the four methods discussed in the Practice Aid. These are 1) the probability-weighted expected return method, 2) the option-pricing method, 3) the current-value method, and 4) hybrid methods, which use a weighted combination of the first three methods. After the allocation the equity needs to be discounted
appropriately for its lack of marketability.

**Performance Condition Awards**

*General description:* Options issued with performance conditions vest based on the achievement of certain specified performance achievements. Examples of performance targets can be annual financial targets (sales, sales growth, EBITDA, cash flow, etc.) or the completion of a specific project (a product launch, a refinancing, an IPO), but are never the price of the underlying company’s shares (see market condition awards below). Often the awards with annual targets vest in tranches, i.e., targets are set for each year for a number of years, with a specified percentage of the award vesting at each date.

*Methodologies:* Similar to service condition awards.

*Valuation complexities:* These are similar to service condition awards, with the exception that many companies whose awards have multiple vesting dates (graded vesting) may want to treat those awards as in-substance multiple awards, and account for each tranche separately.

**Market Condition Awards**

*General description:* These awards vest based on the achievement of a specific price for the shares underlying the options. Vesting for a public company can be realized when the traded share price meets or exceeds a certain dollar target or multiple dollar targets, for either a single point in time or over a specified period. The target can also be the company’s share price performance relative to a specified peer group’s performance. Vesting for a private company can be realized when the value of the shares received in a sale/merger transaction, or in an initial public offering, meets or exceeds a certain target value or multiple target values. Target values in these circumstances can be the realized multiple on an initial investment, or an IRR or a tier of IRRs.

*Methodologies:* To determine how the vesting conditions may be met, we employ Monte Carlo simulation to project potential price paths for the underlying shares over the term of the option. The price path is generated using an appropriate volatility and the risk-free rate. If, for one simulation, we test this price path we can determine which, if any, criteria have been met. We can then apply the vesting criteria to determine how many shares vest and the present value of each option’s proceeds.

*Valuation complexities:* These awards almost always require custom programming to properly mimic the vesting conditions specified. This complexity often translates into more time and expense for the valuation process. For graded vesting, where there are multiple targets set, the price path is generated using volatility for each tranche as appropriate, along with commensurate risk-free rates.

When the target is relative share price performance to a peer group, we must forecast price paths for the subject company and each of the peers. As one would expect historical volatilities in a peer group to exhibit some correlation, a matrix describing the correlation between each pair in the peer group must be developed and implemented to correlate the assumptions driving the
price forecasts.

**RESTRICTED STOCK/RESTRICTED (PARTNERSHIP/MEMBERSHIP) UNITS**

**Service Condition Awards:** There are no special ASC 718 valuation requirements, assuming the value of a share of stock is known.

If the value of a share of stock is not known (i.e., a private company), then the company must undertake a valuation. See the discussion above under Options on Common Stock, Valuation Complexities #3 for more details on the steps required to determine the appropriate per-share value to be used.

**Performance Condition Awards:** Similar to service condition awards of restricted stock.

**Market Condition Awards:** Similar to market condition awards of options on common stock.

**PARTNERSHIP/MEMBERSHIP UNITS STRUCTURED AS PROFITS INTERESTS**

When an enterprise adds a layer to its capital structure as a “profits interest” for the purpose of providing compensation, it usually does so in a manner that does not generate any immediate intrinsic value (or tax consequences) to the recipients. A “threshold value” is set at the grant date, and represents the value of the enterprise’s equity as of the grant date. For ASC 718 purposes, however, this structure resembles an option on the future value of the enterprise which can accrue to the grantee, and it must be valued and expensed as such. The threshold value and the fair value of these awards are established using an option-pricing methodology.

**WARRANTS AND/OR OPTIONS ON PREFERRED STOCK**

Valuation of warrants or options on preferred stock is usually conducted using a contingent claims analysis, which is constructed using a Black-Scholes formula-driven framework. It is applied to the entire enterprise to allocate value to the various layers of the capital structure, one of which would be the warrants. It resembles the option-pricing method, which is described in the Practice Aid mentioned above.

The valuation professionals at VRC have extensive experience valuing many forms of share-based payment. We can also help your compensation committee in estimating costs for upcoming grants or potential savings from changes to your option plan. For more information, contact Summer Parrish, CFA, at 609-243-7009 or your local business development representative listed below.

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