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CPEA Compensation Series:
Stock Appreciation Rights

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The Financial Accounting Standards Board *Accounting Standards Codification* (FASB ASC) provides guidance regarding employee compensation in the following four topics:

- FASB ASC 710, *Compensation–General*
- FASB ASC 712, *Compensation—Nonretirement Postemployment Benefits*
- FASB ASC 715, *Compensation—Retirement Benefits*
- FASB ASC 718, *Compensation—Stock Compensation*

CPEA Compensation Series of Reports

- ✓ Profits Interests Units
- ✓ Phantom Stock
- ✓ Bonus Time
- ✓ Compensated Absences
- ✓ Deferred Compensation Arrangements
- ✓ Rabbi Trust Arrangements
- ✓ Restricted Stock Awards

In this report, we will cover the guidance related to stock appreciation rights (SARs). SARs are a type of employee compensation linked to the company's stock price during a predetermined period. SARs are profitable for employees when the company's stock price rises, which makes them similar to employee stock options (ESOs). However, employees do not have to pay the exercise price with SARs. Instead, they receive the sum of the increase in stock or cash. The primary benefit of SARs is that employees can receive proceeds from stock price increases without having to buy stock.

SARs are similar in some ways to phantom stock. The major difference is that phantom stocks typically are reflective of stock splits and dividends. Phantom stock is a promise that an employee will receive either the value of the company's shares or the amount that the stock price increases during a specified period. The phantom stock bonus an employee receives is taxed as ordinary income at the time it is received. Phantom stock is not tax-qualified, so it does not have to follow the rules that employee stock ownership plans (ESOPs) and 401(k)s must follow.

SARs offer the right to the cash equivalent of a stock's price gains over a predetermined time interval. Employers almost always pay this type of bonus in cash. However, the company may pay the employee bonus in shares. In most cases, employees can exercise SARs after they vest. Employers sometimes issue SARs along with stock options. These SARs are called tandem SARs. They assist in funding the purchase of options and help pay off taxes due at the time the SARs are exercised.

CPEA Observation: The Deferred Compensation–Rabbi Trust Subsections in FASB ASC 710-10 do not apply to SARs, even if an employer funds these benefits through a rabbi trust. Typically, under a SARs plan, an employee eventually receives compensation equal to the increase in the fair value of a stated number of the employer's shares on a designated future date. At the specified time, the employee receives cash or an equivalent amount of the employer's stock that represents the fair value increase. Although an employer that provides a SARs plan may segregate the contract in a rabbi trust, the employer still accounts for the SARs plan under FASB ASC 718.

Classification of SARs

FASB ASC 718-10-25-6 through 718-10-25-18 provides the criteria for determining whether an award should be classified as a liability or as equity. A stock-settled SAR would be classified as equity (assuming the award meets all other requirements for equity classification). The more common cash-settled SAR would be classified as a liability. Further, the following types of awards would be classified as liabilities:

- An award with conditions or other features that are indexed to something other than a market, performance, or service condition (e.g., an award that vests based on the appreciation in the price of a commodity and the company's shares)
- An award that meets certain criteria of FASB ASC 480, *Distinguishing Liabilities from Equity*
- A share award with a repurchase feature that permits an employee to avoid bearing the risks and rewards normally associated with equity ownership for a reasonable period of time by allowing the employee to put shares to the company within six months after the employee vests in the shares

- A share award where it is probable that the employer would prevent the employee from bearing the risks and rewards normally associated with stock ownership within six months after share issuance
- An option or similar instrument that could require the employer to pay an employee cash or other assets, unless cash settlement is based on a contingent event that is not probable and outside the control of the employee

Practice Note: If a SAR offers a choice of settlement in stock or in cash, the classification of the award depends on whether the employee or the company has the choice of the form of settlement. If the employee can choose the form of settlement and can potentially require the company to settle the award in cash, the award should be classified as a liability. If the company has the choice of settlement, it can avoid transferring assets by electing to issue stock. In that case, as long as the company has the ability to deliver shares (i.e., sufficient authorized shares) the award would be classified as equity.

