

September 2014  
Human Resource Services

# ***Stock Compensation*** 2014 Assumption and Disclosure Study

## ***Dear Clients and Friends***

PwC is pleased to share with you our **Stock Compensation 2014 Assumption and Disclosure Study**. This study presents our analysis of the 2013 year-end assumptions and disclosures for large US public companies as well as separately for high tech companies.

In preparing this year's study, we considered only companies that reported stock compensation expense in their 2013 10-K with a December 31 fiscal year-end. Our "large company group" was recast from 2012 and is now comprised of the top 100 ranked companies in the S&P 500. We also recast our 2013 "high tech company group", consisting now of the top 100 companies (equally distributed) on the NASDAQ technology, biotech, and pharmaceutical industry lists. Side-by-side comparative information for the two groups is also provided.

To obtain the financial information for the stock-based compensation plans included in the study, we reviewed the publicly available annual reports for the companies selected. We also included 2009 through 2012 data as well as 2006 data (when ASC 718 stock compensation rules were implemented) for historical comparison and perspective. Please note, all historical data is that of the recast large and high tech company groups.

The study highlights are summarized in the first section, followed by more detailed comparative information and discussion.

We hope you will find the results of our **Stock Compensation 2014 Assumption and Disclosure Study** useful in benchmarking your company's assumptions and other data points associated with your stock compensation plans.

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## ***Table of contents***

<i>Summary</i>	<i>2</i>
<i>Mix of Awards Granted</i>	<i>4</i>
<i>Mix of Awards Granted—Specific Type</i>	<i>7</i>
<i>Option pricing model</i>	<i>8</i>
<i>Option pricing model Assumptions</i>	<i>9</i>
<i>Option pricing model Assumptions —Expected Term</i>	<i>11</i>
<i>Option pricing model Assumptions —Volatility</i>	<i>13</i>
<i>Option pricing model Assumptions —Risk-Free Rate and Dividend Yield</i>	<i>15</i>
<i>Stock Compensation Expense</i>	<i>17</i>
<i>Comparison to Year of ASC 718 (Formerly FAS 123R) Adoption</i>	<i>19</i>

## Summary

We performed an analysis of the stock compensation disclosures made by 100 Large<sup>1</sup> companies and 100 High Tech<sup>2</sup> companies. All information in this analysis is based on published annual reports and other publicly available information of the selected companies. Due to recasting the companies within our Large and High Tech groups, certain companies included in our

study in prior years are not included in this 2014 study. Also, as companies may not have issued stock-based compensation awards in all prior years, data for some years may consist of less than 100 companies<sup>3</sup>.

The following highlights the results of our study and compares the 2013 data to 2012 data.

### Highlights

	Large Companies		High Tech Companies	
	2013	2012	2013	2012
Number of Companies in Study with Stock Compensation	100	100	100	98
Stock Compensation as a Percentage of Income-Median <sup>4</sup>	3.27%	3.71%	9.18%	10.64%
Types of Equity Awards Granted (units)				
Stock Options <sup>5</sup>	49%	42%	41%	48%
Restricted Stock <sup>6</sup>	51%	58%	59%	52%
Use of the Black-Scholes Valuation Model Only	85%	85%	92%	92%
Assumptions Used for Black-Scholes Model-Median				
Expected Term (years)	6.00	6.00	5.70	5.60
Volatility	30.04%	34.00%	37.00%	40.05%
Risk-free Rate	1.10%	1.10%	1.17%	0.90%
Dividend Yield (for Companies with a non-zero yield)	2.30%	2.30%	2.06%	2.34%

1 "Large" refers to the top 100 companies in the S&P 500 with stock compensation expense in 2013 and a fiscal year-end of December 31.

2 "High Tech" refers to the top 100 companies on the NASDAQ technology, biotechnology, and pharmaceutical industry lists, evenly distributed, with stock compensation expense in 2013 and a fiscal year-end of December 31.

3 When data consists of less than 100 companies, results are for only those companies reporting (i.e., proportional distribution will add up to 100% even when there are less than 100 companies in the analysis).

4 Excludes companies with a net operating loss.

5 For purposes of this study "stock options" is used to refer to both employee stock option and stock appreciation right ("SAR") awards granted by a company, unless separately presented and identified.

6 For purposes of this study "restricted stock" is used to refer to restricted stock, restricted stock unit and unvested unit awards granted by a company.

## **Large Companies**

Option pricing model assumptions at December 31, 2013 remained steady compared with those reported at December 31, 2012 for Large companies. The **volatility** assumption on average decreased similar to what we observed for the High Tech companies. But other assumption averages are essentially unchanged since last year.

Equity awards granted by Large companies are showing a balance (by share unit volume) at nearly a 50/50 split between stock options and restricted stock awards in 2013, reflecting a small increase in the number of stock option grants since 2012. And similar to the High Tech companies, the value of restricted stock awards far exceeded the value of stock options granted in 2013, with restricted stock making up 85% of the total grant value, up from 82% in 2012.

## **High Tech Companies**

Overall, option pricing model assumptions at December 31, 2013 changed modestly from assumptions at December 31, 2012. Of the more significant assumptions, the average assumed **expected term** lengthened slightly, while the stock price **volatility** assumption has decreased, following a trend since 2009.

When valuing stock options, companies continue to rely heavily on the Black-Scholes option pricing model and primarily base their expected term and volatility assumptions on historical experience.

Restricted stock awards continue to be the leading type of equity award granted (by share unit volume) for these companies, and trending upwards from 2012 to a 60/40 split. However, the value of restricted stock granted far outpaced stock options at a rate of \$6 of restricted stock value for each \$1 of stock option value in 2013.

