Grant Thornton

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# Share-based payments

## Navigating the guidance in ASC 718

## Contents

# 1. Overview

*Accounting Standards Codification*® (ASC) 718, *Compensation – Stock Compensation,* comprises codified guidance on accounting for employee share-based arrangements and originates primarily from the guidance in Statement 123(R), *Share-Based Payment*, issued in 2004. ASC 718 also reflects the guidance issued in related FASB Staff Positions (FSPs), Accounting Standards Updates (ASUs), and Securities and Exchange Commission (SEC) Staff Accounting Bulletins (SABs). The overarching principle of ASC 718 is to account for the fair value of employee awards as compensation expense in the financial statements.

In 2014, the Financial Accounting Foundation, the oversight body of the FASB, conducted its post-implementation review of Statement 123(R), which identified certain criticisms of the standard, including that the guidance was sometimes difficult to understand and costly to apply. To address some of these concerns, the FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, in March 2016 and ASU 2017-09, *Scope of Modification Accounting*, in May 2017. This guide reflects that new guidance.

In June 2018, the FASB issued ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting,* to simplify the accounting for nonemployee awards by expanding the scope of ASC 718 to include share-based payment transactions involving nonemployees. ASU 2018-17 supersedes the guidance in ASC 505-50, *Equity-Based Payments to Non-Employees*. Once adopted, the amended guidance mostly aligns the accounting for nonemployee awards with the existing accounting model for employee awards, with few differences remaining. The amendments are effective in 2019 for calendar-year public business entities and in 2020 for nonpublic entities. This guide presents in detail the accounting guidance for share-based payments under ASC 718 prior to the amendments in ASU 2018-07 and now includes the accounting guidance for share-based payments under ASC 718 for nonemployee awards, after adoption of ASU 2018-07.

This edition of this publication has been updated to include guidance for evaluating the impact of share-based payments on earnings per share and presentation and disclosure guidance for share-based payments. Section 2.4 on awards granted between entities in a consolidated group has been updated to reflect additional guidance.

# 2. Objective and Scope

## 2.1 Objective

The objective of the guidance in ASC 718 is to recognize the fair value of employee services received in exchange for equity instruments issued, or liabilities incurred, as the employee provides the related services to the entity.

### ASC 718-10-10-1

The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed. This Topic uses the terms *compensation* and *payment* in their broadest senses to refer to the consideration paid for employee services.

### ASC 718-10-10-2

This Topic requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. This Topic establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee stock ownership plans.

The guidance in ASC 718 applies to all entities that enter into share-based payment transactions with employees in which an entity receives services from the employee in exchange for issuing equity instruments, or incurring liabilities, that either

- Are an amount based, at least in part, on the price of the entity's shares or the entity's other equity instruments. Although many liabilities within the scope of ASC 718, such as cash-settled share appreciation rights, are indexed solely to the price of the entity's equity instruments, a liability indexed to both the price of an entity's equity instruments and something else, such as the price of a commodity, would also be accounted for under ASC 718.
- Require or may require settlement by issuing the entity's shares or other equity instruments, for example, an annual bonus granted to a sales representative payable in shares.

### ASC 718-10-15-1

The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Compensation—Stock Compensation Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Compensation—Stock Compensation Topic, with the exception of Subtopic 718-50, which has its own discrete scope.

**ASC 718-10-15-2**

The guidance in the Compensation—Stock Compensation Topic applies to all entities that enter into share-based payment transactions with employees.

**ASC 718-10-15-3**

The guidance in the Compensation—Stock Compensation Topic applies to all share-based payment transactions in which an entity acquires employee services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee that meet either of the following conditions:

a. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase *at least in part* is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.)

b. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

The guidance in ASC 718 only addresses transactions with employees involving the rendering of services. In contrast, equity instruments issued in exchange for cash or other financial assets, such as detachable warrants issued in connection with a debt or preferred share offering that are not subject to the guidance in ASC 718, should be accounted for under other guidance, such as ASC 470-20, *Debt: Debt with Conversion and Other Options,* or ASC 815, *Derivatives and Hedging*.

An award generally is within the scope of ASC 718 if it is granted in exchange for employee services, even if it is awarded by a party other than the employer, such as an investor or affiliate.

Equity instruments held by an employee share ownership plan (ESOP) must be accounted for under ASC 718-40, *Employee Stock Ownership Plans*.

**ASC 718-10-15-4**

Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

**ASC 718-10-15-5**

The guidance in this Topic does not apply to the following payment transactions:

a. Share-based transactions for other than employee services (see Subtopic 505-50 for guidance on those transactions).

**ASC 718-10-15-7**

The guidance in the Overall Subtopic does not apply to equity instruments held by an employee stock ownership plan.

An entity should refer to the guidance in ASC 805, *Business Combinations*, to determine whether share-based payment awards issued in a business combination are either (1) part of the consideration transferred in exchange for the acquiree (and therefore accounted for under ASC 805), or (2) compensation expense accounted for under ASC 718. Some of these awards are accounted for in part as consideration and in part as compensation.

**ASC 718-10-15-6**

Paragraphs 805-30-30-9 through 30-13 provide guidance on determining whether share-based payment awards issued in a business combination are part of the consideration transferred in exchange for the acquiree, and therefore in the scope of Topic 805, or are for continued service to be recognized in the postcombination period in accordance with this Topic.

## 2.2 Guidance applicable to awards to employees

The FASB originally developed the guidance in ASC 718 explicitly for awards to employees. Share-based payments issued to nonemployees were excluded from the scope of ASC 718 and are accounted for using the guidance in ASC 505-50, *Equity-Based Payments to Non-Employees.* Because ASC 505-50 does not provide comprehensive accounting guidance, however, entities have been applying the guidance in ASC 718 by analogy for certain aspects of nonemployee arrangements. However, once ASU 2017-08 is effective in 2019 for calendar-year public business entities and in 2020 for nonpublic entities, the amended guidance mostly aligns the accounting for nonemployee awards with the existing accounting model for employee awards.

The differences in the accounting for share-based payment awards granted to an employee versus a nonemployee relate to the measurement date and recognition requirements. Therefore, determining whether a grantee is an employee or a nonemployee is a significant step in applying the correct accounting.

An **employee** is an individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41. A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction. Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies a grantee potentially subject to U.S. payroll taxes as an employee also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee because the grantee also must be an employee of the grantor under common law.

ASC 718 includes guidance about whether certain individuals, such as outsourced employees, nonemployee directors, and consultants performing management functions, are employees or nonemployees for purposes of applying share-based compensation accounting. The ASC Master Glossary defines “employee” as an individual over whom the grantor of a share-based compensation award can exercise sufficient control to establish an employer-employee relationship based on common law, as exemplified in both case law and under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41.

In the United States, common law employees are subject to payroll taxes. Therefore, to be an employee for purposes of ASC 718, an individual would have to be both an employee under common law, which includes meeting the factors in Revenue Ruling 87-41, and an employee for payroll tax purposes. Being subject to payroll taxes does not, by itself, indicate that an individual is a common law employee or an employee for purposes of applying the guidance in ASC 718. Entities need to analyze both case law and Revenue Ruling 87-41 and, if necessary, consult legal counsel to determine whether an individual qualifies as an employee in a share-based payment transaction. IRS Revenue Ruling 87-41 provides 20 factors for entities to consider in determining whether an individual is an employee or independent contractor, as outlined in the following table.

**Figure 2.1: IRS Revenue Ruling 87-41**

| No. | Factor | Description | Indicator |
|---|---|---|---|
| 1 | Instructions | The person for whom the services are performed has the right to require compliance with instructions. | Employee status |
| 2 | Training | Worker training (for example, requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner. | Employee status |
| 3 | Integration | The person for whom the services are performed integrates the worker’s services into the business operations. | Employee status |
| 4 | Services rendered personally | The services must be performed personally. This factor indicates that the person for whom services are performed is interested in the methods used to accomplish the work. | Employee status |
| 5 | Hiring, supervising, and paying assistants | The person for whom services are performed hires, supervises, and / or pays assistants.<br><br>Under a contract, an independent worker hires and | Employee status |

| No. | Factor | Description | Indicator |
|---|---|---|---|
| | | supervises others, agrees to provide materials and / or labor, and is only responsible for the result. | Independent contractor status |
| 6 | Continuing relationship | The worker and the person for whom the services are performed have a continuing relationship. | Employee status |
| 7 | Set hours of work | The person for whom the services are performed establishes set hours for the worker. | Employee status |
| 8 | Full time required | The worker must devote substantially full-time hours to the business of the person for whom the services are performed. | Employee status |
| | | The worker is free to work when and for whom he or she chooses. | Independent contractor status |
| 9 | Doing work on employer's premises | The work is performed on the premises of the person for whom the services are performed. | Employee status |
| 10 | Order or sequence test | The worker must perform services in the order or sequence set by the person for whom the services are performed, and is not free to follow his or her own pattern of work. | Employee status |
| 11 | Oral or written reports | The worker is required to submit regular reports. | Employee status |
| 12 | Payment by the hour, week, or month | The worker is paid by the hour, week, or month. | Employee status |
| | | The worker is paid by the job or on a commission. | Independent contractor status |
| 13 | Payment of business and / or traveling expenses | The person for whom the services are performed pays expenses, and retains the right to direct the worker. | Employee status |
| 14 | Furnishing tools and materials | The person for whom the services are performed provides significant tools and materials to the worker. | Employee status |
| 15 | Significant investment | The worker invests in facilities used performing services for others. | Independent contractor status |

| No. | Factor | Description | Indicator |
|---|---|---|---|
| 16 | Realization of profit or loss | The worker can realize a profit or suffer a loss as a result of the services (in addition to a profit or loss ordinarily realized by employees). | Independent contractor status |
| 17 | Working for more than one employer/ entity at a time | The worker performs more than de minimis services for multiple entities at the same time. | Independent contractor status |
| 18 | Service available to the general public | The worker makes his or her services available to the public on a regular and consistent basis. | Independent contractor status |
| 19 | Right to discharge | The person for whom the services are performed has the right to discharge the worker. | Employee status |
| 20 | Right to terminate | The worker has the right to terminate the relationship with the person for whom the services are performed at any time he or she wishes, without incurring a liability. | Employee status |

Whether an employer-employee relationship exists in a jurisdiction outside the United States should be determined under the laws of that jurisdiction.

### 2.2.1 Owners of pass-through entities

The FASB's Emerging Issues Task Force (EITF) addressed implementation issues related to FASB Interpretation (FIN) 44 in EITF Issue 00-23, "*Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*" (the guidance in FIN 44 is not included in the Codification). Although ASC 718 superseded the guidance in FIN 44, entities continue to use certain implementation guidance in FIN 44, such as the guidance on clarifying who is an employee, for share-based payment purposes as well as additional clarifying guidance in EITF Issue 00-23. For example, Issue 40(a) of EITF Issue 00-23, addresses whether an individual providing services to a pass-through entity, such as a partnership or a limited liability company (LLC), would be considered an employee of the pass-through entity if he or she holds ownership interests in the entity. In that case, the entity would not withhold payroll taxes from distributions made to the individual. In Issue 40(a), the EITF concluded that the individual providing services would be considered an employee if he or she qualifies as a common law employee; the fact that the individual is not considered an employee for payroll tax purposes would not be relevant in this determination.

The term "shares" as it relates to share based payment arrangements includes various forms of ownership interest that may not be in the form of legal securities, such as partnership interests.

A **share-based payment arrangement** is an arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.

b. The entity incurs liabilities to suppliers that meet either of the following conditions:

   1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)

   2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity. These arrangements are also referred to as share-based compensation arrangements.

### 2.2.2 Part-time and leased employees

A part-time employee may be considered an employee for purposes of applying ASC 718 if the individual meets the definition of employee under the guidance discussed in Section 2.1. This generally would be the case if, for example, an individual has two jobs and receives a share-based compensation from one or both employers. An award to that person would be accounted for as an employee award.

Many employment arrangements described as "part-time" involve personnel management firms or other parties that provide an entity with an individual or individuals for employment. ASC 718 uses the term "leased individuals" to describe employees working under these type arrangements. Employers (lessees) sometimes grant share-based compensation to their leased employees, which may prompt questions about whether these individuals are considered employees for purposes of applying ASC 718.