- An option or similar instrument in which the underlying shares are classified as liabilities

<u>Accounting for SARs</u>

FASB ASC 718 requires that SARs be valued at the fair value of the shares on the date of grant.

Practice Note: Although FASB ASC 718 indicates that the fair value method is preferable, in some cases, nonpublic companies may find it challenging to use the fair value method because of the difficulty of estimating volatility for use in an option pricing model. And, while nonpublic companies can look at volatility of similar public companies to help develop a volatility assumption, if sufficient information is not available to estimate expected volatility, nonpublic companies may use the calculated value method. A nonpublic entity must make an accounting policy election regarding whether to measure all liabilities incurred in share-based compensation arrangements at fair value, calculated value, or intrinsic value (amount by which fair value exceeds exercise price). A nonpublic company that uses fair value to measure its equity-classified awards should adopt an accounting policy to measure all of its liability-classified awards using fair value or intrinsic value. A nonpublic company that uses a calculated value to measure its equity-classified awards would have an accounting policy choice to measure all of its liability-classified awards using the calculated value method or the intrinsic value method. Under each of the measurement alternatives for liability-classified awards, the company will remeasure the award on each reporting date using the same method until the award is settled.

CPEA Observation: In October 2021, FASB issued Accounting Standards Update (ASU) 2021-07, *Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards (A Consensus of the Private Company Council)*. ASU 2021-07 provides a practical expedient, whereby a nonpublic entity is allowed to determine the current price input of equity-classified share-based awards issued to both employees and nonemployees using the reasonable application of a reasonable valuation method. The practical expedient in ASU 2021-07 can be elected for equity-classified share-based awards within the scope of FASB ASC 718. The practical expedient is not available for liability-classified awards. For more information about this practical expedient, please see our CPEA Alert dated October 28, 2021.

Stock-Settled SARs (Time-Vested)

For time-vested SARs, fair value is determined using an option pricing model (e.g., Black-Scholes or binomial model). Compensation is then accrued as expense over the SAR's requisite service period (e.g., typically the vesting period).

Stock-Settled SARs (Performance Condition)

For SARs with a performance condition (rendering service AND achieving a specified performance target that is solely defined by entity's operations), fair value is determined using an option pricing model (e.g., Black-Scholes or binomial model). Thereafter, for 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. 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 SARs (Market Condition)

For SARs with a market condition (relates to the achievement of either a specified price for entity's shares or specified price for entity's shares in terms of similar equity securities/index of similar equity securities), fair value may be determined using a Monte Carlo simulation or a binomial model but, generally, not Black-Scholes (since this model does not take into account that the award could be exercised before the expiration date). Compensation is then accrued as expense over the SAR's requisite service period. Regardless 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.

CPEA Observation: Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which grantees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date.

Cash-Settled SARs (Time Vested)

For time-vested SARs, fair value is determined using an option pricing model (e.g., Black-Scholes or binomial model). Compensation is then accrued as expense over the SAR's requisite service period (e.g., typically the vesting period). Because these awards are considered to be a liability, the entity will need to periodically adjust the value of the liability (and the corresponding compensation expense), based on changes in the fair value of the stock. The periodic expense (and adjustment to the liability) is the fraction of the total compensation earned to date by recipients of the SARs (based on the elapsed fraction of the service period) reduced by an amount expensed in prior periods. 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 each reporting period until settlement and any increase/decrease in the fair value immediately would be 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 SARs (Performance Condition)

For SARs with a performance condition, fair value is determined using an option pricing model (e.g., Black-Scholes or binomial model). Thereafter, 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 and amortized over the remaining requisite period less amounts previously recognized. 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 until settlement and any increase/decrease in the fair value immediately would be 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 SARs (Market Condition)

For SARs with a market condition, 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, the SAR's fair value is re-measured and amortized over the remaining requisite service period less amounts previously recognized. 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 until settlement and any increase/decrease in the fair value immediately would be recognized as a compensation cost or income. Previously recognized compensation cost for SARs that did not vest would be reversed.