## Mix of Awards Granted

### Large Companies

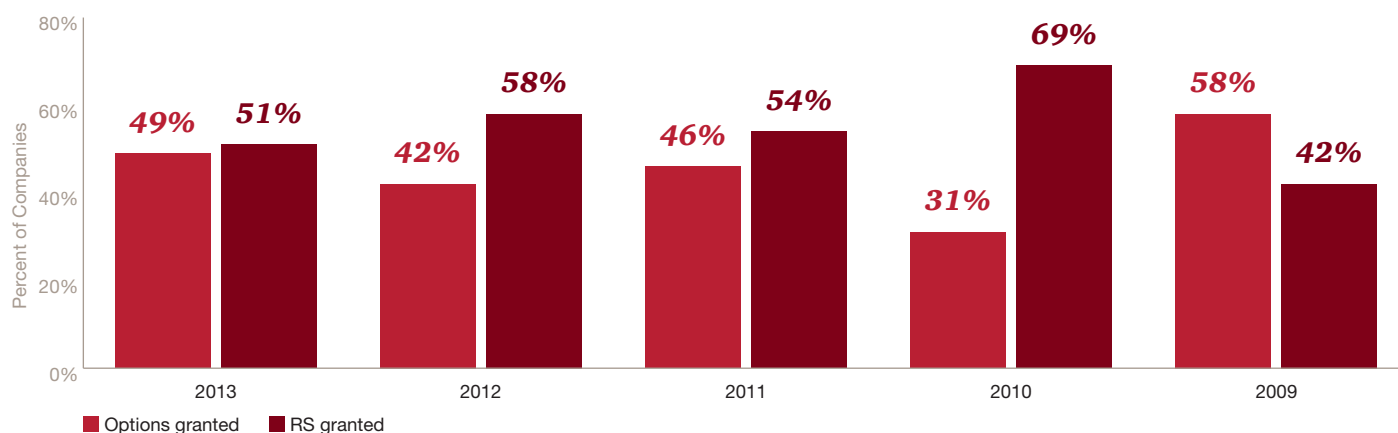
Over the last 5 years, the shift from options to stock awards has been consistent. The number of options granted exceeded stock awards by a 1.5 to 1 ratio in 2009 for the Large companies in our study group. Since then, the number of options granted has been just under the number of stock awards (with 2010 being a 2 to 1 ratio in favor of stock awards primarily on account of financial services companies in the study group).

From a value perspective, option grants have steadily decreased in comparison to stock awards. In 2009, the ratio of stock to option awards was about 2.5 to 1; by 2013 that ratio had grown to almost 6 to 1, similar to the High Tech company ratio.

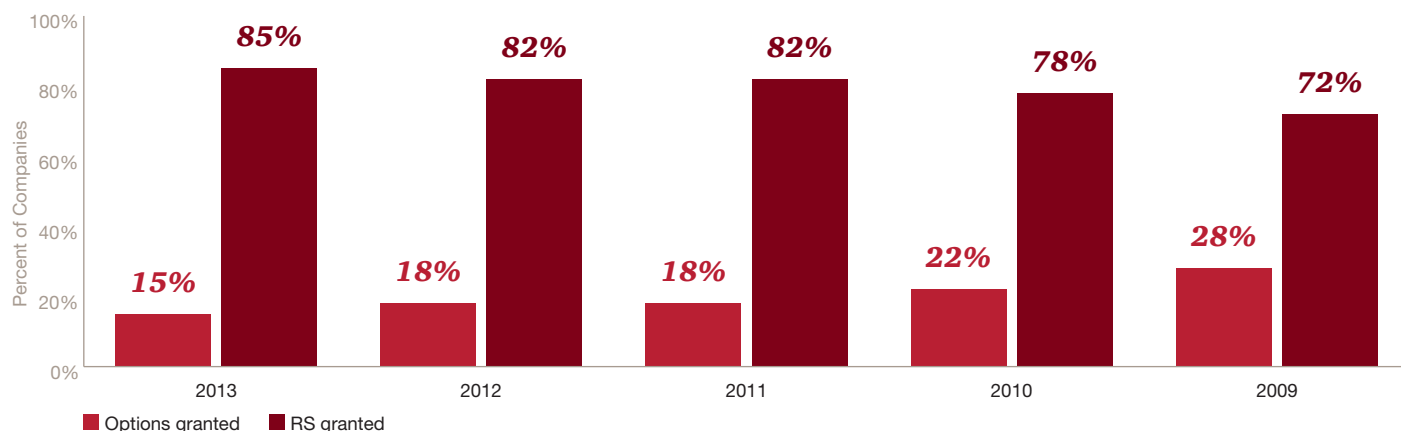
(In thousands)

	2013	2012	2011	2010	2009
Total options	354,338	401,276	423,465	576,338	1,052,524
Total grant date option value	\$3,579,354	\$3,871,881	\$4,329,668	\$4,863,435	\$5,365,314
Total stock	373,147	558,987	496,114	1,272,572	759,557
Total grant date stock value	\$20,651,821	\$17,918,469	\$19,400,143	\$26,146,607	\$12,396,387

### Award Mix—Options and Restricted Stock (percent of share units awarded)



## Award Mix—Options and Restricted Stock (percent of value)



### High Tech Companies

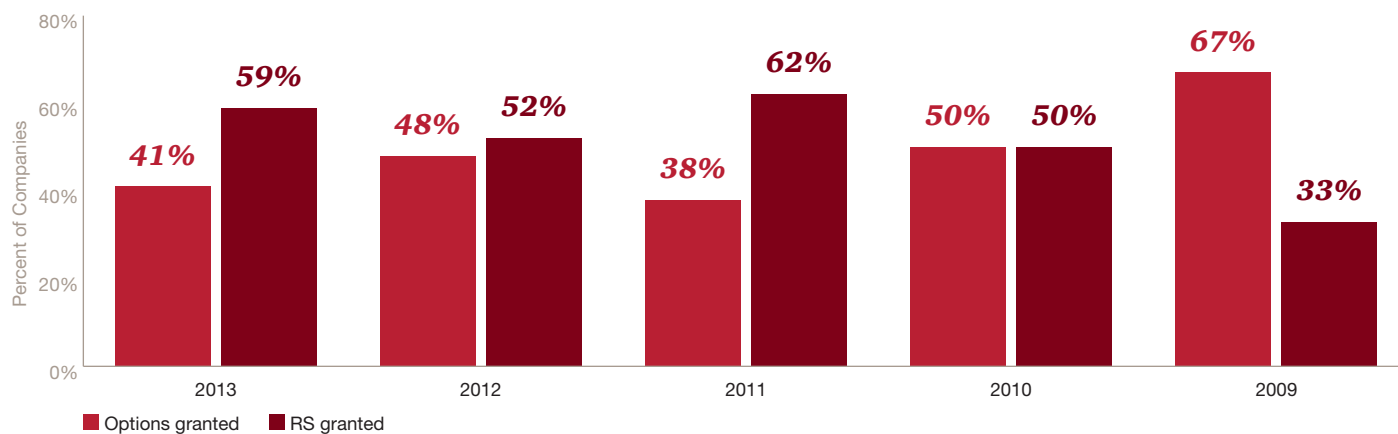
Over the last 5 years, the shift from options to stock awards has been consistent. The number of options granted exceeded stock awards by a 2 to 1 ratio in 2009 for the High Tech companies in our study group. Since then we've seen a reversal in that ratio, with a significantly higher proportion of restricted stock to options. This movement is due to a number of factors, including pressure from

shareholder advisory firms, employee perceptions of value, alignment of employee and shareholders interests, manage shareholder dilution, etc.