The definition of employee in the ASC Master Glossary, discussed below, provides criteria that indicates an individual is an employee of the lessee for purposes of applying the guidance in ASC 718.

An **employee** is a leased individual who is deemed to be an employee of the lessee if all of the following requirements are met:

a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.

b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:

   1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.

2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).

The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.

### 2.2.3 Nonemployee directors

An individual who serves an entity as a member of the board of directors is not a common law employee and therefore is not considered an employee for purposes of applying ASC 718. However, the guidance in ASC 718 includes a limited exception for certain nonemployee directors. The exception focuses on the role of the individual and the reason for granting the award.

A **nonemployee director** does not satisfy this definition of employee. Nevertheless, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were elected by the employer's shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees.

This narrow exception applies only to an individual who provides services as a director subject to a shareholder election. In addition to a board of directors, many entities appoint individuals in other roles that use the words "director" or "board" in the title. This exception would not apply, for example, to awards granted to an individual appointed to serve on an entity's "advisory board'" or "medical board of advisors" unless the individual meets the common law definition of an employee.

Nonemployee directors meeting this exception may often perform other professional services for the entity as well as serving on the board of directors. Individual directors may, for example, perform legal services, investment advisory services, or marketing services. Share-based payment awards granted for these types of services are accounted for as awards to nonemployees, as illustrated in the following example.

**Awards granted for other services performed by nonemployee directors**

An entity annually awards each nonemployee member of its board of directors 5,000 restricted stock units for board service. In 20X1, however, the entity awards one director, who is an attorney, 10,000 restricted stock units.

The entity evaluates the incremental award to determine whether it relates to services as a member of the board of directors or to other services, such as legal advice.

After examining the particular facts and circumstances and applying judgment, the entity concludes that the incremental shares relate to legal services that the director provided to the entity.

At times, a nonemployee director award will be bifurcated into an employee award for that portion related to director service and a nonemployee award for other services.

The guidance in ASC 718 further limits the circumstances in which an entity may use employee accounting for awards granted to nonemployee directors. If a consolidated group has multiple boards of directors, an entity may apply employee accounting to nonemployee directors of consolidated subsidiaries only if shareholders that are not controlled, directly or indirectly, either by the parent or another member of the consolidated group elect those individuals. The examples that follow discuss the exception for nonemployee directors.

### Example 2: Definition of Employee

**ASC 718-10-55-89**

This Example illustrates the evaluation as to whether an individual meets conditions to be considered an employee under the definition of that term used in this Topic.

**ASC 718-10-55-90**

This Topic defines employee as an individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41. An example of whether that condition exists follows. Entity A issues options to members of its Advisory Board, which is separate and distinct from Entity A’s board of directors. Members of the Advisory Board are knowledgeable about Entity A’s industry and advise Entity A on matters such as policy development, strategic planning, and product development. The Advisory Board members are appointed for two-year terms and meet four times a year for one day, receiving a fixed number of options for services rendered at each meeting. Based on an evaluation of the relationship between Entity A and the Advisory Board members, Entity A concludes that the Advisory Board members do not meet the common law definition of employee. Accordingly, the awards to the Advisory Board members are accounted for as awards to nonemployees under the provisions of this Topic.

**ASC 718-10-55-91**

Nonemployee directors acting in their role as members of an entity’s board of directors shall be treated as employees if those directors were elected by the entity’s shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to them for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees in accordance with Section 505-50-25. Additionally, consolidated groups may have multiple boards of directors; this guidance applies only to either of the following:

a. The nonemployee directors acting in their role as members of a parent entity’s board of directors

b. Nonemployee members of a consolidated subsidiary's board of directors to the extent that those members are elected by shareholders that are not controlled directly or indirectly by the parent or another member of the consolidated group

### 2.2.4 Certain transactions with related parties and other economic interest holders

ASC 718 Entities are required to account for share-based payment awards that are granted to employees by a *related party or other economic interest holder* as compensation cost under ASC 718, unless the award clearly represents something other than compensation for services provided to the entity.

A "related party" is defined as follows in ASC 718.

**Related parties** include:

a. Affiliates of the entity

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

An "economic interest" is broadly defined as any financial interest or arrangement the entity might issue or be a party to.

**ASC 718-10-15-4**

Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

This provision encompasses share-based payment awards transferred to employees by a related party, shareholder, other holder of an equity instrument, holder of long-term debt or other debt-financing arrangement, or a party to a contractual arrangement with the employer, such as a lease, management contract, service contract, or intellectual property license.

An **economic interest in an entity** is any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses.

### 2.2.5 Escrowed share arrangements

Under certain circumstances, shareholders are required to put a portion of their shares into escrow, subject to forfeiture if the shareholders do not meet specified performance requirements. For example, in a business combination, the acquiree's shareholders are employed after the acquisition, but must place a number of their shares in escrow until they provide a specified service within a designated time period. After the shareholders complete the service, the shares are released back to them. If the shareholders do not complete the service, the shares are forfeited. In a way, the shareholders who previously owned the shares must "re-earn" them after the acquisition by performing the agreed-upon services. Another example is a financing transaction in which the lender requires the shareholders to place their shares in escrow until a specified time period elapses or other conditions are met. If the conditions are met, the shares are then released to the shareholders. If the conditions are not met, the shares are forfeited. In these cases, the entity must determine whether an escrow arrangement is compensatory and accounted for under the guidance in ASC 718.

The SEC staff has historically considered such arrangements compensatory when escrowed shares are released back to certain shareholders only if specified performance conditions are satisfied. According to the SEC staff guidance in ASC 718-10-S99-2, *SEC Staff Announcement: Escrowed Share Arrangements and the Presumption of Compensation*, an entity must consider the substance of an arrangement, including whether it was entered into for purposes unrelated to continued employment, to overcome the presumption that an arrangement is compensatory. The SEC staff believes that

- An escrowed share arrangement qualifies as employee compensation if the escrowed shares are automatically forfeited when the shareholder's employment terminates.
- Rather than being compensatory, an arrangement is an inducement to facilitate the acquisition on the entity's behalf if the escrowed shares will be released or cancelled without regard to the shareholder's employment status. In this case, the measured cost should be classified as a reduction of the proceeds generated by the newly issued securities.

Regardless of whether the escrowed share arrangement is negotiated between the entity and the shareholders or between the shareholders and the new investors, the SEC staff believes that the entity should reflect the benefit, if any, created by the escrow arrangement in the financial statements.

## 2.3 Investor grants to employees of equity-method investees

An entity that grants equity instruments based on its own stock as compensation to the employees of its equity-method investee should account for the equity instruments using the guidance in ASC 323-10-25-3 through 25-6, *Investments – Equity Method and Joint Ventures,* if all of the following conditions are met:

- No proportionate funding is provided by other investors
- The contributing investor does not receive an increase in its ownership percentage of the investee
- The grant is not part of a transaction in which the contributing investor acquires an interest in the investee

**ASC 323-10-25-3**

The guidance in the following paragraph and paragraph 323-10-25-5 addresses the accounting for stock-based compensation based on the investor's stock granted to employees of an investee accounted for under the equity method if no proportionate funding by the other investors occurs and the investor does not receive any increase in the investor's relative ownership percentage of the investee. That guidance assumes that the investor's grant of stock-based compensation to employees of the equity method investee was not agreed to in connection with the investor's acquisition of an interest in the investee. That guidance applies to stock-based compensation granted to employees of an investee by an investor based on that investor's stock (that is, stock of the investor or other equity instruments indexed to, and potentially settled in, stock of the investor).

**ASC 323-10-25-4**

In the circumstances described in the preceding paragraph, a contributing investor shall expense the cost of stock-based compensation granted to employees of an equity method investee as incurred (that is, in the same period the costs are recognized by the investee) to the extent that the investor's claim on the investee's book value has not been increased.

**ASC 323-10-25-5**

In the circumstances described in paragraph 323-10-25-3, other equity method investors in an investee (that is, noncontributing investors) shall recognize income equal to the amount that their interest in the investee's net book value has increased (that is, their percentage share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Further, those other equity method investors shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).

ASC 323-10-25-4 through 25-5 requires the contributing investor to recognize the cost of the equity instruments in the same periods the cost is recognized by the investee, to the extent that the contributing investor's claim on the investee's book value does not increase.

Because the grantee is an employee of the investee and not the investor, the investor may not apply the employee award guidance in ASC 718 but instead should apply the guidance for awards to nonemployees. Similarly, because the investee's employee receives an award that is not an equity instrument of his or her employer, the investee should also apply the nonemployee accounting guidance.

The guidance in ASC 718 requires the noncontributing equity-method investors to recognize income equal to their percentage share of the capital contribution recognized by the investee (that is, how much their interest in the investee's net book value increased due to the contribution of the equity instruments). The noncontributing equity-method investors must also recognize their percentage share of earnings or losses in the investee.

In ASC 323-10-S99-4, the SEC staff indicates that equity-method investors who are SEC registrants should classify income and expense resulting from the contribution of equity instruments to an investee in the same income statement caption as equity in earnings or losses of the investee.

## 2.4 Awards granted between entities in a consolidated group

Entities in a consolidated group often issue awards to employees of different entities within the group. The accounting at the consolidated level generally is straightforward because the grantee is an employee within the consolidated entity. The accounting for these awards in the subsidiary' separate financial statements may be complex, depending on the specific facts and circumstances. As a result, entities should carefully consider the potential accounting impact of granting stock-based awards among subsidiary employees or from a subsidiary to parent employees. Some of these awards may result in applying the guidance on derivatives in ASC 815 in the employer subsidiary's separate financial statements.

A parent entity may grant a stock-based award to an employee of one of its wholly owned subsidiaries, or a subsidiary may grant a stock-based award to an employee of its parent or another subsidiary in the consolidated group. The guidance in ASC 718 applies only to awards made to employees of the grantor, but does not directly address awards granted within a consolidated group of entities (that is, awards granted by one entity to an employee of another entity within the group). Before the guidance on share-based payments was codified in ASC 718, the guidance in FIN 44 and EITF Issue 00-23 addressed these arrangements, and entities continue to look to FIN 44 and EITF Issue 00-23 for guidance on how to account for awards within a consolidated group.

Figure 2.2 summarizes the accounting that is explained further in the sections that follow.

**Figure 2.2 – Awards granted between entities within a consolidated group**

| Award description | Parent consolidated financial statements | Subsidiary separate financial statements |
|---|---|---|
| Parent issues award of parent stock to consolidated subsidiary employee | Account for the award as an employee award in accordance with ASC 718 | Account for award as an employee award in accordance with ASC 718 and expense as if the subsidiary had granted the award. Subsidiary credits equity for the capital contribution from the parent if the subsidiary does not provide consideration to the parent. |
| Consolidated subsidiary grants awards of its stock to employees of its parent entity | Account for the award as an employee award in accordance with ASC 718 | Measure the award at fair value at the grant date and recognize the amount as a dividend to the parent. The subsidiary does not recognize an expense. |

| Award description | Parent consolidated financial statements | Subsidiary separate financial statements |
|---|---|---|
| Consolidated subsidiary grants awards to employees of another consolidated subsidiary | Account for the award as an employee award in accordance with ASC 718 | *Grantor subsidiary:* Measure the award at fair value at the grant date and recognize the amount as a dividend to the parent. The subsidiary does not recognize an expense.<br><br>*Employer subsidiary:* The award received by the employee is not in the employer's equity and therefore is outside the scope of ASC 718. As a result, employer subsidiary accounts for award using the guidance in ASC 815. |

### 2.4.1 Consolidated financial statements

According to Paragraph 11 of FIN 44, the evaluation of whether a grantee is an employee should be made at the consolidated group level. Therefore, within the consolidated financial statements, stock compensation granted based on the stock of any consolidated group member is accounted for as an employee award if the grantee meets the definition of an employee for any entity within the consolidated group.

### 2.4.2 Separate subsidiary financial statements: parent award to subsidiary employee

Paragraph 14 of FIN 44 requires an entity to apply the employee accounting model to stock compensation based on the stock of the parent entity that is granted to employees of a consolidated subsidiary for purposes of reporting in the subsidiary's separate financial statements. This requirement exists despite the fact that the subsidiary employee receives a stock award from an entity other than his or her subsidiary employer (the parent entity's stock). This narrow exception applies only to stock compensation based on the stock of the parent entity that is granted to employees of an entity that is part of the consolidated group.

