How Will the Changes to ASC 718 Impact the Way Your Company Expenses Its Equity Awards?

On March 30, 2016, FASB released the final version of the updates to Accounting Standards Codification Topic 718: Compensation-Stock Compensation ("ASC 718"). The update includes an option on how a company may account for forfeitures in its expense amortization.

New Versus Old: A Comparative Analysis

Under the current accounting rules, an employer must estimate forfeitures (resulting from the failure to provide the requisite service) when recognizing compensation cost for all share-based payments (equity or liability).

Under the new rules, an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or *account for forfeitures as they occur (new option).*

An Example of the impact of forfeiture rate selection on an award:

Options Grant Information	
Options Granted: 100,000 # of Employees Granted Options: 1,000 Expected Forfeitures Per Year: 3%	Grant Date Fair Value Per Option: $11.76 Vesting: 3-year graded
Treatment Under the Old Accounting Rules	**Optional Treatment Under the New Accounting Rules**
Initial Calculation of Amortizable Options = Options Granted * ((1 - forfeiture rate) ^length of vesting period) = 100,000 * ((1 - .03) ^3) = 91,267.3	**Initial Calculation of Amortizable Options** = Options Granted (no estimated forfeitures) = 100,000
Initial Expense Amortization Calculation =Amortizable Options * Grant Date Fair Value Per Option = 91,267.3 * $11.76 = $1,073,303.45	**Initial Expense Amortization Calculation** = Amortizable Options * Grant Date Fair Value Per Option = 100,000 * $11.76 = $1,176,000.00
Accounting Treatment of Amortizable Expense Debit Compensation Cost $1,073,303.45 Credit Additional Paid-in Capital $1,073,303.45	**Accounting Treatment of Amortizable Expense** Debit Compensation Cost $1,176,000.00 Credit Additional Paid-in Capital $1,176,000.00
Revaluation of Estimated Forfeitures 60 employees term & forfeit 100 options each Triggers a revaluation of the forfeiture rate (follow above steps) Amortizable Options = 100,000 * ((1-.02) ^3) = 94,119.2 New Amortizable Expense = 94,119.2 * $11.76 = $1,106,841.79	**Recognition of Actual Forfeitures** 60 employees term & forfeit 100 options each Options Forfeited = 100 * 60 = 6,000 Expense Forfeited = 6,000 * $11.76 = $70,560.00
Accounting Treatment of Revaluation of Estimated Forfeitures Debit Additional Paid-in Capital $1,073,303.45 Credit Compensation Cost $1,073,303.45 Debit Compensation Cost $1,106,841.79 Credit Additional Paid-in Capital $1,106,841.79	**Accounting Treatment of Recognition of Actual Forfeitures** Debit Additional Paid-in Capital $70,560.00 Credit Compensation Cost $70,560.00
True Up For Actual Vesting vs. Estimated Vesting at End of Period Actual Options Vested = 100,000 - 6,000 = 94,000 Total Expense for Vested Award = 94,000 * $11.76 = $1,105,440.00 True-Up Needed = Total Expense - Amortized Expense = $1,105,440.00 - $1,106,841.79 = ($1,401.79)	
Accounting Treatment of True-Up of Expense Debit Additional Paid-in Capital $1,401.79 Credit Compensation Cost $1,401.79	
Total Expense Amortized = $1,105,440.00	**Total Expense Amortized = $1,105,440.00**

Please note: For simplification purposes, we have included an example where true-up occurs at final vest date rather than at forfeiture date. Your plan may not follow this design, in which case, the Treatment Under the Old Accounting Rules would include the true-up adjustments as of the forfeiture date.

Pros & Cons of Keeping the Old Method:

Pros	Cons
Due to the fact that this is already established, your finance department is accustomed to seeing this methodology.	The initial estimate of forfeitures is time-consuming and unwieldy, using historical data plus actual trends.
Since forfeitures aren't realized in real time, the expense amortization tends to be smoother over time, with an annual (or quarterly) revaluation and true-up that is easily explained.	Revaluation is complicated, using historical rates plus actual rates, and future assumed trends.
Many companies already have this established, meaning that their auditors are accustomed to the methodology and audit procedures surrounding forfeitures.	Some components are not easily audited.

Pros of Adopting the New Method:

Pros	Cons
The initial expense amortization is easy to value and set up.	Not what finance is used to seeing.
There is no revaluation or true up at any time, just realization of actual forfeitures.	The expense amortization is more volatile, showing fluctuations based on actuals.
Easily audited.	

Our Recommendation:

Whether your company chooses to adopt the new option or continue with the old option, your expense will end up being the same at the end of the amortization period. Aon's recommendation depends largely on two things: the size of your company and your experience granting stock-based awards. For large, established companies with a lot of granting experience, a reasonable prediction of forfeitures can typically be estimated. Because this more accurate prediction allows for consistent and predictable accounting, Aon recommends the company continue to estimate forfeitures, and apply any true-ups when necessary.

For smaller companies with limited experience granting stock-based awards, an accurate forfeiture rate is much harder to determine, potentially spurring an environment of volatile accounting. In order to avoid uncertainty created by inaccurate predictions, Aon recommends the company recognize forfeitures as they occur. This eliminates the potential of inadvertently overstating the forfeiture rate, thus leading to a sudden unexpected increase of expense.

It is important to note that any further change in policy after the initial election will qualify as a change in accounting principle, thus requiring a preferability letter from an entity's external auditor and further retrospective application.

To learn more about the Equity Services team at Aon, visit our website: radford.com/home/valuation. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

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