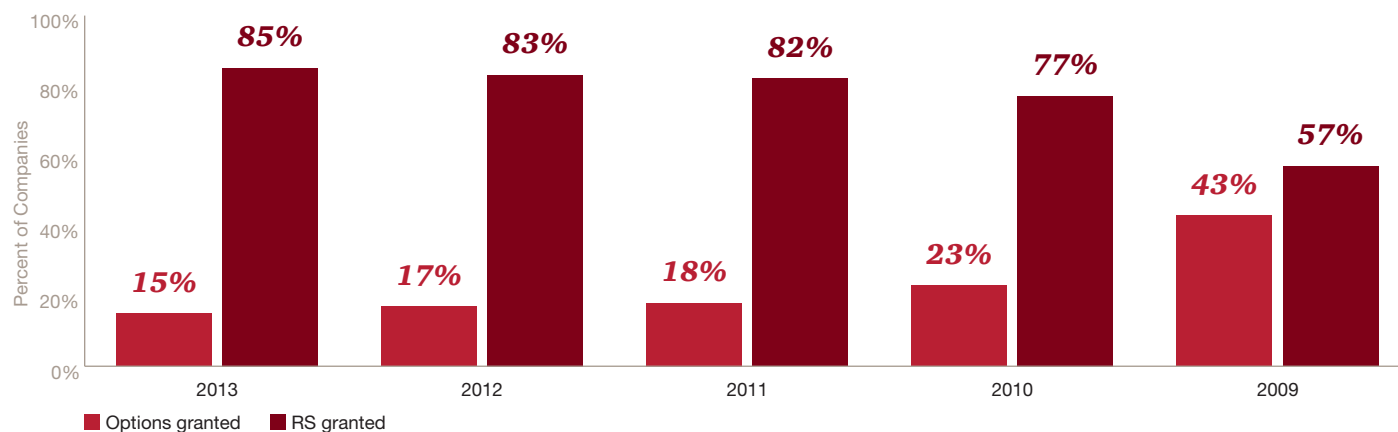
From a value perspective, option grants have steadily decreased in comparison to stock awards. In 2009, the ratio of value of stock to option awards was about 3 to 2; by 2013 that ratio had grown to almost 6 to 1.

(In thousands)					
	2013	2012	2011	2010	2009
Total options	257,845	278,514	287,803	320,890	607,581
Total grant date option value	\$3,206,120	\$2,972,944	\$2,582,255	\$2,781,762	\$5,039,336
Total stock	375,806	304,292	466,490	327,161	299,924
Total grant date stock value	\$17,871,123	\$14,662,241	\$11,798,608	\$9,175,154	\$6,716,321

### Award Mix—Options and Restricted Stock (percent of share units awarded)



### Award Mix—Options and Restricted Stock (percent of value)





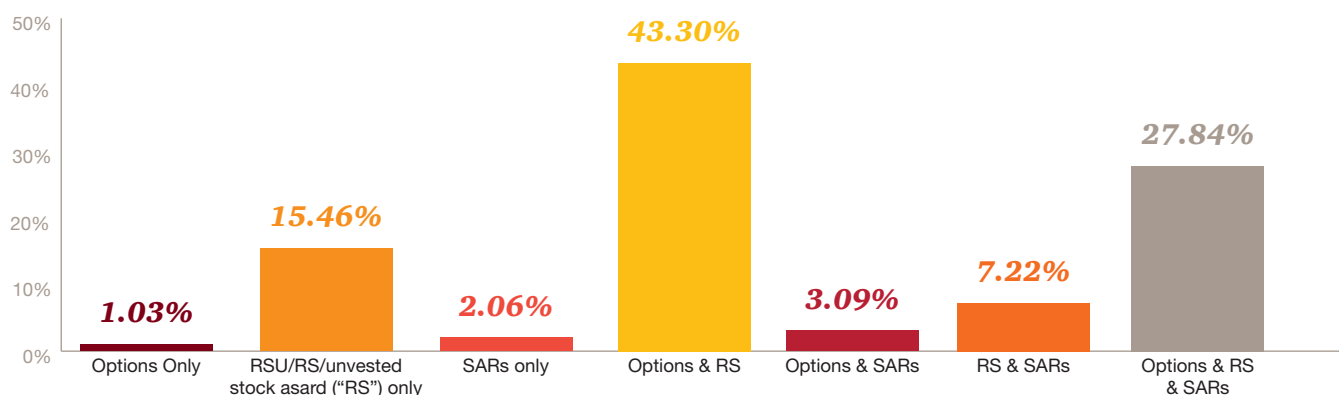
## Mix of Awards Granted—Specific Type

### Large Companies

Of the Large companies in our study, for 2013 nearly 19% of companies granted just one type of equity award (including 15% of companies granting only stock awards). However, the

majority of companies (71%) provided a mix of equity award types including both stock options and restricted stock, with about a third of those companies also providing SARs.

Award Mix—By Specific Type (percent of companies)

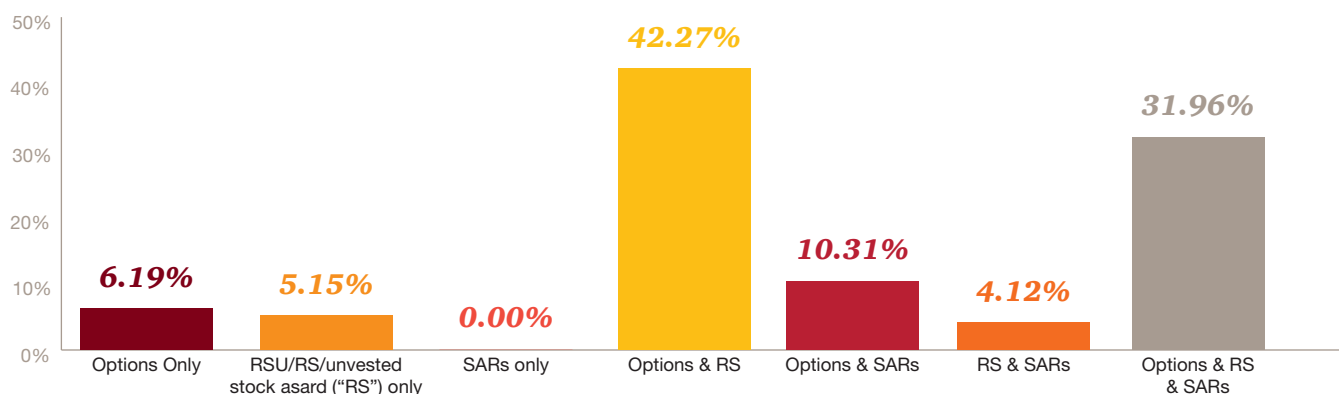


### High Tech Companies

Of the High Tech companies in our study, for 2013 only 11% of companies granted just one type of equity award (6% granted stock options only, 5% granted restricted stock only, and none granted SARs only). The

majority of companies (74%) provided a mix of equity award types including both stock options and restricted stock, with nearly half of these companies also providing SARs.