As a result, when a parent issues awards to employees of a subsidiary, the subsidiary recognizes the awards in its separate financial statements as though the subsidiary itself had issued the awards, with a credit to equity that reflects the parent's capital contribution to the subsidiary.

FIN 44 and EITF 00-23 did not address whether an employer subsidiary should follow subsequent measurement guidance (See Section 4.1) when recognizing compensation cost for liability-classified parent awards in the subsidiary's separate financial statements. However, in practice, we have observed that most subsidiary entities remeasure awards classified as liabilities each period in their separate financial statements as this is how a subsidiary would account for the award as though the subsidiary itself had issued the award. As a result, the compensation cost recognized by a subsidiary might fluctuate significantly from reporting period to reporting period but would be the same compensation cost as would be recognized in the parent entity's consolidated financial statements.

We also receive inquiries about whether the award's classification either as an equity instrument or as a liability instrument might impact whether the employer subsidiary recognizes the award in its separate balance sheet either as a credit to equity for the capital contribution from the parent, or as a liability. FIN 44 and EITF 00-23, along with ASC 718-10-15-4 do not address the accounting. We believe that if liability classification results from a repurchase feature (see Section 3.2.3), its terms and conditions are one of the factors that the subsidiary might consider when making this determination. Generally, for example, if the subsidiary were the obligor under the repurchase feature, it would recognize a liability in its separate balance sheet. If the parent, instead of the subsidiary, is the obligor, but the parent lacks substance apart from its investment in the subsidiary (as a result, there is a presumption that the parent would obtain the funds to exercise the repurchase feature from the subsidiary) or if the parent explicitly represents that it intends to direct the subsidiary to fund the repurchase, the subsidiary would also recognize a liability in this fact pattern. On the other hand, we generally believe that the employer subsidiary would recognize a credit to equity related to a liability-classified parent award if the subsidiary is not an obligor under the repurchase feature, the parent has substance apart from its investment in the subsidiary, or the parent does not intend to direct the subsidiary to fund the repurchase. However, entities should consider all of the facts and circumstances, including the other terms and conditions of the award and past practices, when making these determinations. Again, as noted in the preceding paragraph, the compensation cost and corresponding adjustment to either a liability or equity may fluctuate as the parent remeasures the liability award each period.

### 2.4.3 Separate subsidiary financial statements: awards between subsidiaries

#### *Grantor subsidiary accounting for award to parent or another subsidiary's employee*

The exception discussed in Section 2.4.2 does not apply to an award made by the subsidiary in its stock to employees of the parent entity or to awards made to employees of other subsidiaries. Looking to Issue 21 in EITF Issue 00-23, the grantor subsidiary records a dividend to the parent equal to the fair value of the award at the grant date. Since the parent may direct any entity it controls to enter into this type of transaction (that is, a subsidiary granting an award to a parent or another subsidiary's employee), the EITF noted that dividend treatment most closely mirrors the economics of the arrangement. Further, the EITF noted that it is unclear whether the grantor subsidiary has received the goods or services in return for the grant, and whether the fair value of those goods or services approximates the value of the awards.

#### *Employer subsidiary accounting for award to its employee by another subsidiary*

The employer subsidiary's accounting can be complex and different from the accounting model in ASC 718. The accounting used by an employer is included in Issue 22 in EITF Issue 00-23. Because the award is not granted in the stock of the employer, the employer should not apply guidance that applies to employee awards. Instead, the EITF concluded, the employer entity should account for the award under *the fair value model*, without stating whether the entity is using the grant-date fair value in ASC 718, the remeasured fair value in ASC 505-50, or other guidance, such as ASC 815.

Because the employer's employee receives an award in another entity's stock, the most appropriate guidance in this situation is ASC 815 on derivatives and hedging. This accounting is the same accounting that is applied when an employer awards stock in a wholly unrelated entity to one of its employees; the related-party relationship between two subsidiaries in a consolidated group does not affect whether an entity applies ASC 815.

ASC 815-10-45-10 states that changes in the fair value of an option granted to an employee should be included in net income. In practice, the employer subsidiary remeasures fair value each period (under ASC 820, not ASC 718) and recognizes compensation cost based on vesting terms. After vesting, the employer continues to recognize changes in fair value, but does not need to classify the income statement charge (or credit) as compensation expense.

### ASC 815-10-45-10

**Options Granted to Employees**

Subsequent changes in the fair value of an option that was granted to an employee and is subject to this Subtopic shall be included in the determination of net income. (See paragraphs 815-10-55-49 through 55-55 for discussion of such an option.) Changes in fair value of the option award before vesting shall be characterized as compensation expense in the employer's income statement. Changes in fair value of the option award after vesting may be reflected elsewhere in the employer's income statement.

# 3. Classification

## 3.1 Liability versus equity

One of the most critical questions to answer when accounting for a share-based payment is: How should the award be classified—as a liability or in equity? This section is designed to help an entity determine the appropriate classification of a share-based payment award.

## 3.2 Liability classification

Entities must carefully evaluate each award's terms and conditions to determine whether the award should be classified in equity or as a liability. In general, share-based payments must be classified as a liability when any one of the following conditions is met:

- The award is classified as a liability under the guidance in ASC 480, *Distinguishing Liabilities from Equity* (see Section 3.2.1)
- Shares underlying options or similar instruments would be classified as liabilities (Section 3.2.2)
- Cash settlement can be required (Section 3.2.2)
- The award has certain repurchase features (Section 3.2.3)
- The award is indexed to conditions other than market, performance, or service conditions (Section 3.2.4)
- The substantive terms of the award indicate that it is a liability (Section 3.2.5)

The following sections discuss each of the features that require liability classification.

### 3.2.1 ASC 480 requires liability accounting

Although share-based payment awards are excluded from the scope of ASC 480, the FASB nonetheless decided to require entities to apply the classification requirements in ASC 480-10-25-1 through 25-15, with certain modifications, to freestanding financial instruments granted to employees in a share-based payment transaction accounted for under ASC 718.

**ASC 718-10-25-6**

This paragraph through paragraph 718-10-25-19A provide guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in those paragraphs shall be classified as a liability or as equity, an entity shall apply generally accepted accounting principles (GAAP) applicable to financial instruments issued in transactions not involving share-based payment.

**ASC 718-10-25-7**

Topic 480 excludes from its scope instruments that are accounted for under this Topic. Nevertheless, unless paragraphs 718-10-25-8 through 25-19 require otherwise, an entity shall apply the classification criteria in Section 480-10-25 and paragraphs 480-10-15-3 through 15-4, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 718-10-35-9 through 35-14 provide criteria for determining when instruments subject to this Topic subsequently become subject to Topic 480 or to other applicable GAAP.

As discussed below, under ASC 480, the following instruments are classified as liabilities:

- Mandatorily redeemable shares
- Obligations to repurchase the issuer's equity by transferring assets (other than a share that obligates the issuer to repurchase its shares or is indexed to such an obligation)
- Certain obligations to issue a variable number of shares

### *Mandatorily redeemable shares*

A financial instrument is "mandatorily redeemable" if the terms unconditionally obligate both

- The issuing entity to redeem the instrument either at a specified or determinable date, or upon an event that is certain to occur, and
- The holder to tender the instrument in redemption

**A mandatorily redeemable financial instrument** is any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

If redemption is not unconditionally required, the award is not mandatorily redeemable. For example, a puttable share is not considered mandatorily redeemable, because the holder has a choice of whether to redeem the instrument, and the entity is required to redeem the instrument only if the holder exercises the put.

The obligation to redeem an instrument may be stipulated in the share-based award document or in a separate buy/sell or shareholders' rights agreement.

**ASC 480-10-25-4**

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

**ASC 480-10-25-5**

A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

**ASC 480-10-25-6**

In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption

**ASC 480-10-25-7**

If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

### *Scope exception for mandatorily redeemable financial instruments of nonpublic entities*

There are differences in accounting for certain mandatorily redeemable financial instruments issued by public entities and those issued by nonpublic entities. For awards within the scope of ASC 718, the most frequently encountered circumstance is when an award must be redeemed because an employee either terminates employment or dies. An award may also exhibit other attributes that would trigger mandatory redemption. The determination of whether an entity is public or nonpublic for accounting purposes is important in concluding whether certain awards are excluded from the scope of classifying the award as a liability under ASC 480.

For public entities, the required redemption of an employee award upon death or termination results in liability classification based on the guidance in ASC 480-10-25-4. In contrast, a nonpublic entity would generally not classify an employee award requiring redemption upon death or termination as a liability based on the scope exception in ASC 480-10-15-7A. Nonpublic entities that are not “SEC registrants,” as defined in the ASC Master Glossary, are not required to apply liability classification to a mandatorily redeemable share under ASC 480, unless it is redeemable on a fixed date for an amount that is either fixed or determined by reference to an external index.

**ASC 480-10-15-7A**

The classification, measurement, and disclosure guidance in this Subtopic does not apply to mandatorily redeemable financial instruments that meet both of the following:

a. They are issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants

b. They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index

**ASC 480-10-15-7B**

Mandatorily redeemable financial instruments issued by an SEC registrant are not eligible for the scope exception in paragraph 480-10-15-7A, even if the entity meets the definition of a nonpublic entity.

**ASC 480-10-15-7C**

Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, those mandatorily redeemable shares meet the scope exception in paragraph 480-10-15-7A if they meet the conditions specified in that paragraph.

**ASC 480-10-15-7D**

Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

**ASC 480-10-15-7E**

The guidance in this Subtopic does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

a. The classification and measurement provisions of this Subtopic do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements.

b. The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-S99-3A) continues to apply.

**ASC 480-10-15-7F**

All public entities as well as nonpublic entities that are SEC registrants with mandatorily redeemable noncontrolling interests subject to the classification and measurement scope exception in paragraph 480-10-15-7E are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance.

**Grant Thornton insights: Employee options on mandatorily redeemable shares**

An employee option on a mandatorily redeemable share issued by a nonpublic entity that is not an SEC registrant is not classified as a liability if (1) the shares underlying the option meet the scope exception in ASC 480, and (2) no other conditions requiring liability classification apply to the option.

The determination of whether an entity is subject to the exception in ASC 480 is important. For example, an employee option on a mandatorily redeemable share issued by a nonpublic broker/dealer in securities would require liability classification because broker/dealers are required to file with the SEC, even if their shares are not publicly traded. As a result, the shares underlying the option would be subject to liability classification under ASC 480 when issued.

### *Book value awards*

Nonpublic entities sometimes issue awards in the form of "book value shares," which are typically a separate class of equity with a purchase price that is a formula price, meaning the entity uses the same formula that was used to calculate the book value of the shares. The terms of book value shares generally require the employee to sell the shares back to the entity when employment is terminated using the same formula price. The mandatory redemption provision of book value shares (repurchase feature) does not cause them to be classified as a liability under ASC 480, if they meet the scope exception in ASC 480-10-15-7A (discussed above).

Next, an entity would consider the classification guidance in ASC 718-10-25-9 (see Section 3.2.3). In applying that guidance, if the terms of the book value shares include a put (or employer call) or another provision that could result in the employee putting the shares back to the entity (or the employer calling the shares) before the shares had been fully vested for six months, the shares would be classified as liabilities as long as that condition exists. In other words, not all book value awards are automatically classified as equity because other terms might cause liability classification.

ASC 718 provides an example of book value plans. Consideration is also given to whether or not the terms of the plans are compensatory. If the terms of the plan require employees to purchase or redeem the shares at the formula price, the transaction is not compensatory as described in ASC 718-10-55-132. However, if employees purchase the shares at a discount from the formula, the discount is compensatory as described in ASC 718-10-55-133.

**Example 8: Book Value Plans**

**ASC 718-10-55-131**

A nonpublic entity that is not a Securities and Exchange Commission (SEC) registrant has two classes of stock. Class A is voting and held only by the members of the founding family, and Class B (book value shares) is nonvoting and held only by employees. The purchase price of Class B shares is a formula price based on book value. Class B shares require that the employee, six months after retirement or separation from the entity, sell the shares back to the entity for cash at a price determined by using the same formula used to establish the purchase price. Class B shares may not be required to be accounted for as liabilities pursuant to Topic 480 because the entity is a nonpublic entity that is not an SEC registrant. Nevertheless, Class B shares may be classified as liabilities if they are granted as part of a share-based payment transaction and those shares contain certain repurchase features meeting criteria in paragraph 718-10-25-9; this Example assumes that Class B shares do not meet those criteria. Because book value shares of public entities generally are not indexed to their stock prices, such shares would be classified as liabilities pursuant to this Topic.

