Share-Based Payment > Best Practice Series

ASC Topic 718 Financial Reporting Disclosures

The Overview

As part of our Share-Based Payment (SBP) Best Practice Series, Montgomery Investment Technology, Inc. (MITI) is pleased to provide you with illustrative examples and a template for financial reporting disclosures compliant with ASC Topic 718 Section 10-50. These examples typify the disclosures in common use today and are consistent with current best practices.

The Standard

ASC 718 Section 10-50 states that:

*"An entity with one of more **share-based payment arrangements** shall disclose information that enables users of the financial statements to understand all of the following:*

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders.

b. The effect of compensation cost arising from share-based payment arrangements on the income statement.

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period.

d. The cash flow effects resulting from share-based payment arrangements.

This disclosure is not required for interim reporting."

For your information, the full text of Paragraphs A240-A242 of FAS 123R (which was the precursor to the current standard) is presented below.

The Practice

We have surveyed the market to identify current practices. In the Share Based Payment Disclosure Template, we have presented a number of examples assembled from actual company filings. A sheet of Instructions for use of these examples is also provided.

a. Sample Disclosures for an Employee Stock Option (ESO) plan.

b. Sample Disclosures for a Total Shareholder Return (TSR) plan.

c. Sample Disclosures for a Performance Price Target (PPT) plan.

The Future

Recently, we have seen occasional examples of extensive disclosure of the features of an entity's Total Shareholder Return program. The Schedule 10-K of Nutrisystem, Inc. (NASDAQ:NTRI) dated March 13, 2012 provides extensive disclosure of the share-based payment features of the Executive Compensation Program. Additional disclosures are provided in a section of Interactive Data provided with the Schedule. We feel that there is a trend toward more detailed disclosure as a result of the Dodd-Frank Act and increased shareholder activism.

Suggestions

If you would like to discuss a valuation of your SBP program with complete documentation of all assumptions and procedures, please contact us at 610-688-8111. We can provide assistance for our clients in the development of explanatory material for use by independent auditors. We welcome your comments and questions at miti@fintools.com. Thank you for your feedback!

April 2013

Reference

FAS 123R Paragraphs A240-A242

MINIMUM DISCLOSURE REQUIREMENTS AND ILLUSTRATIVE DISCLOSURES

A240. The minimum information needed to achieve the disclosure objectives in paragraph 64 of this Statement is set forth below. To achieve those objectives, an entity should disclose the following information:[136]

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as the requisite service period(s) and any other substantive conditions (including those related to vesting), the maximum contractual term of equity (or liability) share options or similar instruments, and the number of shares authorized for awards of equity share options or other equity instruments. An entity shall disclose the method it uses for measuring compensation cost from share-based payment arrangements with employees.

b. For the most recent year for which an income statement is provided:

    1. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units): (a) those outstanding at the beginning of the year, (b) those outstanding at the end of the year, (c) those exercisable or convertible at the end of the year, and those (d) granted, (e) exercised or converted, (f) forfeited, or (g) expired during the year.
    2. 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 paragraphs 24 and 25 of this Statement) of equity instruments not specified in paragraph A240(b)(1) (for example, shares of nonvested stock), for each of the following groups of equity instruments: (a) those nonvested at the beginning of the year, (b) those nonvested at the end of the year, and those (c) granted, (d) vested, or (e) forfeited during the year.

c. For each year for which an income statement is provided:
    1. 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 pursuant to paragraphs 24 and 25 of this Statement) of equity options or other equity instruments granted during the year.
    2. 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.

d. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position:
    1. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding.
    2. 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).

e. For each year for which an income statement is presented:[137]
    1. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements.
    2. 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):
        a. Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and post-vesting employment termination behavior into the fair value (or calculated value) of the instrument.
        b. 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

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[136] In some circumstances, an entity may need to disclose information beyond that listed in this paragraph to achieve the disclosure objectives.

[137] An entity that uses the intrinsic value method pursuant to paragraphs 24 and 25 of this Statement is not required to disclose the following information for awards accounted for under that method.

volatilities used and the weighted-average expected volatility. A nonpublic entity that uses the calculated value method should 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.

c. 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.
d. 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.
e. Discount for post-vesting restrictions and the method for estimating it.

f. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraphs A240(a)–(e) separately for different types of awards 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.

g. For each year for which an income statement is presented:

   1. Total compensation cost for share-based payment arrangements (a) recognized in income as well as the total recognized tax benefit related thereto and (b) the total compensation cost capitalized as part of the cost of an asset.
   2. A description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications.

h. 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.

i. 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 realized from stock options exercised during the annual period.

j. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements.

k. 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.

A241. An illustration of disclosures of a public entity's share-based compensation arrangements follows. The illustration assumes that compensation cost has been recognized in accordance with this Statement for several years. The amount of compensation cost recognized each year includes both costs from that year's grants and costs from prior years' grants. The number of options outstanding, exercised, forfeited, or expired each year includes options granted in prior years.

* * *

On December 31, 20Y1, the Entity has two share-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was $29.4 million, $28.7 million, and $23.3 million for 20Y1, 20Y0, and 20X9, respectively. The total income tax benefit recognized in the income statement for share-based compensation arrangements was $10.3 million, $10.1 million, and $8.2 million for 20Y1, 20Y0, and 20X9, respectively. Compensation cost capitalized as part of inventory and fixed assets for 20Y1, 20Y0, and 20X9 was $0.5 million, $0.2 million, and $0.4 million, respectively.