Award Mix—By Specific Type (percent of companies)



## Option pricing model

### Model Choices

Companies generally have a choice of what option pricing model to use to determine the fair value of their stock options. However more complex awards or those with market conditions (i.e., conditions to earn the award are indexed to the value of the issuer's shares) will need to be valued using a more sophisticated approach, such as a lattice model or Monte Carlo simulation<sup>7</sup>. Monte Carlo simulations can also be used to develop just a particular assumption, such as the expected term, and in turn that outcome is used in a Black-Scholes option pricing model.

### Large Companies

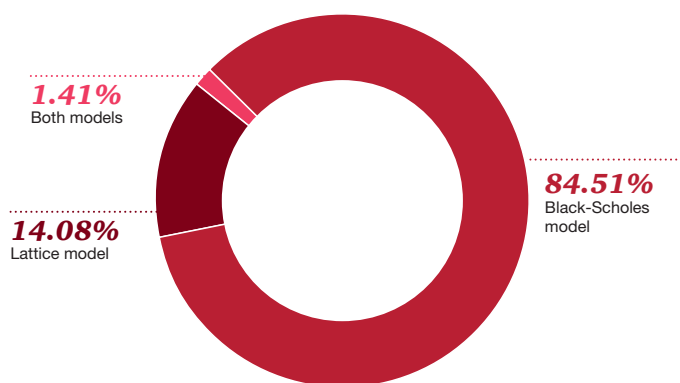
For Large companies, the model of choice is also the Black-Scholes

option pricing model. However, approximately 15% of companies (nearly twice the rate for High Tech companies) employed a lattice option pricing model, likely reflecting more market-based criteria, such as the increased prevalence of Total Shareholder Return (or TSR) measures, in the terms of awards.

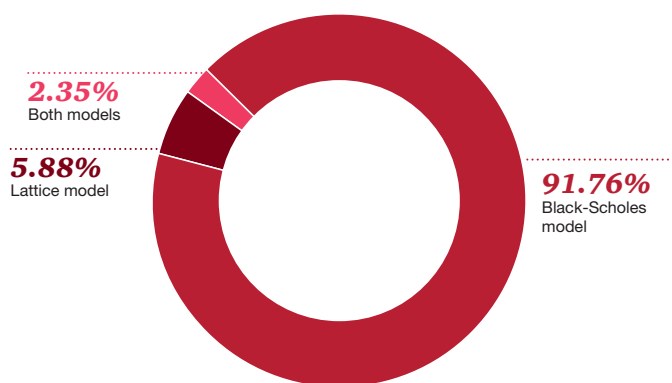
### High Tech Companies

For High Tech companies, the option pricing model most used is the Black-Scholes model, which is the least-cost method of valuation for options without complications (e.g., the majority of option grants). However, lattice pricing models are used by about 8% of the High Tech companies for some of their awards which require the more advanced valuation modelling.

Large Companies 2013 Valuation Basis



High Tech 2013 Valuation Basis



<sup>7</sup> "Lattice model" for this study refers to both lattice model and Monte Carlo simulations.

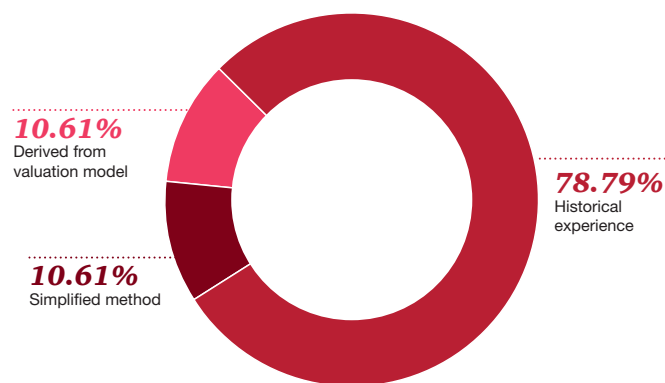
## Option pricing model Assumptions

### Basis for Expected Term and Volatility—Large Companies

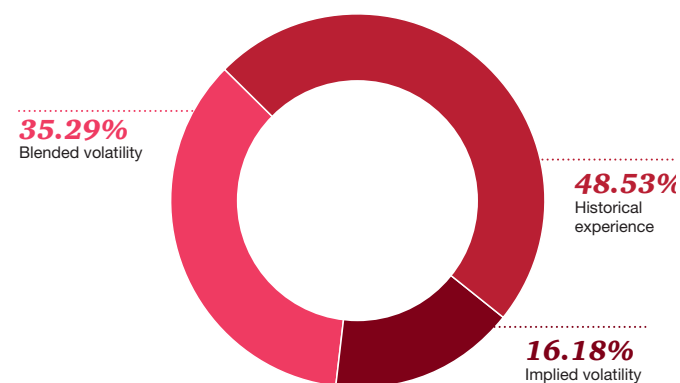
Large companies have continued to rely mostly on historical experience in 2013. For Large companies disclosing their **expected term** methodology, 78% relied solely on their historical experience, 11% used the simplified method<sup>8</sup>, and another 11% relied on other methods (e.g., derived using a Monte Carlo simulation or other model).

Of the 68 Large companies that granted stock options in 2013 and disclosed their volatility, 49% relied on historical stock price data for their **volatility assumption**, 16% of the companies in the analysis relied solely on their implied volatility<sup>9</sup>, and 35% used a blend of historical and implied volatilities. None of the Large companies disclosed using peer group volatility.

#### 2013 Expected Term



#### 2013 Volatility



<sup>8</sup> As described in ASC 718-10-S99; we did not validate whether use of the simplified method was appropriate—a company should consider their historical data available for awards with similar terms and issued to employees with similar characteristics, among other criteria to substantiate the lack of credible data and reliance upon the simplified method.

<sup>9</sup> As described in ASC 718-10-S99; we did not validate whether use of implied volatility alone was appropriate or met the various criteria in the standard (e.g., plain vanilla option, option contracts of 1-year or longer only, at or near-the-money contracts, sufficient volume, etc.).