**ASC 718-10-55-132**

Determining whether a transaction involving Class B shares is compensatory will depend on the terms of the arrangement. For instance, if an employee acquires 100 shares of Class B stock in exchange for cash equal to the formula price of those shares, the transaction is not compensatory because the employee has acquired those shares on the same terms available to all other Class B shareholders and at the current formula price based on the current book value. Subsequent changes in the formula price of those shares held by the employee are not deemed compensation for services.

**ASC 718-10-55-133**

However, if an employee acquires 100 shares of Class B stock in exchange for cash equal to 50 percent of the formula price of those shares, the transaction is compensatory because the employee is not paying the current formula price. Therefore, the value of the 50 percent discount should be attributed over the requisite service period. However, subsequent changes in the formula price of those shares held by the employee are not compensatory.

Book value plans issued by public entities generally result in liability classification because, as stated in ASC 718-10-55-131, the shares are generally not indexed to the entity's share price. In addition, a mandatory redemption provision would require a public entity to classify the shares as liabilities under the classification criteria of ASC 480.

### *Obligations to repurchase equity shares by transferring assets (for example, cash)*

An entity must classify as liabilities freestanding forward purchase contracts, or written put options on the issuer's equity shares that will be physically settled or net-cash settled.

**ASC 480-10-25-8**

An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.

b. It requires or may require the issuer to settle the obligation by transferring assets.

**ASC 480-10-25-9**

In this Subtopic, *indexed to* is used interchangeably with *based on variations in the fair value of*. The phrase *requires* or *may require* encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

**ASC 480-10-25-10**

Examples of financial instruments that meet the criteria in paragraph 480-10-25-8 include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net-cash settled.

### *Certain obligations to issue a variable number of shares*

An entity must classify as liabilities instruments that require or allow the issuer to settle by issuing a variable number of its equity shares if the value is based predominantly on any one of the following conditions:

- A fixed monetary amount that is known at the award's inception, such as a grant of $500,000 payable in a variable number of shares in 36 months. An example is when an employee award specifies that upon vesting, a variable number of shares will be issued equal to $500,000, divided by the fair value of the shares at the vesting date.
- Variations in something other than the fair value of the issuer's equity shares, for example, a grant of an amount indexed to changes in the price of gold that are payable in a variable number of shares in 36 months.
- Variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option settled net in shares.

**ASC 480-10-25-14**

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

### 3.2.2 Options and similar instruments subject to liability classification

The guidance in ASC 718 modifies how to apply the liability classification guidance under ASC 480-10-25-8 for share-based payment awards in the form of options or similar instruments. These instruments are classified as liabilities if either of the following conditions applies (this is a more limited scope than ASC 480-10-25-8 where both conditions would need to apply to classify a financial instrument as a liability):

- The shares underlying the options or similar instruments would be classified as liabilities, or
- The entity can be required *under any circumstances* to settle the option or similar instrument by transferring cash or other assets.

**ASC 718-10-25-11**

Options or similar instruments on shares shall be classified as liabilities if either of the following conditions is met:

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that event will occur.

**ASC 718-10-25-12**

For example, a Securities and Exchange Commission (SEC) registrant may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share. Because the mandatorily redeemable share would be classified as a liability under Topic 480, the option also would be classified as a liability.

### *Contingent cash settlement features*

The guidance in ASC 718-10-25-11b addresses a cash settlement feature in an option or similar instrument issued to an employee that is contingent on the occurrence of an event outside the employee's control (such as a change of control). In this example / scenario, the option or similar instrument is not classified as a liability until the occurrence of the contingent event becomes probable. For example, if an option allows an employee to require the entity to net-cash settle the employee's vested option upon a change of control, the entity would not classify the option as a liability until a change of control becomes probable. That said, certain contingent events such as a change in control are not considered to be probable until they occur.

Other contingent cash settlement provisions sometimes found in employee awards relate to the occurrence of a significant change in ownership (say, more than 20 percent), an initial public offering (IPO) or other liquidity event, or the death or disability of the employee. Under current practice, the occurrence of a liquidity event is generally not considered probable until it occurs (see section 3.2.3).

An instrument similar to an option that could be affected by ASC 718-10-25-11 would be a stock-settled share appreciation right that can be net-cash settled only in the event of a specified contingency outside the employee's control.

Entities should continuously reassess the probability of whether a contingent cash settlement event will occur. If an instrument classified in equity subsequently becomes a liability because it is probable that a contingent net-cash settlement event will occur, the accounting to reclassify the award as a liability is similar to the accounting for a modification under ASC 718, which results in reclassifying the instrument from an equity to a liability award (see Section 8.12). Under that accounting, the offsetting debit is a charge to equity to the extent that the amount reclassified as a liability (the portion of the current fair value attributable to past service) does not exceed the amount previously recorded in equity for the award. If the reclassified amount exceeds the amount previously recorded in equity, the excess is recognized instead as compensation cost.

**ASC 718-10-35-15**

An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.

ASC 718-20-55-123 through 55-133 provides detailed guidance on the accounting for an award that is reclassified due to a modification (see Section 8.12). The total recognized compensation cost for an award with a contingent cash settlement feature should at least equal the fair value of the award at the grant date.

#### *Options with guaranteed intrinsic values*

Entities sometimes issue employee call options with a guarantee that the options will have a specific amount of intrinsic value by a specified date. Under the guarantee, if the amount of intrinsic value is not achieved by the specified date, the employer makes a cash payment to the employee equal to the guaranteed amount, minus the intrinsic value of the options on that date. If the options have a term that extends beyond the specified guarantee date and the employee is not required to exercise the option on the specified date (that is, the call options are freestanding instruments whose exercise is independent of the guarantee of their intrinsic value on a certain date), the award is accounted for as a combination plan consisting of call options and a net-cash settled put option with an exercise price equal to the guaranteed amount. The call options would be accounted for as equity instruments, but the put (the guarantee) would be classified as a liability because the entity may be required to settle the put by transferring cash.

#### *Net-share settlement*

An option may be settled in net shares, meaning that the holder exercises the option without paying the exercise price and receives shares equal to the intrinsic value of the options, which is sometimes referred to as "cashless exercise." A net-share settlement provision would not cause an option (or an option-like instrument) to be classified as a liability.

### 3.2.3 Shares with repurchase features

Shares with embedded puts or calls are not within the scope of the guidance on distinguishing whether an instrument is a liability or equity under ASC 480. However, under ASC 718-10-25-9, a puttable (or callable) share (that is, a share with an embedded put that can be exercised by the employee or an embedded call that can be exercised by the employer) that is awarded to an employee as compensation *is classified as a liability* if either

- The employee can avoid bearing the risks and rewards normally associated with equity share ownership for a “reasonable period of time,” which ASC 718 defines as six months, from the date the requisite service is rendered and the share is issued, or
- It is probable that the employer would prevent the employee from bearing those risks for a reasonable period of time (six months) from the date the share is issued

This guidance in ASC 718-10-25-9 is clearly written in terms of a repurchase of the shares at fair value at the date of repurchase. Entities should give careful consideration to how the terms of an award define “repurchase price” (see “Repurchase features other than fair value” below in this Section 3.2.3).

**ASC 718-10-25-9**

Topic 480 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee’s control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

**ASC 718-10-25-10**

A puttable (or callable) share that does not meet either of those conditions shall be classified as equity (see paragraph 718-10-55-85).

The guidance in ASC 718-10-25-9(a) addresses employee put options, while the guidance in ASC 718-10-25-9(b) addresses employer call options. Both conditions assume fair value of the option at the repurchase date. An important distinction is that ASC 718-10-25-9(a) disregards the probability that the employee will put the shares back to the entity, while ASC 718-10-25-9(b) requires liability classification if it is probable that the employer will exercise its call right and if doing so prevents the employee from bearing the risks and rewards of equity share ownership for a reasonable period of time from the date the requisite service is rendered and the shares are issued.

The “date the requisite service is rendered and the shares are issued” is either when the share vests or the option is exercised.

**Figure 3.1: Summary of ASC 718-10-25-9**

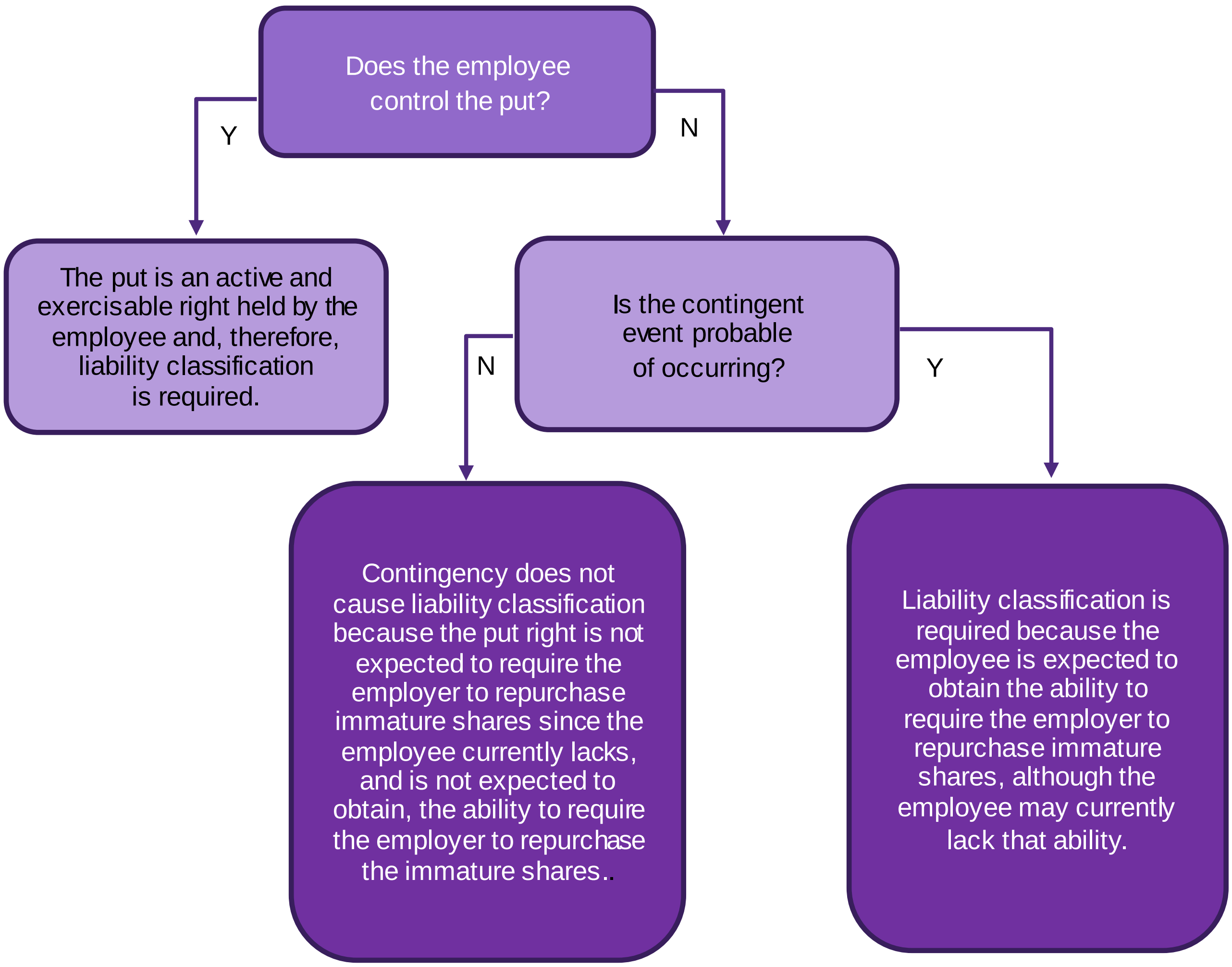
| | | |
|---|---|---|
| **ASC 718-10-25-9(a)** | Addresses employee put options | Disregards the probability that the employee will put the shares back to the entity |
| **ASC 718-10-25-9(b)** | Addresses employer call options | Considers the probability that the employer will exercise its call right |

### *Embedded put options*

Because an employee holding a share with an embedded put option is considered able to avoid the risks and rewards of ownership for a reasonable period of time, the entity would classify the award as a liability if any one of the following conditions applies:

- The employee can exercise the put before the share has been fully vested for six months. If the put right is contingent on an event that is outside the employee’s control, such as a change of control, the puttable share would not be classified as a liability until it becomes probable that the contingent event will occur within six months. Although ASC 718 is silent on evaluating the probability of a liquidity event, such as a change of control, the impact of a business combination, an IPO, or a similar liquidity event is not accounted for in practice until the event occurs. This practice stems from applying the guidance on business combinations in ASC 805-20-55-50 and 55-51 that calls for recognizing the impact of events contingent on a business combination only when the business combination is consummated.
- It is probable the employer would permit the employee to exercise the put before the share has been fully vested for six months.
- The employee must hold the shares for at least six months before it can put them to the employer, but the repurchase price is fixed. In this situation, the employee avoids bearing the risks and rewards of ownership for a reasonable period of time because of the fixed (in effect, guaranteed) repurchase price.