The following examples illustrate the accounting for an equity-classified award (Example 1) and a liability-classified award (Example 2):

Example 1:

Assume that on December 31, 2022, ABC Company issued 4,000 SARs that, upon exercise, entitle employees to receive compensation equal in value to the excess of the market price at exercise over the share price at the grant date. The SARs vest ratably each year until the end of 2026 and expire at the end of 2030. The fair value of the SARs, estimated by an appropriate option pricing model, is $25 per SAR at December 31, 2022.

12/31/22 No entry; calculate total compensation expense $25 x 4,000 = $100,000 to be recognized over the requisite service period

On December 31, 2023 – 2026, the following entry would be recorded:

12/31/XX	Stock-based compensation expense	$25,000	
	Paid-in capital—SAR plan		$25,000

If, on the other hand, the employee will receive or can elect to receive cash, the award would be classified as a liability. When a SAR is classified as a liability, determination of fair value at grant date and recognition of compensation expense over the service period is consistent with accounting for an equity-classified award. However, because these awards are considered to be a liability, the entity will need to periodically adjust the value of the liability (and the corresponding compensation expense), based on changes in the fair value of the SAR.

The periodic expense (and adjustment to the liability) is the fraction of the total compensation earned to date by recipients of the SAR (based on the elapsed fraction of the service period) reduced by an amount expensed in prior periods.

Example 2:

Assume that on December 31, 2022, ABC Company issued 4,000 SARs that, upon exercise, entitle employees to receive compensation equal in value to the excess of the market price at exercise over the share price at the grant date. The SARs vest ratably each year until the end of 2026 and expire at the end of

2030. The employees may choose to receive cash at settlement. The fair value of the SARs, estimated by an appropriate option pricing model, is $25 per SAR at December 31, 2022.

12/31/22 No entry; calculate total compensation expense $25 x 4,000 = $100,000

On December 31, 2023, the following entry would be recorded:

12/31/23	Stock-based compensation expense	$25,000	
	Liability—SAR plan		$25,000

Assume that, on 12/31/24, the fair value of the SARs is $27. The following entry would be recorded:

12/31/24	Stock-based compensation expense	$29,000*	
	Liability—SAR plan		$29,000

* ($27 x 4,000 x 2/4) - $25,000 = $29,000

Assume that, on 12/31/25, the fair value of the SARs is $28. The following entry would be recorded:

12/31/25	Stock-based compensation expense	$30,000*	
	Liability—SAR plan		$30,000

* ($28 x 4,000 x 3/4) – ($25,000 + $29,000) = $30,000

Assume that, on 12/31/26, the fair value of the SARs is $23. The following entry would be recorded:

12/31/26	Stock-based compensation expense	$8,000*	
	Liability—SAR plan		$8,000

* ($23 x 4,000 x 4/4) – ($25,000 + $29,000 + $30,000) = $29,000

On December 31, 2026, the following entry would be recorded to settle the SARs (assuming all employees choose cash settlement):

12/31/26	Liability—SAR plan	$92,000	
	Cash		$92,000

Disclosures

FASB ASC 718-10-50-2 and 50-2A outline the "minimum information" an entity must disclose in its annual financial statements related to share-based payments. The following generally would be applicable to SARs plans:

- A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:
    - The employee's requisite service period(s) and, if applicable, the nonemployee's vesting period and any other substantive conditions (including those related to vesting)
    - The maximum contractual term of equity (or liability) share options or similar instruments
    - The number of shares authorized for awards of equity share options or other equity instruments
- The method it uses for measuring compensation cost from share-based payment arrangements
- For the most recent year for which an income statement is provided, both of the following:
    - The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):
        - Those outstanding at the beginning of the year
        - Those outstanding at the end of the year
        - Those exercisable or convertible at the end of the year
        - Those that during the year were:
            - Granted
            - Exercised or converted
            - Forfeited
            - Expired
    - The number and weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured pursuant to FASB ASC 718-10-30-21) for all of the following groups of equity instruments:
        - Those nonvested at the beginning of the year
        - Those nonvested at the end of the year
        - Those that during the year were:

        - Granted
        - Vested
        - Forfeited

- For each year for which an income statement is provided, both of the following:
    - The weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured at that value) of equity options or other equity instruments granted during the year
    - The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year

- For fully vested share options (or share units) and share options expected to vest (or unvested share options for which the employee's requisite service period or the nonemployee's vesting period has not been rendered but that are expected to vest based on the achievement of a performance condition, if an entity accounts for forfeitures when they occur) at the date of the latest statement of financial position, both of the following:
    - The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic entities), and weighted-average remaining contractual term of options (or share units) outstanding
    - The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic entities), and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible)

- For each year for which an income statement is presented, both of the following (an entity that uses the intrinsic value method is not required to disclose the following information for awards accounted for under that method):
    - A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements
    - A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):

- Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and grantees' expected exercise and post-vesting termination behavior into the fair value (or calculated value) of the instrument
- Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. A nonpublic entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index
- Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends
- Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used
- Discount for post-vesting restrictions and the method for estimating it

- An entity that grants equity or liability instruments under multiple share-based payment arrangements shall provide the information separately for different types of awards (including nonemployee versus employee) to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements shall disclose information separately for

different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation

- For each year for which an income statement is presented, both of the following:
    - Total compensation cost for share-based payment arrangements
        - Recognized in income as well as the total recognized tax benefit related thereto
        - Capitalized as part of the cost of an asset
    - A description of significant modifications, including:
        - The terms of the modifications
        - The number of grantees affected
        - The total (or lack of) incremental compensation cost resulting from the modifications
- As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized
- If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements
- A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If, as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period
- If not separately disclosed elsewhere, the policy for estimating expected forfeitures or recognizing forfeitures as they occur
- If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit from stock options exercised during the annual period

The following is an example of these disclosure requirements from AZZ Incorporated. Please note that not all of the disclosure requirements are applicable in the example from AZZ Incorporated and, therefore, does not reflect a comprehensive disclosure example:

Stock Appreciation Rights and Option Awards

Stock appreciation rights and option awards are granted with an exercise price equal to the market value of our common stock on the date of grant. These awards generally have a contractual term of 7 years and vest ratably over a period of three years although some may vest immediately on issuance. These awards are valued using the Black-Scholes option pricing model.

A summary of the Company's stock appreciation rights and option awards activity for the three-month period ended May 31, 2012 is as follows:

	Options/ SAR's	Weighted Average Exercise Price
Outstanding as of February 29, 2012	573,000	$ 15.46
Granted	116,114	25.67
Exercised	(109,000)	12.23
Forfeited	—	—
Outstanding at end of the period ended May 31, 2012	580,114	$ 18.11
Exercisable at end of period ended May 31, 2012	258,104	$ 14.21
Weighted average fair value of options and SARs granted during the period ended May 31, 2012		$ 8.79

The average remaining contractual term for those options/stock appreciation rights outstanding at May 31, 2012, is 5.24 years, with an aggregate intrinsic value of $5.1 million. The average remaining contractual terms for those options/stock appreciation rights that are exercisable as of May 31, 2012 is 4.51 years, with an aggregate intrinsic value of $3.3 million.

Conclusion

SARS plans overcome a major disadvantage of stock option plans that require employees to actually buy shares when the options are exercised. Even though the options' exercise price may significantly be lower than the market price of the shares, the employee still must come up with enough cash to take advantage of the bargain. Unlike stock options, SARs enable an employee to benefit by the amount that the market price of the company's stock rises without having to buy the shares.

We hope this report is helpful in understanding the proper accounting for SARs. And, as always, the CPEA is available to answer our members' questions.

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