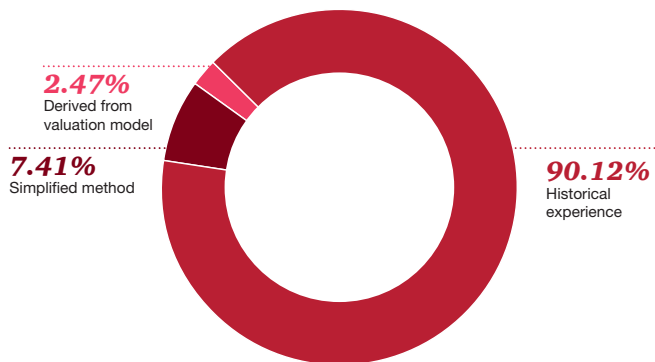
### ***Basis for Expected Term and Volatility— High Tech Companies***

When setting the **expected term** or **volatility** assumptions (the more significant assumptions for the Black-Scholes pricing model), the High Tech companies in our study continue to rely heavily on historical experience. For High Tech companies disclosing their **expected term** assumption, 90% of companies relied solely on their historical experience while 7% used the so-called simplified method<sup>10</sup> and another 3% relied on other methods (e.g., derived from a Monte Carlo simulation or other model). As many companies now

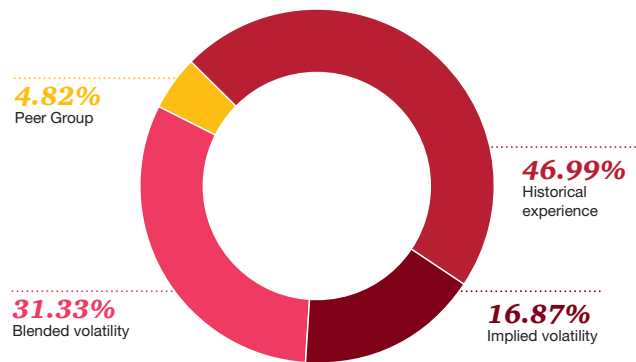
have credible historical data they can track and analyze, a significant number of companies have switched from the simplified method to historical experience.

Of the 83 High Tech companies that granted stock options in 2013 and disclosed their **volatility** methodology, 47% of the companies used historical stock price data as the sole basis for their **volatility**<sup>11</sup> assumption, 17% of the companies relied solely on implied volatility (i.e., the volatility inherent in the company's market traded options), 31% used a blend of historical and implied volatilities, and the remaining 5% relied on peer group data.

#### **2013 Expected Term**



#### **2013 Volatility**



<sup>10</sup> As described in ASC 718-10-S99; we did not validate whether use of the simplified method was appropriate—a company should consider their historical data available for awards with similar terms and issued to employees with similar characteristics, among other criteria to substantiate the lack of credible data and reliance upon the simplified method.

<sup>11</sup> As described in ASC 718-10-S99; we did not validate whether use of implied volatility alone was appropriate or met the various criteria in the standard (e.g., plain vanilla option, option contracts of 1-year or longer only, at or near-the-money contracts, sufficient volume, etc.).

## Option pricing model Assumptions —Expected Term

### Large Companies

The average **expected term** assumption in 2013 was 5.72 years, reflecting a decrease from 2012 (5.88 years) and slightly less than the average in 2009 (5.80 years).

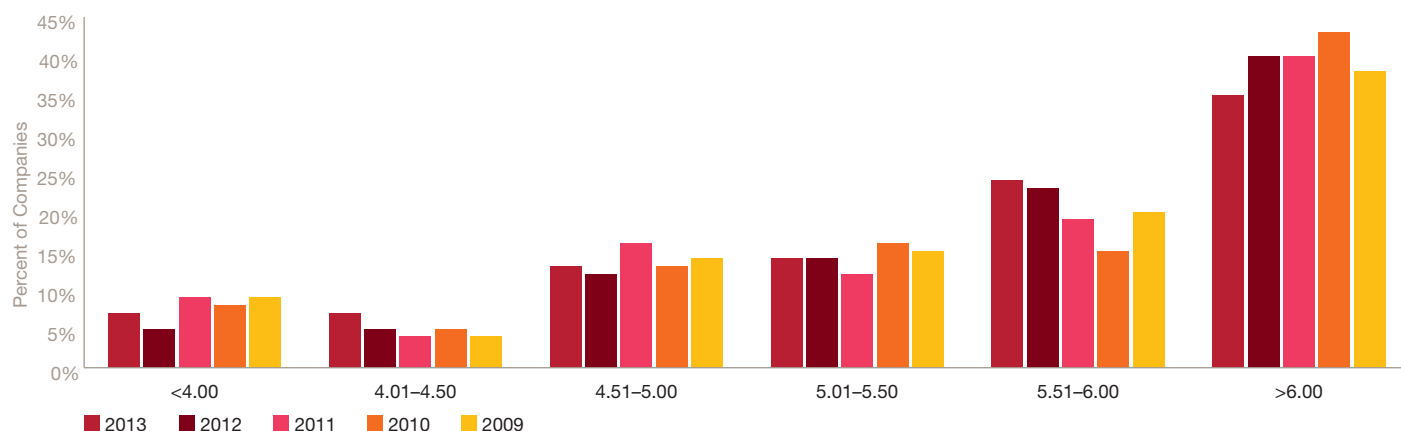
For 2013, the **expected term** assumption for the 20th to 80th percentiles (comprising 60% of the Large companies and excludes

outliers, generally) ranged from 5.00 years to 6.60 years, identical to the 2009 the range. Similarly, the percent of Large companies in 2013 with an **expected term** of over 5 years was 73%, essentially unchanged since 2009. We did however, see movement at the high-end, with the percentage of Large companies assuming greater than 6.00 years decreasing since 2010, moving from 43% in 2009 to 35% in 2013.

#### Expected Term

	2013	2012	2011	2010	2009
Low	0.50	1.50	2.00	2.50	3.35
Median (middle)	6.00	6.00	5.90	6.00	6.00
Mean (average)	5.72	5.88	5.78	5.79	5.80
High	8.20	9.00	8.00	8.00	8.10