**Figure 3.2: Evaluation of put options on immature shares**




### *Repurchase features other than fair value*

If the repurchase feature gives the employee the right to sell shares back to the entity for a fixed amount *over* the shares' fair value at the date of repurchase, the entity would separately account for (accrue) the fixed amount over fair value as additional compensation cost over the requisite service period.

**ASC 718-10-55-85**

An entity may, for example, grant shares under a share-based compensation arrangement that the employee can put (sell) to the employer (the entity) shortly after the vesting date for cash equal to the fair value of the shares on the date of repurchase. That award of puttable shares would be classified as a liability because the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the share is issued (see paragraph 718-10-25-9(a)). Alternatively, an entity might grant its own shares under a share-based compensation arrangement that may be put to the employer only after the employee has held them for a reasonable period of time after vesting but at a fixed redemption amount.

Those puttable shares also would be classified as liabilities under the requirements of this Topic because the repurchase price is based on a fixed amount rather than variations in the fair value of the employer's shares. The employee cannot bear the risks and rewards normally associated with equity share ownership for a reasonable period of time because of that redemption feature. However, if a share with a repurchase feature gives the employee the right to sell shares back to the entity for a fixed amount over the fair value of the shares at the date of repurchase, paragraph 718-20-35-7 requires that the fixed amount over the fair value be recognized as additional compensation cost over the requisite service period (with a corresponding liability being accrued).

**ASC 718-20-35-7**

The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Figure 3.3 summarizes the relationship between the repurchase price and the classification of the award, assuming that (1) the employee must hold the shares for at least six months from the date the requisite service is rendered and the share is issued, and (2) the award has no other features that would cause liability classification.

**Figure 3.3: Relationship of repurchase price and classification**

| Repurchase price | Who bears the risks and rewards of share ownership | Classification |
|---|---|---|
| Repurchase price is at fair value | Employee bears the risks and rewards of share ownership | Equity classification not precluded |
| Repurchase price is not at fair value | Employee does not bear the risks and rewards of share ownership | Equity classification precluded |
| Repurchase price is set at a fixed dollar amount | Employee does not bear the risks and rewards of share ownership | Equity classification precluded |
| Repurchase price is set at a fixed premium | Employee bears the risks and rewards of share ownership | Equity classification not precluded (however, the excess repurchase price over fair value is accrued over the |

| Repurchase price | Who bears the risks and rewards of share ownership | Classification |
|---|---|---|
| | | vesting period similar to a bonus) |

### *Call features*

Many employee share-based awards include employer call features. When granting an award, the grantor should carefully evaluate the accounting impact of employer call features and decide whether they preclude equity classification. The guidance in ASC 718-10-25-9b discusses the probability that the employer would prevent the employee from bearing the risks and rewards for a reasonable period of time, but it does not include some of the relatively extensive discussion of repurchase features in EITF Issue 00-23. Many still refer to this EITF issue when evaluating the accounting for share-based awards with employer call features.

The guidance in EITF Issue 00-23 states that when an employer call feature results in, or could potentially result in, a repurchase amount that is less than the fair value of the underlying shares, there is always an expectation that the repurchase feature will be exercised. In this case, liability classification and remeasurement each period is required, even if the shares are not expected to be repurchased within six months of exercising the option or issuing the share. This is, the existence of a potentially less than fair value call feature leads to liability classification despite the considerations discussed below.

Issue 23(a) in EITF 00-23 identifies factors that an entity would consider when assessing whether a call right at fair value creates an expectation that an employer will repurchase immature shares, starting with the employer's representation that it does not intend to call any immature shares. An entity would then consider additional facts and circumstances, including

- How often the employer has called immature shares in the past
- Under which circumstances the employer has called immature shares in the past
- The existence of any legal, regulatory, or contractual limitations on the employer's ability to repurchase shares
- Whether the employer is a closely held, private entity (A closely held private entity may have a policy that shares cannot be widely held. As a result, the entity generally would be expected to repurchase immature shares.)

If the employer is unable to support or represent that it has no intention to call immature shares, there may be a presumption that it intends to call them in the future.

If the employer previously had the right to call immature shares but has seldom exercised that right, the employer might not be expected to exercise that the right in the future. On the other hand, if the employer routinely repurchases immature shares, the employer generally would be expected to continue such repurchases in the future.

If the employer has called immature shares only in connection with previous, yet infrequent, significant staffing reductions but has no current plans for another reduction, the employer might not be expected to exercise the call right. On the other hand, if the employer has announced similar staffing reductions in the future, exercising the call right to repurchase immature shares generally would be expected.

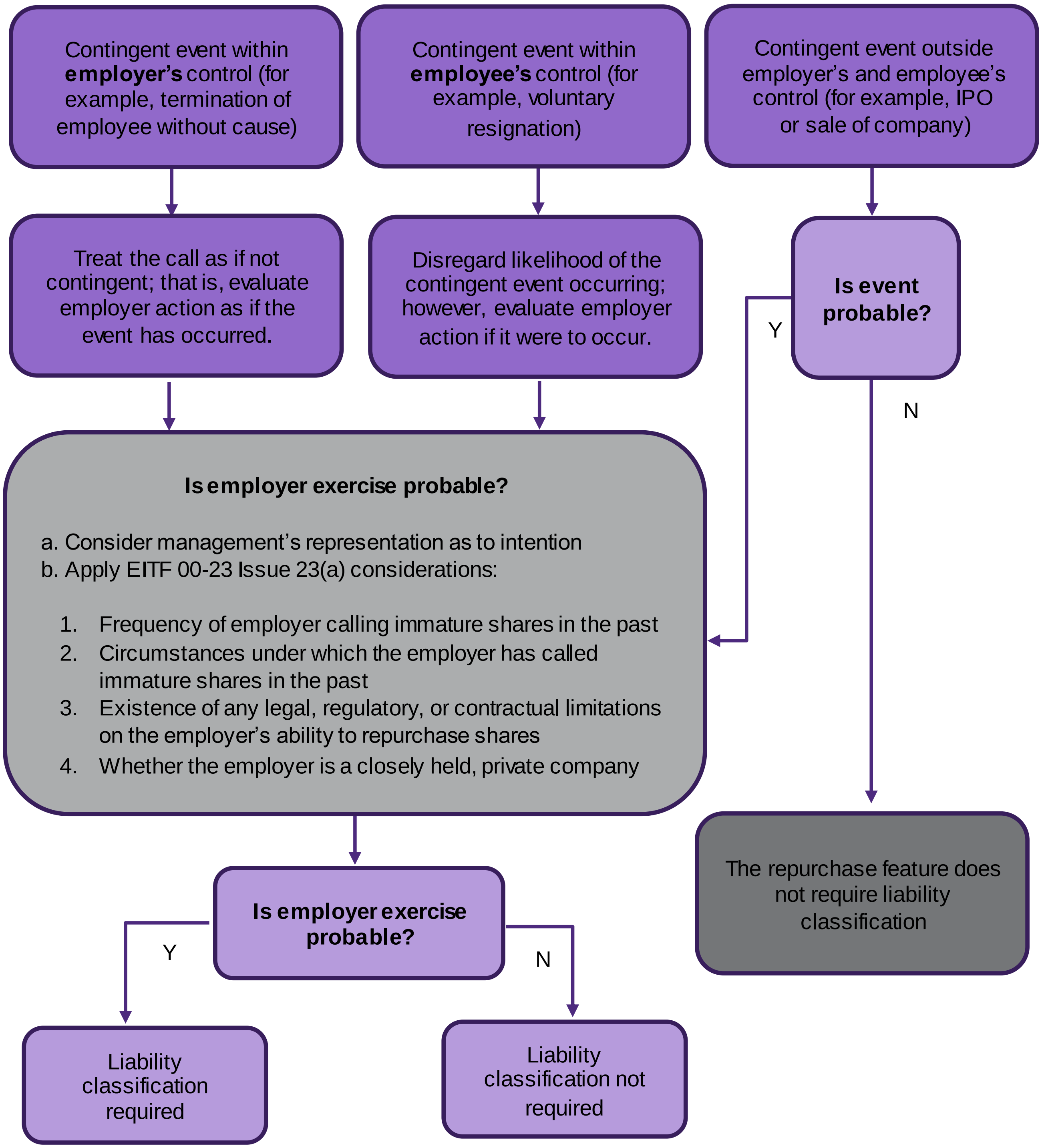
### *Contingent call features*

For a call feature that is contingent only on a specified future event, an entity should evaluate the probability that the repurchase call of immature shares will occur. If the contingent event that triggers the call feature is controlled by the party that will exercise the call feature, an entity would evaluate the event as if it were not contingent, taking into consideration the probability that the employer might take actions that cause the call feature to become exercisable.

Some employer call features can be exercised only upon termination of employment. In this situation, an employee can voluntarily terminate employment and therefore controls the contingent event in the employer call feature. As a result, the entity should consider whether it is probable that the employee will exercise the call before the shares mature. If the contingent event is outside of the control of the party that can exercise the call feature, the employer should assess whether the occurrence of the contingent event is probable. If the occurrence of the contingent event is not probable, liability treatment is not required. If it is probable that the contingent event will occur when the shares are immature, the call feature would be evaluated as if it were not contingent. The evaluation of contingent events should be made for each individual employee grant and reassessed each reporting period during the term of the contingency.

Figure 3.4 summarizes an employer's consideration of various contingent call features.

**Figure 3.4: Evaluating contingent call features on immature shares**



### *Fair value repurchase feature accounting after the six-month period*

Shares with fair value repurchase features that are classified as liabilities because the employee avoids bearing (or enables the employer to prevent the employee from bearing) the risks and rewards of ownership for at least six months should continue to be classified as liabilities until six months after the option is exercised or the vesting date of the unvested shares occurs. Note, as discussed above, that a potentially less than fair value repurchase leads to ongoing liability classification.

The guidance in ASC 718-10-25-9 states that six months is a reasonable period of time for the employee to be exposed to the risks and rewards of share ownership. Following that logic, any fair value repurchase after six months is akin to a repurchase from a shareholder that did not receive equity instruments through stock compensation. Therefore, after the six-month deadline, the grantor should remeasure the liability for the shares to fair value through the income statement once more and then reclassify this final amount to equity. However, see "Awards requiring classification outside of permanent equity" in Section 3.5 for the requirements for SEC registrants to reclassify the redemption amount of such awards outside of permanent equity.

### 3.2.4 Awards indexed to conditions other than market, performance, or service conditions

With a narrow exception for certain awards with an exercise price denominated in a foreign currency, an award is classified as a liability if it is indexed to a factor that is not a market, performance, or service condition in addition to being indexed to the entity's share price.

**ASC 718-10-25-13**

An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this Topic, and the additional factor shall be reflected in estimating the fair value of the award. Paragraph 718-10-55-65 provides examples of such awards.

As discussed further in Section 5.3, a "market condition" relates to the achievement by an entity of a specified price of the issuer's shares, a specified amount of intrinsic value indexed solely to the issuer's shares, or a specified price of the issuer's share in terms of similar (or an index of similar) equity securities. An example of an award with a market condition is an award that vests if the entity's share price increases at least 10 percent more than the average increase of the share prices of three specific entities in the entity's industry at the end of a three-year period.