Share Option Plan

The Entity's 20X4 Employee Share Option Plan (the Plan), which is shareholder approved, permits the grant of share options and shares to its employees for up to 8 million shares of common stock. The Entity believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Entity's stock at the date of grant; those option awards generally vest based on 5 years of continuous service and have 10-year contractual terms. Share awards generally vest over five years. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the Plan).

The fair value of each option award is estimated on the date of grant using a lattice-based option valuation model that uses the assumptions noted in the following table. Because lattice-based option valuation models incorporate ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based on implied volatilities from traded options on the Entity's stock, historical volatility of the Entity's stock, and other factors. The Entity uses historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; the range given below results from certain groups of employees exhibiting different behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	20Y1	20Y0	20X9
Expected volatility	25%–40%	24%–38%	20%–30%
Weighted-average volatility	33%	30%	27%
Expected dividends 1.5% 1.5% 1.5%	1.50%	1.50%	1.50%
Expected term (in years)	5.3–7.8	5.5–8.0	5.6–8.2
Risk-free rate	6.3%–11.2%	6.0%–10.0%	5.5%–9.0%

A summary of option activity under the Plan as of December 31, 20Y1, and changes during the year then ended is presented below:

Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 20Y1	4,660	$42		
Granted	950	60		
Exercised	(800)	36		
Forfeited or expired	80	59		
Outstanding at December 31, 20Y1	4,730	$47	6.5	$85,140
Exercisable at December 31, 20Y1	3,159	$41	4.0	$75,816

The weighted-average grant-date fair value of options granted during the years 20Y1, 20Y0, and 20X9 was $19.57, $17.46, and $15.90, respectively. The total intrinsic value of options exercised during the years ended December 31, 20Y1, 20Y0, and 20X9, was $25.2 million, $20.9 million, and $18.1 million, respectively.

A summary of the status of the Entity's nonvested shares as of December 31, 20Y1, and changes during the year ended December 31, 20Y1, is presented below:

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Nonvested Shares	Shares (000)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 20Y1	980	$40.00
Granted	150	63.50
Vested	(100)	35.75
Forfeited	(40)	55.25
Nonvested at December 31, 20Y1	990	$43.35

As of December 31, 20Y1, there was $25.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 4.9 years. The total fair value of shares vested during the years ended December 31, 20Y1, 20Y0, and 20X9, was $22.8 million, $21 million, and $20.7 million, respectively.

During 20Y1, the Entity extended the contractual life of 200,000 fully vested share options held by 10 employees. As a result of that modification, the Entity recognized additional compensation expense of $1.0 million for the year ended December 31, 20Y1.

Performance Share Option Plan

Under its 20X7 Performance Share Option Plan (the Performance Plan), which is shareholder-approved, each January 1 the Entity grants selected executives and other key employees share option awards whose vesting is contingent upon meeting various departmental and company-wide performance goals, including decreasing time to market for new products, revenue growth in excess of an index of competitors' revenue growth, and sales targets for Segment X. Share options under the Performance Plan are generally granted at-the-money, contingently vest over a period of 1 to 5 years, depending on the nature of the performance goal, and have contractual lives of 7 to 10 years. The number of shares subject to options available for issuance under this plan cannot exceed five million.

The fair value of each option grant under the Performance Plan was estimated on the date of grant using the same option valuation model used for options granted under the Plan and assumes that performance goals will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost is reversed. The inputs for expected volatility, expected dividends, and risk-free rate used in estimating those options' fair value are the same as those noted in the table related to options issued under the Share Option Plan. The expected term for options granted under the Performance Plan in 20Y1, 20Y0, and 20X9 is 3.3 to 5.4 years, 2.4 to 6.5 years, and 2.5 to 5.3 years, respectively.

A summary of the activity under the Performance Plan as of December 31, 20Y1, and changes during the year then ended is presented below:

Performance Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 20Y1	2,533	$44		
Granted	995	60		
Exercised	(100)	36		
Forfeited or expired	(604)	59		
Outstanding at December 31, 20Y1	2,824	$47	7.1	$50,832
Exercisable at December 31, 20Y1	936	$40	5.3	$23,400

The weighted-average grant-date fair value of options granted during the years 20Y1, 20Y0, and 20X9 was $17.32, $16.05, and $14.25, respectively. The total intrinsic value of options exercised during the years ended December 31, 20Y1, 20Y0, and 20X9, was $5 million, $8 million, and $3 million, respectively. As of December 31, 20Y1, there was $16.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Performance Plan; that cost is expected to be recognized over a period of 4.0 years.

Cash received from option exercise under all share-based payment arrangements for the years ended December 31, 20Y1, 20Y0, and 20X9, was $32.4 million, $28.9 million, and $18.9 million, respectively. The actual tax benefit realized for the tax deductions from option exercise of the share-based payment arrangements totaled $11.3 million, $10.1 million, and $6.6 million, respectively, for the years ended December 31, 20Y1, 20Y0, and 20X9.

The Entity has a policy of repurchasing shares on the open market to satisfy share option exercises and expects to repurchase approximately one million shares during 20Y2, based on estimates of option exercises for that period.

Supplemental Disclosures

A242. In addition to the information required by this Statement, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this Statement. The alternative assumptions should be described to enable users of the financial statements to understand the basis for the supplemental information.

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