#### Expected Term Assumption (in years)



## High Tech Companies

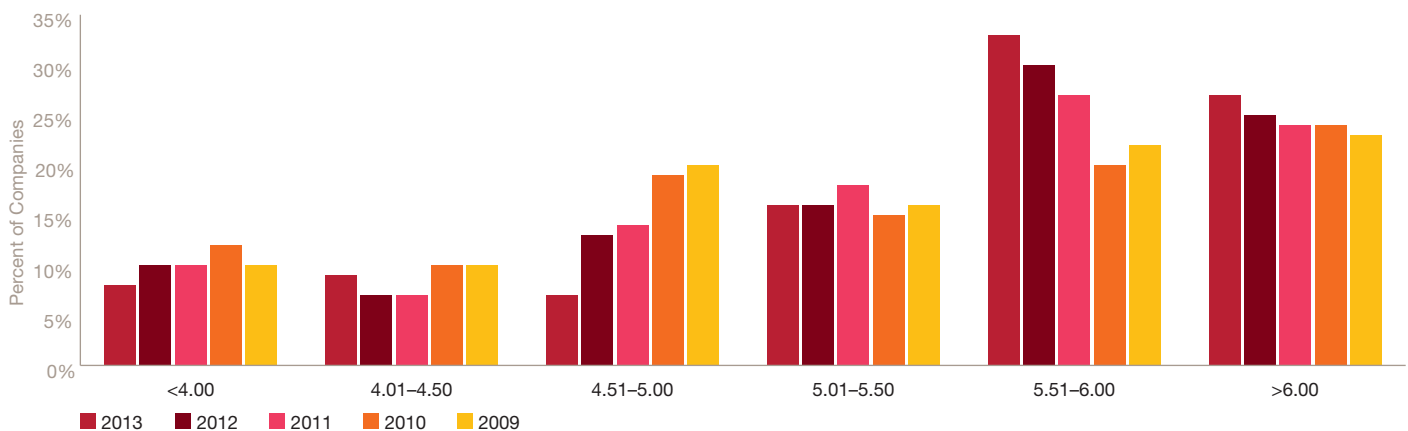
Over the last 5 years, the average **expected term** assumption has increased somewhat from 5.40 years to 5.57 years, increasing consistently since 2010. As High Tech companies primarily use historical experience to develop this assumption, the inference is that employees are choosing to hold stock options longer or letting under-water awards expire.

For 2013, the **expected term** assumption for the 20th to 80th percentiles (comprising 60% of the High Tech companies and excludes outliers, generally) ranged from 5.00 years to 6.30 years while in 2009 the range was 4.60 years to 6.10 years, reflecting further the continued lengthening of this assumption. Additionally, the percent of High Tech companies in 2013 with an **expected term** of over 5 years was 76% whereas in 2009 it was just 61%.

### Expected Term

	2013	2012	2011	2010	2009
Low	0.25	0.25	0.25	0.25	2.95
Median (middle)	5.70	5.60	5.60	5.40	5.43
Mean (average)	5.57	5.48	5.41	5.29	5.40
High	9.10	9.10	8.60	9.50	9.45

### Expected Term Assumption (in years)



## Option pricing model Assumptions —Volatility

### Large Companies

For Large companies, the average **volatility** has decreased from 36% in 2009 to 31% in 2013, with only 2012 showing a slight uptick. Again, the more likely reason for the steady decrease in **volatility** assumptions is the lessening impact from the financial crisis 5-years ago.

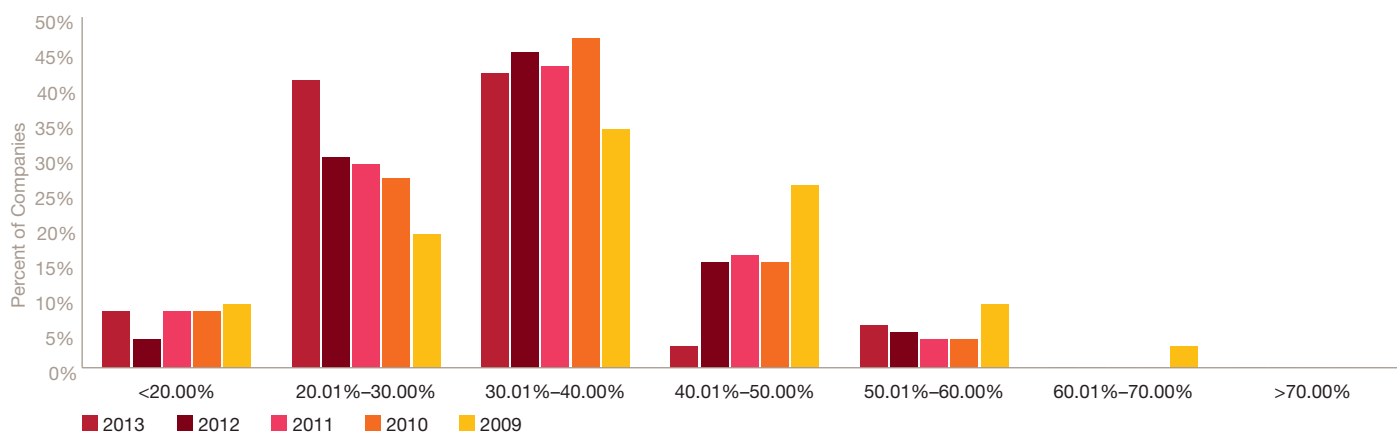
For 2013, the **volatility** assumption for the 20th to 80th percentiles (comprising 60% of the Large companies and excludes outliers, generally) ranged from 25% to 36% while in 2009 the range was 25% to 46%. Also reflecting the decrease in **volatility**, 9% of Large companies in 2013 reported a **volatility** of over 40% whereas in 2009 it was 38% of the companies.

Volatility					
	2013	2012	2011	2010	2009
Low	15.40%	12.86%	12.54%	14.50%	15.60%
Median (middle)	30.04%	34.00%	33.26%	33.15%	36.01%
Mean (average)	31.23%	33.98%	33.20%	33.37%	36.49%
High	56.59%	58.98%	55.39%	55.00%	63.50%

For companies in each percentile, High Tech companies are using significantly greater volatility assumptions, with the

20th percentile volatility for High Tech companies approaching twice that of Large companies.

### Volatility Assumption



## High Tech Companies

For High Tech companies, the mean **volatility** has decreased over the last 5 years, from 50% in 2009 to 43% in 2013. With most High Tech companies

relying on historical stock price data to set the **volatility** assumption, the further we move from the 2007–2009 turmoil, the less impact that period's extreme market fluctuations will bear.