A "performance condition" relates to the achievement of a specified target that is defined by referring to the employer's own operations or activities, such as an option that vests if the employer's growth rate increases by a certain amount or if regulatory approval is obtained for a product (see Section 5.2). A performance condition may also refer to the same performance measure of another entity or group of entities, such as a vesting requirement that the entity attain an increase in earnings per share that exceeds the average growth rate in earnings per share for other entities in the same industry.

### Indexed to something other than a market, performance, or service condition

**Scenario 1**

A share-based payment award that vests based on the achievement of inflation-adjusted growth either in earnings per share (EPS), which is sometimes referred to as "real growth in EPS," or in earnings before interest, taxes, depreciation, and amortization (EBITDA) is classified as a liability because it is indexed to inflation—a factor in addition to the entity's share price that is not a market, performance, or service condition.

**Scenario 2**

An option whose exercise price is indexed to changes in the price of gold, or that becomes vested based on appreciation in the price of gold, is classified as a liability because it is indexed to a factor in addition to the entity's share price that is not a market, performance, or service condition.

### *Exercise price denominated in a foreign currency*

An exception applies to the provision related to an award indexed to a factor in addition to the entity's share price that is not a market, performance, or service condition for employees of an entity's foreign operations. An option with a fixed exercise price denominated in a foreign currency that is awarded to an employee of an entity's foreign operation is *not* required to be classified as a liability if both of the following conditions apply:

- The award otherwise qualifies for equity classification
- The foreign currency is either the functional currency of the foreign operation or the currency in which the employee's pay is denominated

### ASC 718-10-25-14

For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in euros granted to employees of a U.S. entity's foreign operation whose functional currency is the euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in euros.

Further, if an award's exercise price is denominated in the currency of a market where a substantial portion of an entity's equity securities are traded, the award would not be classified as a liability if it otherwise qualifies for equity classification, even if that currency is not the entity's functional or payroll currency. For example, if a Canadian entity whose securities trade on a U.S. dollar–denominated exchange issues employee options denominated in U.S. dollars, the options would be classified in equity if they meet the other requirements for equity classification, provided that a substantial portion of the entity's shares are traded on a U.S. dollar—denominated exchange.

**ASC 718-10-25-14A**

For purposes of applying paragraph 718-10-25-13, a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, in accordance with that paragraph, such an award shall not be classified as a liability if it otherwise qualifies for equity classification. For example, a parent entity whose functional currency is the Canadian dollar grants equity share options with an exercise price denominated in U.S. dollars to employees of a Canadian entity with the functional and payroll currency of the Canadian dollar. If a substantial portion of the parent entity's equity securities trades on a U.S. dollar denominated exchange, the options are not precluded from equity classification.

### *Applicability of other guidance on instruments indexed to entity's own stock*

However, some entities issue specially structured equity-linked financial instruments to investors to establish a market-based measure of the grant-date fair value of their employee stock options. Those equity-linked financial instruments are not within the scope of ASC 718 and are instead subject to the classification guidance in ASC 815-40-15-5 through 15-8, *Derivatives and Hedging: Contracts in Entity's Own Equity,* (see "Observable market price: Market-traded instruments" under Section 7.4).

ASC 815-40-15-5 through 15-8 provides a two-step method for determining whether an equity-linked financial instrument is considered to be indexed to the entity's own stock. This guidance is significant in determining whether an equity-linked financial instrument is within the scope of the accounting guidance for derivatives in ASC 815.

The guidance in ASC 815-40-15-5 through 15-8 does *not* apply to share-based payment awards subject to ASC 718 for purposes of determining whether the awards should be classified as liabilities or in equity. Classification is based on the substantive terms of the award.

### *Substantive terms of awards*

Share-based payment awards are accounted for based on their substantive terms. The best evidence of the substantive terms of an award is generally the award agreement, but the entity's historical actions should also be considered, as discussed in ASC 718-10-25-15.

**ASC 718-10-25-15**

The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a tandem award under which an employee receives either a stock option or a cash-settled stock appreciation right is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether:

a. It has the ability to deliver the shares. (Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this Topic, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.)

b. It is required to pay cash if a contingent event occurs (see paragraphs 718-10-25-11 through 25-12).

#### *Employee choice of settling award*

A tandem award may give an *employee* a choice of exercising a fixed option or a cash-settled share appreciation right. Exercising one instrument cancels out the other. Such an award may be structured by giving the employee the choice of settlement methods: physical settlement if the employee pays the exercise price and a share or net-cash settlement if the employee receives the intrinsic value of the award in cash (equivalent to a share appreciation right). These awards are classified as liabilities because the entity may have to settle the award in cash. Note that a share option that provides a choice of settlement methods—physical settlement or net-cash settlement—is, in substance, a similar tandem award that would require liability classification.

#### *Employer's choice of settling award*

If a tandem award gives the *entity* the choice of settling in shares or in cash, the terms of the award might permit equity classification for the award. However, an entity's past practice may indicate that the substantive terms of the award differ from the written terms.

In considering whether an entity that chooses to settle awards in shares has a substantive liability, the entity must first consider whether it has the ability to deliver shares. To the extent that an entity does not have enough authorized and unissued shares to settle its share-based awards in shares, the awards should be classified as liabilities. Delivery of registered shares may be required under federal securities law, in which case, an entity must determine whether it has the ability to deliver registered shares. However, entities in this situation are not required to apply the provisions in ASC 815-40-25-11 through 25-18, which presume that a contract with a requirement to settle in registered shares would be net-cash settled and therefore require liability classification. ASC 718 does not require entities to classify employee share-based awards as liabilities based solely on this provision in ASC 815-40-25.

### 3.2.5 Short-term inducements

ASC 718 defines a "short-term inducement" as "an offer by the entity that would result in modification of an award to which an award holder may subscribe for a limited period of time." If an entity makes a short-term, limited-time offer to settle employee awards for cash, the offer would not affect how the awards are classified when the offer is made (that is, during the period when the award remains outstanding). However, when an employee accepts the settlement offer, the entity accounts for the repurchase of the award as discussed under "Repurchases and settlements" in Section 8.6. In contrast, an inducement that is not short-term would require applying the modification accounting in ASC 718 (see Section 8) for all awards subject to the offer when the offer is made, not just for those awards the grantees later choose to settle under the terms of the offer.

**ASC 718-20-35-5**

A short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Determining whether an inducement is short-term is an important step in this evaluation. The mention of “other inducements” in ASC 718-20-35-5 indicates that if an inducement is not short-term, then modification accounting applies to all awards subject to the inducement, not only to those that the grantees elect to settle. This guidance does not state what the phrase “limited period of time” means in the definition of short-term inducement.

In practice, short-term inducement offers have durations of several weeks to, at most, a few months. Entities should consider all relevant facts and circumstances when evaluating whether an inducement is short-term, including securities laws and regulations that specify offer periods and the time needed for grantees to evaluate the terms of the offer and to decide whether to participate.

Characterizing grantor repurchase offers as inducements does not change the requirement to consider whether the grantor has a history or pattern of settling awards for cash. An entity that undertakes repeated inducement offers may have a substantive liability for all outstanding awards.

## 3.3 Equity classification

If the guidance in ASC 718 and ASC 480 do not require liability classification, the entity classifies an employee share-based award in equity.

### 3.3.1 Broker-assisted cashless exercise

Some public entities enter into arrangements with a broker to enable employees to carry out a cashless exercise of their employee options. This arrangement, called a “broker-assisted cashless exercise,” usually consists of an employee exercising the option while the broker simultaneously sells the shares. These arrangements do not result in liability classification if the award would otherwise qualify as equity and both of the following conditions are satisfied:

- The arrangement requires a valid exercise of the option
- The employee is the legal owner of the shares subject to the option

For the award to qualify for equity classification, if the broker is a related party of the entity that issued the awards, the broker would have to sell the shares in the public market within a normal settlement period, which is typically three days in the United States.

A **broker-assisted cashless exercise** is the simultaneous exercise by a grantee of a share option and sale of the shares through a broker (commonly referred to as a broker-assisted exercise).

Generally, under this method of exercise:

a. The grantee authorizes the exercise of an option and the immediate sale of the option shares in the open market.

b. On the same day, the entity notifies the broker of the sale order.

c. The broker executes the sale and notifies the entity of the sales price.

d. The entity determines the minimum statutory tax-withholding requirements.

e. By the settlement day (generally three days later), the entity delivers the stock certificates to the broker.

On the settlement day, the broker makes payment to the entity for the exercise price and the minimum statutory withholding taxes and remits the balance of the net sales proceeds to the grantee.

**ASC 718-10-25-16**

A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option)

**ASC 718-10-25-17**

A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

### 3.3.2 Tax withholding provisions

For entities that have already adopted ASU 2016-09, an immediate share repurchase feature for tax withholding purposes would not be classified as a liability if the award otherwise qualifies as equity and both:

- The withholding is limited to the employer's maximum statutory tax rates in the employees' applicable jurisdictions
- The employer has a statutory obligation to withhold taxes on the employee's behalf

If the entity withholds, or may withhold at the employee's discretion, an amount exceeding the maximum statutory tax rates in the employees' applicable jurisdictions, the entire award is classified as a liability.

The maximum statutory tax rates are based on the rates issued by tax authorities such as federal, state, and local authorities, including the employee's share of payroll or similar taxes, as provided by tax law or regulations. While the rate can exceed the highest rate that may apply to the grantee, the rate cannot exceed the highest statutory rate in that jurisdiction.

**ASC 718-10-25-18**

Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if the amount that is withheld, or may be withheld at the employee's discretion, is in excess of the maximum statutory tax rates in the employees' applicable jurisdictions, the entire award shall be classified and accounted for as a liability. That is, to qualify for equity classification, the employer must have a statutory obligation to withhold taxes on the employee's behalf, and the amount withheld cannot exceed the maximum statutory tax rates in the employees' applicable jurisdictions. The maximum statutory tax rates are based on the applicable rates of the relevant tax authorities (for example, federal, state, and local), including the employee's share of payroll or similar taxes, as provided in tax law, regulations, or the authority's administrative practices, not to exceed the highest statutory rate in that jurisdiction, even if that rate exceeds the highest rate that may be applicable to the specific award grantee.

The guidance in ASC 718 prior to the adoption of ASU 2016-09 is mostly similar, except that the limitation is tied to the employer's minimum statutory withholding requirement in the jurisdiction, which is typically a much lower amount, rather than to the maximum statutory tax rates in the employees' applicable jurisdictions.

### 3.4 Special classes of stock, profits interests, and similar instruments

Some entities in a variety of industries have created special classes of stock solely for employees. At the 2006 AICPA National Conference on SEC and PCAOB Developments, the SEC staff discussed[1] two examples of these instruments. In one example, the employer grants an employee instruments whose value is based predominantly on the operations of a subsidiary that the employee is involved in, rather than granting the employee an equity award of the parent entity. The other example relates to special

[1] 2006 AICPA National Conference on SEC and PCAOB Developments, Joseph B. Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant.

classes of stock that allow employees to participate in the stocks' appreciation realized through a future IPO or the sale of the entity. The EITF addressed a similar instrument—a profits interest in an LLC, LLP, or other pass-through entity—in Issue 40 of EITF Issue 00-23, which was not included in the Codification. These interests are often structured to provide grantees with distributions after other interest holders recover their investment plus a specified return.

In Issue 40(b) of EITF Issue 00-23, the EITF noted that, depending on its terms, an award may be similar to

- An equity interest, for example, restricted stock that is subordinate to existing equity
- A stock option, such as the right to purchase an interest in the future at a specified price
- A share appreciation right
- A profit-sharing arrangement

Regardless of the nomenclature used in award agreements, such as profits interests or incentive interests among many other terms, entities must understand the substance of the instrument to properly account for the award, which includes reviewing the legal form and evaluating its relevant features.

The instrument may be a substantive class of equity in its own right or an instrument whose amount is based, at least in part, on the price of the entity's shares of other equity instruments that should be accounted for under ASC 718, regardless of whether the award would be classified in equity or as a liability under ASC 718. In practice, most of these awards are linked to the price of the entity's shares, which means that they would clearly fall within the scope of ASC 718. Despite that link, however, some entities have asserted that ASC 718 should not be applied because, among other assertions, the awards are intended to share investor profits with employees; the grantees have no substantive equity in the entity; and the grantees have no measurable opportunity to realize any value from the awards absent a sale. These assertions do not overcome the conclusion that the awards are within the scope of ASC 718 because they are linked to the price of the entity's equity.

In contrast, when the amount is not based, at least in part, on the price of the entity's shares or other equity instruments, the instrument may, in substance, be a performance bonus or a profit-sharing arrangement, which is accounted for under ASC 710, *Compensation – General*. An example is an award whose amount is based on a multiple of EBITDA or revenue. Determining whether an arrangement is within the scope of ASC 718 or other guidance, such as ASC 710, is important because of the differences in accounting.

### *Considerations for instruments within the scope of ASC 718*

Characteristics that may indicate an award should be classified in equity include substantive voting rights and dividend rights similar to those of other shareholders. To qualify as an equity award under ASC 718, an instrument should be legal equity and have a residual interest in net assets. Other characteristics might include the class of equity instrument, conditions related to vesting (for instance, over time or contingent upon a liquidity event), repurchase, clawback, transferability, and forfeiture, among other features. An instrument may be within the scope of ASC 718 even if it is not equity, for example, a stock appreciation right. Therefore, entities must carefully consider if certain terms of an in-scope award require liability accounting. Share-based payment awards classified as liabilities are accounted for under the measurement and recognition provisions in ASC 718-30, *Awards Classified as Liabilities,* which requires variable accounting until an award is settled or expires unexercised.

If the special class of stock or profits interest is within the scope of ASC 718, then valuation questions arise. These instruments, by design, often derive all or substantially all of their value from the right to participate in the future appreciation of the share price or in profits. Accordingly, the SEC staff[2] has rejected using valuation methods based primarily on current liquidation value because it believes that this approach would not capture the stock's significant upside potential. Generally, for both public and private entities, a grant-date fair value of zero is not appropriate, nor is a calculated amount based on a hypothetical waterfall assuming the sale of the entity. Because of the complex valuation issues typically related to these arrangements, use of a valuation specialist may be necessary.

### *Considerations for bonus or profit-sharing arrangements outside the scope of ASC 718*

When the award is not linked to the grantor's equity price, other features of the award may support the conclusion that the substance is similar to a bonus or profit-sharing arrangement. These features include few, if any, assets underlying the instrument; the holders' claim on the assets being significantly subordinated; liquidation or repayment provisions; and provisions for realizing value, including put and call rights that limit the employee's downside risk or provide for cash settlement. If the instruments are, in substance, performance bonus or profit-sharing plans, they should be accounted for as liabilities, generally under ASC 710. In these cases, any returns to the employee are recognized as compensation expense, not as equity distributions. The entity recognizes any amount of consideration that the employee had to pay the employer at the beginning of the arrangement as a deposit liability.

## 3.5 Awards requiring classification outside of permanent equity

To determine whether share-based payment awards not accounted for as liabilities may be classified in permanent equity, public entities need to consider the SEC's guidance in ASC 505-50, ASC 480-10-S99 (Accounting Series Release [ASR] 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks*), and ASC 718-10-S99 (SEC Staff Accounting Bulletin [SAB] Topic 14.E).

ASC 480-10-S99-3A reflects an SEC staff announcement that cites ASR 268, which requires instruments to be classified outside of permanent equity if they are redeemable

a. At a fixed or determinable price on a fixed or determinable date;

b. At the option of the holder; or

c. On the occurrence of an event not solely within the control of the issuer.

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[2] 2006 AICPA National Conference on SEC and PCAOB Developments, Joseph B. Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant.

### ASC 480-10-S99-3A (excerpt)

ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that "[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital."

Awards classified in equity under ASC 718 that may be subject to temporary equity classification include:

- Shares with a repurchase feature that the employee can exercise only after the shares have been vested for at least six months, as well as options on such shares.
- Shares that have a contingent repurchase feature that is outside the control of the employee and the entity if it is currently probable that the contingency would not occur. Examples include shares redeemable only on the occurrence of a liquidity event, such as a change of control.
- Options that have a contingent cash-settlement provision not within the employee's or the entity's control if it is not currently probable that the contingency would occur.

ASC 718-10-S99, which codifies SAB Topic 14.E, clarifies that, for purposes of classification outside of permanent equity under ASR 268, share-based payment awards classified as equity under ASC 718 that are not redeemable for cash or other assets would not be presumed to require net-cash settlement (under ASC 815-40-25-11 through 25-18) solely because the terms of the award require settlement in registered shares.

ASC 718 does not require an employee award to be classified as a liability because it contains provisions for either a direct or an indirect repurchase of shares when the employee options are exercised solely for income tax withholding purposes, to the extent allowed by ASC 718. ASC 480-10-S99-3A(3)(d) provides that the SEC staff would not expect SEC registrants to classify these awards outside of permanent equity.

ASC 718-10-S99 also addresses how to determine the amount of a share-based payment award that should be reported in temporary equity. A registrant "should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services" at that date. In other words, the amount reported as temporary equity for an award of common shares that is not fully vested is based on the redemption amount determined at the balance-sheet date, prorated for the cumulative vesting percentage of the award at that date. When awards are fully vested, the amount reported in temporary equity should be adjusted to the redemption amount in the period a change in the redemption amount occurs.

### ASC 718-10-S99: SAB Topic 14.E (excerpt)

**Question 2**: How should Company F apply ASR 268 and related guidance to the shares (or share options) granted under the share-based payment arrangements with employees that may be unvested at the date of grant?

**Interpretive Response**: Under FASB ASC Topic 718, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital[85] is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuer's control but are classified as equity instruments under FASB ASC Topic 718. The [SEC] staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under FASB ASC Topic 718 is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable stock that qualifies for equity classification under FASB ASC Topic 718 is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic value of the option should be presented as temporary equity at that date.

FN85 Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

### Measurement of the amount in temporary equity

Two years ago, an entity awarded 100,000 common shares to employees. The grant-date fair value of the shares was $25. The shares have a four-year vesting provision and are puttable to the entity at fair value any time after the shares have been vested for six months. The current share price is $30. The entity should report the redeemable shares in temporary equity with a carrying amount of $1.5 million (100,000 x $30 x 0.5), because the cumulative vesting percentage at the balance-sheet date was 50 percent.

The required adjustments to temporary equity at each balance-sheet date are recorded as a reclassification between permanent equity and temporary equity. Although there is no explicit guidance on the equity accounts affected by this reclassification, retained earnings would generally not be charged, unless there is an insufficient amount of additional paid-in capital. The reclassification does not affect the amount of recognized compensation cost and therefore would not affect the income statement.

ASC 718-10-S99 and ASC 480-10-S99 provide guidance on the amount to be classified as temporary equity if the redeemable instrument is an option or similar instrument. For these instruments, the amount initially reported in temporary equity should be based on the redemption provisions of the instrument and prorated for the vested percentage of the instrument on that date. If the instrument is an option on a share that is redeemable at fair value, the amount reported in temporary equity should be the vested percentage of the intrinsic value of the option on the balance-sheet date, rather than the vested percentage of the redeemable amount, because the option holder will pay the entity the exercise price when the option is exercised. Therefore, although the entity will pay the redemption price when the holder redeems the shares, the net cash outflow for the entity is the option's intrinsic value. If the instrument is a fully vested option redeemable at its intrinsic value upon a change of control and a change in control is not probable, an amount representing the grant-date intrinsic value of the option should be reported in temporary equity.

ASC 480-10-S99 provides general guidance on determining the amount that should be reported outside of permanent equity if an award is not currently redeemable because a contingency has not been met and it is not probable at the balance-sheet date that the instrument will become redeemable. (This would apply, for example, to a share that is redeemable on a change of control before the change of control becomes probable, but only if the share is not otherwise subject to classification as a liability under the guidance in ASC 718.) If the award is a share that is contingently redeemable at fair value, the amount reported in temporary equity would be the share's grant-date fair value, or the vested percentage of the share's grant-date fair value if the share is not fully vested. The amount reported in temporary equity would continue to be the grant-date fair value (or the grant-date fair value prorated for the vested percentage) of the award as long as it is not probable that the contingent event will occur. However, if the award is an option that is redeemable for its intrinsic value only if a specified contingency occurs, then the grant-date intrinsic value of the option (or the grant-date intrinsic value prorated for the vested percentage) should be reported in temporary equity if it is not probable that the contingency will occur on the balance-sheet date. Therefore, no amount would be reported in temporary equity if an equity-classified option can be cash settled for its intrinsic value on a change of control and the option had no intrinsic value on the grant date. An entity should reassess the probability of a contingent event occurring each reporting period. If the contingent event becomes probable, the award becomes a liability and the temporary equity provisions no longer apply.

The following table summarizes the SEC staff's requirements for reclassifying an amount from permanent equity to temporary equity when an instrument classified in equity under ASC 718 has redemption features.

**Figure 3.5: SEC staff's requirements for reclassifying an amount from permanent to temporary equity**

| Instrument classified in equity | Amount required to be classified outside of permanent equity | |
|---|---|---|
| | **Fully vested award** | **Partially vested award** |
| Share with redemption features (that apply only after share has been fully vested for six months) | Redemption amount at balance-sheet date | Redemption amount at balance-sheet date multiplied by the vested percentage of the award |
| Option on a share redeemable at fair value (redemption feature applies only after option has | Intrinsic value of the option at the balance-sheet date | Intrinsic value of the option at the balance-sheet date multiplied by the vested percentage of the award |

| Instrument classified in equity | Amount required to be classified outside of permanent equity | |
|---|---|---|
| | **Fully vested award** | **Partially vested award** |
| been exercised and share has been held six months) | | |
| Contingently redeemable share if contingent event is outside the employee's control and if it is not probable at the balance-sheet date that the event will occur | Redemption amount at grant date | Redemption amount at grant date multiplied by the vested percentage of the award |
| Option redeemable at intrinsic value on occurrence of contingent event not within the employee's control, provided it is not probable at the balance-sheet date that the event will occur | Grant-date intrinsic value (which would be $0 if the award was at-the-money when granted) | Grant-date intrinsic value multiplied by the vested percentage of the award |

# 4. Measurement date

## 4.1 Overview

Stock compensation awards involve several different dates, and the terminology used can be confusing. Entities providing awards to employees should carefully consider the wording used in their agreements and keep in mind that the guidance in ASC 718 is quite specific about determining several key dates for accounting purposes. The dates used in accounting for stock compensation awards might not coincide with the dates expressed in an award agreement or otherwise communicated to employees. Moreover, the unit of account under ASC 718 is the individual award, so the accounting determinations are based on the specific facts and circumstances for each award, and not on the general terms in a plan agreement or similar document.

Some of the confusion stems from how the term "grant date" and its variations are used in award agreements and in the guidance. The date when an award is granted under an award agreement with the employee might, or might not, be the grant date for accounting purposes, which is an important distinction.

Another date involved in accounting for an award is the "service inception date." An award agreement might stipulate when the employee's services commence to begin earning the award, but this date might, or might not, be the service inception date for accounting purposes.

Finally, entities must determine the "measurement date" of an award—that is, the date when the share price and other factors enter into the *final* measurement of the award's total cost. The measurement date might be at the inception of the award, which often occurs with equity-classified awards. Or, it might be when all conditions required for vesting are achieved, or even later, which occurs with many awards classified as liabilities that are remeasured each period until an accounting measurement date occurs in the future.

It is critical for entities to approach the accounting for share-based awards based on a clear understanding of the impact of the various dates and time periods used in ASC 718.

The cost for a share-based payment award classified in equity is measured on the award's grant date. Consequently, determining the grant date is an important aspect of determining the cost of a share-based equity award.

An entity would not recognize compensation cost for an employee award until all five conditions required for establishing a grant date have been met (discussed below), unless the service inception date precedes the grant date so that cost recognition begins before the grant date (see Section 4.3.1). Otherwise, for most awards, there is no "catch-up" of compensation cost on the grant date for the period from the date the award is made to the accounting grant date. A simple example is an equity award with only a service condition: Compensation cost would generally be recognized on a straight-line basis over the remaining service period beginning when all grant-date criteria are met.

**Effect on cost recognition when grant date is delayed for time-based award**

Assume that a time-based vesting award subject to shareholder approval is communicated to employees and approved by the board of directors on January 1. The award has a one-year vesting period ending December 31, and the required approval by shareholders was obtained on July 1.

As a result, a grant date (that is, the measurement date under ASC 718) is achieved on July 1. Compensation cost would be recognized on a straight-line basis over the six-month period from the July 1 grant date through December 31. There would be no catch-up of compensation cost on July 1 for the period from January 1 through June 30.