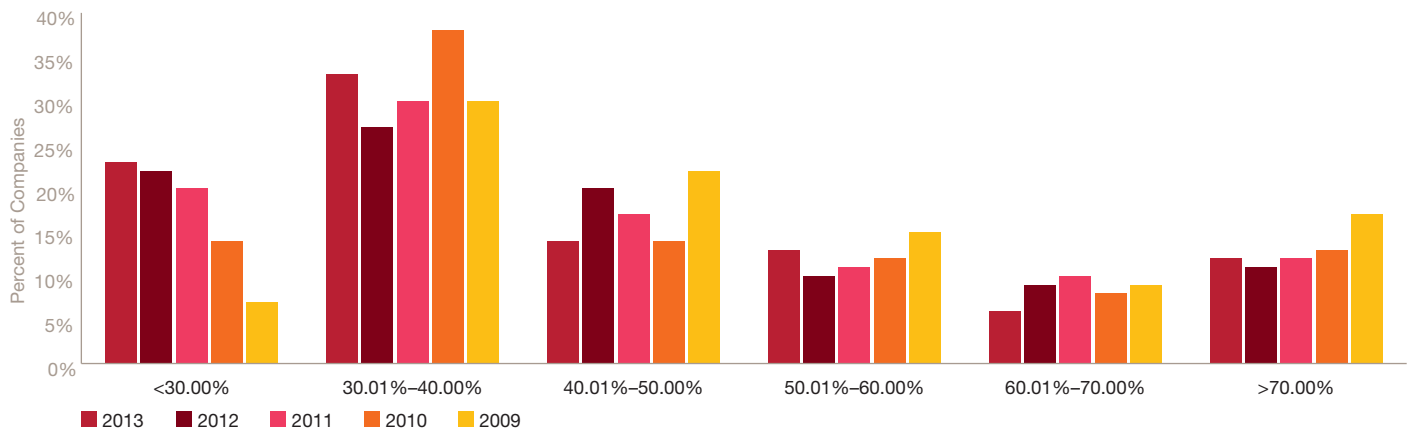
### Volatility

	2013	2012	2011	2010	2009
Low	10.68%	18.38%	18.20%	17.40%	19.50%
Median (middle)	37.00%	40.63%	39.95%	39.69%	46.10%
Mean (average)	43.43%	45.95%	46.00%	46.65%	50.00%
High	105.00%	111.00%	111.00%	134.66%	98.00%

For 2013, the **volatility** assumption for the 20th to 80th percentiles (comprising 60% of the High Tech companies and excludes outliers, generally) ranged from 29% to 58% while in 2009 the range was

34% to 65%. Also reflecting the decrease in **volatility**, 30% of High Tech companies in 2013 reported a **volatility** of over 50% whereas in 2009 it was 40% of the companies.

### Volatility Assumption





## Option pricing model Assumptions —Risk-Free Rate and Dividend Yield

### Large Companies

For Large companies over the last 5 years, the average **risk-free interest rate** decreased from 2.26% in 2009 to 2.13% in 2013, after a slight (0.01%) bump up from the low in 2012.

The average dividend yield for the Large companies reporting a **dividend yield** assumption decreased from 2.87% in 2009 to 2.28% in 2013. For the recent 4-year period, the **dividend yield** has stayed within a narrow range, with the 2009 assumed **dividend yield** likely impacted by the depressed stock prices at that time.

#### Risk-Free Interest Rate

	2013	2012	2011	2010	2009
Low	0.10%	0.40%	0.58%	0.87%	1.25%
Median (middle)	1.10%	1.10%	2.30%	2.50%	2.20%
Mean (average)	1.13%	1.12%	2.19%	2.48%	2.26%
High	2.50%	2.19%	3.40%	3.89%	3.70%

#### Dividend Yield<sup>12</sup>

	2013	2012	2011	2010	2009
Low	0.10%	0.10%	0.10%	0.10%	0.10%
Median (middle)	2.30%	2.38%	2.20%	2.50%	3.00%
Mean (average)	2.28%	2.36%	2.27%	2.43%	2.87%
High	4.30%	5.40%	5.96%	6.61%	7.00%

<sup>12</sup> The above results for the dividend yield assumption reflect only those companies reporting a non-zero dividend yield assumption.

### High Tech Companies

Generally, the **risk-free rate** and the **dividend yield** assumptions will not have as significant an impact on the option pricing model results compared to the **expected term** and **volatility** assumptions, but they are still important factors in determining fair market value of employee stock options. For High Tech companies over the last 5 years, the average **risk-free interest rate** decreased from 2.23% in 2009 to 1.21% in 2013, after a

slight bump up from the low of 0.94% in 2012.

The average dividend yield for the High Tech companies reporting a **dividend yield** assumption decreased from 3.54% in 2009 to 2.27% in 2013. For the recent 4-year period, the **dividend yield** has stayed within a narrow range, with the 2009 assumed **dividend yield** likely impacted by the depressed stock prices at that time.

#### Risk-Free Interest Rate

	2013	2012	2011	2010	2009
Low	0.10%	0.10%	0.10%	0.10%	1.06%
Median (middle)	1.17%	0.90%	1.90%	2.18%	2.25%
Mean (average)	1.21%	0.94%	1.85%	2.18%	2.23%
High	2.20%	2.10%	2.90%	3.30%	3.80%

#### Dividend Yield<sup>13</sup>

	2013	2012	2011	2010	2009
Low	0.20%	0.26%	0.25%	0.30%	0.35%
Median (middle)	2.13%	2.50%	2.30%	2.30%	3.10%
Mean (average)	2.27%	2.54%	2.37%	2.28%	3.54%
High	4.30%	4.40%	4.30%	4.10%	6.30%

<sup>13</sup> The above results for the dividend yield assumption reflect only those companies reporting a non-zero dividend yield assumption.

## Stock Compensation Expense

### Large Companies

For the Large companies in our study, the median stock compensation expense and company earnings have

both grown over the last 5 years, with earnings nearly doubling in that time span.

#### Median Earnings and Stock Compensation Expense (pre-tax, in millions)

	2013	2012	2011	2010	2009
Stock Comp. Expense	\$129	\$125	\$113	\$113	\$113
Earnings	\$3,880	\$3,234	\$3,541	\$3,260	\$1,996

Stock Compensation Expense as a percent of earnings was the highest in 2009 than at any point in the

5-year period, but has remained in the 3% to 4% range throughout the 5-year period.

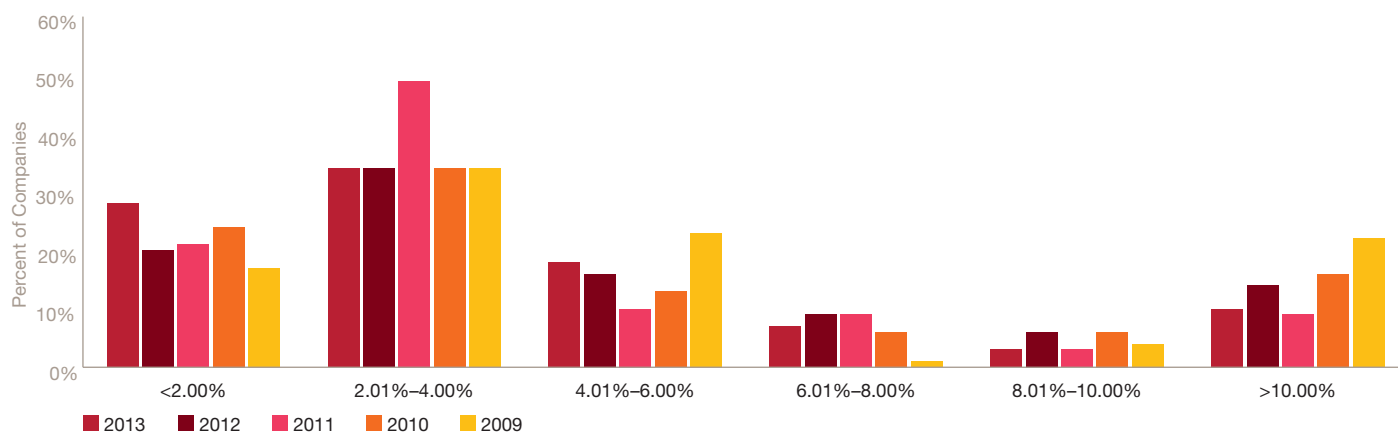
#### Stock Compensation Expense as % of Income before Taxes<sup>14</sup>

	2013	2012	2011	2010	2009
Median	3.27%	3.71%	3.32%	3.32%	3.93%

For 2013, stock compensation as a percentage of income for the 20th to 80th percentiles (comprising 60% of the High Tech companies and excludes

outliers, generally) ranged from about 1.5% to 6%, down from 2009 when the range was 2.2% to nearly 11%.

### Stock Compensation Expense as a Percent of Earnings



<sup>14</sup> Excludes companies with a net operating loss reported in the year shown.

## High Tech Companies

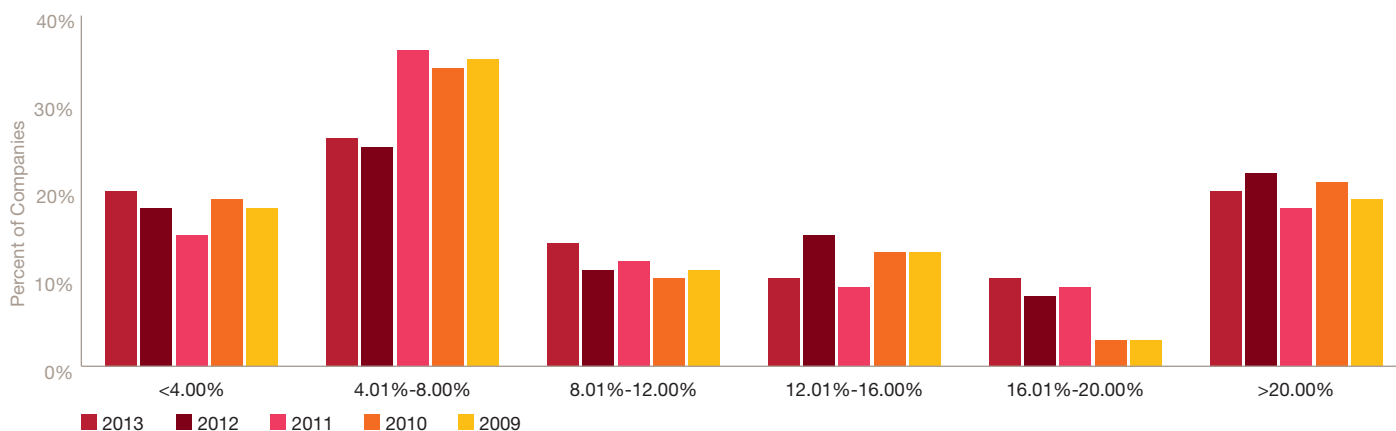
For the High Tech companies in our study, the median stock compensation expense and company earnings have both grown over the last 5 years.

Median Stock Compensation Expense and Company Earnings (pre-tax, in millions)					
	2013	2012	2011	2010	2009
Stock Comp. Expense	\$42	\$38	\$29	\$23	\$21
Earnings	\$395	\$293	\$250	\$190	\$170

Stock Compensation Expense as a percent of earnings was the highest in 2012 than at any point in the 5-year period, but still represents a hefty percentage in 2013.

Stock Compensation Expense as % of Income before Taxes <sup>15</sup>					
	2013	2012	2011	2010	2009
Median	9.18%	10.64%	7.76%	7.02%	7.39%

### Stock Compensation Expense as % of Income before Taxes



<sup>15</sup> Excludes companies with a net operating loss reported in the year shown.

## **Comparison to Year of ASC 718 (Formerly FAS 123R) Adoption**

The following is a comparison of 2013 data to 2006, when the current stock compensation rules were implemented and expense moved from being pro forma to an actual P&L impact. Of note, both High Tech and Large company groups are moving to stock awards and away from options (further evidenced in the body of this study when comparing values granted by type of award). Stock compensation as a percentage of income remains at 10%+/- for High Tech companies, but just in the 3%+ range for Large companies.

Methods/processes established over 7 years ago remain prevalent in 2013. The Black-Scholes option valuation model is still widely used, although we note there is nothing to stop a company from using a lattice model with more advanced techniques to value any option award, such as use of exercise rates at different multiples of the original grant date stock price. Reliance on historical

data for the expected term is used by most companies, although Large companies are more likely to use a derived period (possibly to more appropriately deal with the volume of pre-2009 under-water awards expired or unexercised for long periods). Historical data for volatility is also a common basis, but over 50% of companies in both groups rely on implied volatility in combination with historical volatility or on a stand-alone basis.

Since 2006, the High Tech median assumptions for the expected term and dividend yield have increased significantly, volatility has decreased slightly, and risk-free rate has followed Treasury rates. For Large company median assumptions, the dividend yield has increased also, but the expected term has remained flat and volatility has actually increased. Interestingly, with these movements, the median assumptions between the two groups of companies have begun to converge.

### Comparison to 2006 Data

	Large Companies		High Tech	
	2013	2006	2013	2006
Stock Compensation as a Percentage of Income-Median	3.27%	3.14%	9.18%	11.06%
Types of Equity Awards Granted (by units)				
Stock Options	49%	63%	41%	82%
Restricted Stock	51%	37%	59%	18%
Methods Used for Valuation or Assumption Setting Purposes				
Use of the Black-Scholes Valuation Model Only	85%	84%	92%	93%
Use of Only Historical Data for Expected Term	79%	88%	90%	93%
Use of Only Historical Data for Volatility	49%	46%	47%	47%
Assumptions Used for Black-Scholes Model-Median-(Average Rates)				
Expected Term (years)	6.00	6.00	5.70	5.00
Volatility	30.04%	26.00%	37.00%	40.00%
Risk-free Rate	1.10%	4.64%	1.17%	4.73%
Divided Yield	2.30%	1.80%	2.13%	1.38%

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