The guidance for determining the measurement date for a liability-classified award contrasts sharply with the typical equity-classified award, discussed above. The measurement date for an award classified as a liability is the *settlement date*. As a result, liabilities are remeasured at the end of each reporting period through settlement, often requiring quarterly or annual valuations. For a time-based vesting liability award, the liability is adjusted each period based on the percentage vested, multiplied by the current period's valuation. The amount of the liability can increase or decrease each period, depending on the impact of each valuation. An entity would continue to remeasure this liability, even when fully vested, until the award is settled. The final measurement of the award is the amount of cash or other assets paid to settle the liability. Therefore, in the period when settlement occurs, the entity performs a final valuation to determine the settlement amount and then adjusts cumulative compensation cost recognized to reflect that settlement amount.

The rest of this section discusses how an entity determines when the grant date is established and, in certain cases, the accounting when the service inception date precedes the grant date.

## 4.2 Determining the grant date

The **grant date** is the date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory), for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. Paragraph 718-10-25-5 provides guidance on determining the grant date.

The grantee must be an employee (see Section 2.2) and then, as identified in the definition above, the following criteria, or conditions, must be met to establish a grant date for an employee award:

- A mutual understanding of the terms of the award exists between the employer and the employee
- All appropriate approvals have been obtained

- The grantee is an employee under common law
- The entity is obligated to issue the award
- The employee is affected by subsequent changes in the share price

Entities must ascertain for each employee award the date on which all conditions have been met, which becomes the grant date for the award.

### 4.2.1 Mutual understanding between employer and employee

**ASC 718-10-25-5**

As a practical accommodation, in determining the grant date of an award subject to this Topic, assuming all other criteria in the grant date definition have been met, a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices.

For additional guidance see paragraphs 718-10-55-80 through 55-83.

**ASC 718-10-55-81**

The definition of grant date requires that an employer and employee have a mutual understanding of the key terms and conditions of the share-based compensation arrangement. Those terms may be established through any of the following:

a. A formal, written agreement

b. An informal, oral arrangement

c. An entity’s past practice

**ASC 718-10-55-82**

A mutual understanding of the key terms and conditions means that there is sufficient basis for both the employer and the employee to understand the nature of the relationship established by the award, including both the compensatory relationship and the equity relationship subsequent to the date of grant. The grant date for an award will be the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares. In order to assess that financial exposure, the employer and employee must agree to the terms; that is, there must be a mutual understanding. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory). Additionally, to have a grant date for an award to an employee, the recipient of that award must meet the definition of an employee.

The employer and the employee must reach a mutual understanding sufficient for both to understand the compensatory and the equity relationship established by the award. In other words, the employer and employee must agree on the key terms of the share-based payment award and the conditions the employee must satisfy to earn the award. Both parties should understand the award's key terms, including the option's exercise price and contractual term, the vesting provisions, and the number of options the employee will receive. Those terms may be established through a written or oral agreement. Often, awards are unilateral, as noted in ASC 718-10-25-5(a), such as when an employer determines the terms of an award and then communicates them to an employee. Many employees are not in a position to negotiate the terms of the award. However, when an employee is in a position to negotiate the terms of an award (for example, a senior executive), both parties must agree to the terms of the award for a mutual understanding to exist under ASC 718.

The implementation guidance in ASC 718 further discusses the components that are required to establish a grant date.

### Mutual understanding of key terms

On October 31, 20X1, the compensation committee voted to approve the grant of a pool of 10,000 preferred shares to Employees A, B, and C, which will vest over a one-year service period beginning October 31, 20X1. The number of shares will be allocated to the individual employees at a future date. The three employees are notified of the award and told that the allocation of shares will be made in the future.

The grant date is not established at October 31, 20X1 because the approval of an aggregate number, or pool, of shares to be allocated to these individual employees at a later date does not sufficiently establish a mutual understanding of the key terms of the arrangement.

Management allocates the shares on February 28, 20X2 and communicates to each employee the number of shares they will receive. As a result, February 28 is the date when a mutual understanding was reached and is the grant date of these awards.

### Grant Thornton insights: Formal versus informal documentation

Although ASC 718-10-55-81 says that a mutual understanding of the key terms and conditions of an arrangement may be established through formal or informal agreements, or an entity's past practice, we believe that relying on informal, oral agreements or past history to establish a mutual understanding is rare and could present challenges.

In practice, employers formally document the vast majority of awards in written agreements with employees. The assertion that informal, oral agreements or past practices are sufficient to establish the existence of mutual understanding is often difficult to support, especially after a period of time elapses and employers and employees might have differing recollections of the key terms and conditions. Also, an entity's past practices might be inconsistent in hindsight.

That said, employers frequently issue informal documentation, such as emails or memos, to employees outlining the terms of awards when they are approved, and those communications may in fact provide support for establishing a mutual understanding, particularly when those terms are memorialized in formal, signed award agreements in a short period after an award's approval.

Even with written agreements, past practices, such as verbally agreeing to allow cash settlement of employee shares, might call into question other aspects of accounting for an award, such as equity versus liability classification. For example, an employer with a history of settling option awards in cash might be asked to cash settle awards by employees whose agreements do not provide for cash settlement. In this situation, the employer and employee understand the existence of a net-cash settlement feature based on past practice, so the options would be classified as a liability.

An entity must consider the specific facts and circumstances for each award to establish a grant date. We believe that formal documentation that specifies the exercise price, number of shares, and vesting conditions is necessary to establish a mutual understanding and therefore a grant date. In other words, an informal agreement or an entity's past practice is insufficient evidence that a mutual understanding exists, which is essential to establish a grant date.

### *'Look-back' share options*

The definition of grant date includes the words "the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares." An important word in this excerpt is "or" in the context of beginning to benefit or be adversely affected by changes in the price of the shares awarded. Some options, called "look-back" share options, state, for example, that the award's exercise price will be the lower of the share price either on the grant date of the award or on the employee's one-year anniversary date. In this case, the employee knows that the exercise price cannot exceed the share price on the grant date and that it may in fact be lower. Therefore, the employee begins to benefit from the award if the share price at year-end is higher than at the beginning of the year, and the information about the exercise price and the current share price is sufficient to support a mutual understanding of the compensatory and equity relationship established by the award.

In contrast, another type of award, may allow for setting the exercise price at a future date, such as one year after the award is made. In this case, the employee neither benefits from a share price increase nor is adversely affected by a share price decrease, so there is insufficient information to support a mutual understanding of the compensatory and equity relationship.

This distinction is clearly stated in ASC 718-10-55-83.

**ASC 718-10-55-83**

The determination of the grant date shall be based on the relevant facts and circumstances. For instance, a look-back share option may be granted with an exercise price equal to the lower of the current share price or the share price one year hence. The ultimate exercise price is not known at the date of grant, but it cannot be greater than the current share price. In this case, the relationship between the exercise price and the current share price provides a sufficient basis to understand both the compensatory and equity relationship established by the award; the recipient begins to benefit from subsequent changes in the price of the employer's equity shares. However, if the award's terms call for the exercise price to be set equal to the share price one year hence, the recipient does not begin to benefit from, or be adversely affected by, changes in the price of the employer's equity shares until then. Therefore, grant date would not occur until one year hence. Awards of share options whose exercise price is determined solely by reference to a future share price generally would not provide a sufficient basis to understand the nature of the compensatory and equity relationships established by the award until the exercise price is known.

### *Subjective performance conditions*

Awards with performance conditions (see Section 5.2) often are the focus of questions about whether an employer and employee have reached a mutual understanding of the key terms of the award. This is an area of significant judgment.

For example, consider whether the employer and employee have reached a mutual understanding of the key terms and conditions of the award in the following scenario: An award includes a performance condition based on the outcome of an employee's annual performance review. Whether a mutual understanding exists depends on how objective the performance criteria are and how objectively the employer applies the criteria. If the criteria cannot be objectively determined based on the award's terms, such as an award will vest if a supervisor decides that an employee's business decisions and actions benefitted the employer in the year, it is unlikely the evaluation process would be sufficiently objective to establish a mutual understanding of the award.

In contrast, consider a situation where (1) the employer uses an established evaluation system as the basis for all compensation decisions, (2) the system includes specific criteria to evaluate the employee's performance, and (3) the results of the evaluation must result in a specified distribution pattern. In this case, the performance condition may be sufficiently objective to ensure that the conditions of the award are mutually understood by the employer and the employee.

**Grant Thornton insights: Subjective performance conditions**

Determining if the parties reach a mutual understanding of the key terms and conditions of a share-based payment award may require the use of significant judgment. An example is when one of the key terms is a performance condition and determining whether that condition has or has not been met requires a degree of discretion and judgment.

At one end of the spectrum, if little discretion is necessary to determine whether a performance condition has been met, such as achieving a specified, clearly defined EBITDA at the end of the performance period, it might be rather straightforward to conclude that the parties have reached a mutual understanding of the key terms and conditions of the award.

On the other end of the spectrum, the compensation committee or management may exercise complete discretion in determining whether a performance condition has been met at the end of the relevant performance period. For example, a question is whether the grantor is able to assert that a mutual understanding exists before the end of the performance period; that is, whether a mutual understanding exists when no specified level or definition of EBITDA is included in the terms of the award. In this case, it seems highly unlikely that the parties could demonstrate a mutual understanding of the award's key terms without drawing on additional information or events, such as for example, past practice.

Most share-based payments awards will fall somewhere within this broad spectrum and will require varying levels of careful evaluation and judgment when determining whether a mutual understanding exists.

**Subjective performance conditions**

**Scenario 1**

The compensation committee met on October 31, 20X1 and agreed to grant Employee A up to 10,000 preferred shares that will vest one year later on October 31, 20X2. Vesting depends on Employee A meeting defined performance criteria; however, the compensation committee will exercise discretion in deciding how many shares vest under the terms of the agreement.

Because the compensation committee has discretion to decide how many shares will vest, the entity concludes that a sufficient mutual understanding of the award terms and conditions does not exist.

**Scenario 2**

The compensation committee met on October 31, 20X1 and agreed to grant Employee B up to 10,000 preferred shares that will vest one year later on October 31, 20X2. Vesting depends on Employee B meeting defined performance criteria that are objective and were provided to the employee as part of the employee's compensation plan. The compensation committee's role at the end of the period is solely to apply those criteria against Employee B's performance. If the criteria are met, the shares vest.

The entity determines that there is a sufficient mutual understanding of the terms and conditions of the award because the employer has provided Employee B with objective performance criteria, which the entity will use to determine whether the shares will vest one year later.

### *Timing of communication*

The guidance in ASC 718-10-25-5 provides, in part, that the employer is expected to communicate the key terms of an award to the employee "within a relatively short time period after the approval date." This guidance defines a "relatively short time period" as "that period an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practice."

**Grant Thornton insights: Relatively short period of time**

Each entity has protocols for communicating personnel matters. Some entities have a policy or practice of communicating personnel issues via email in as little as a day or two, while others have internal procedures that require a number of days, or even a few weeks, to formalize and issue the communications. In any case, the time period for communicating the terms of employee awards should be short and consistent with how other personnel matters are communicated to employees, according to the guidance in ASC 718. For example, say that awards to employees are determined and approved on December 15, with an intended grant date of the following January 1, but that this communication to employees is delayed until late January. The delayed communications casts, doubt on a January 1 grant date.

We believe that no more than a few weeks should elapse between the time when an award is approved and when its key terms are communicated to employees. We encourage entities to expedite the communications, especially if an award is made near the end of a period.

### 4.2.2 All approvals are obtained

One of the five conditions to establish a grant date for an employee award is that all of the required approvals have been obtained, including the approval of shareholders, the board of directors, the compensation committee, and / or management. Share-based award plans generally specify the level(s) of approval that must be obtained, but approval may also be required by board resolutions or regulatory requirements, among other means. ASC 718 clearly states that a grant date does not exist until approval is obtained, if required, with one exception (described below). Many public entities and some nonpublic entities require shareholder approval, depending on such factors as the level of the employee who is receiving the award. An entity granting awards to multiple employees might face shareholder approval requirements for some (for example, senior executives) and only board or lower level approval for all other employee awards. Since shareholder meetings might occur only annually or at relatively long intervals, entities should carefully consider when approvals can be obtained in planning the timing of issuing awards.

An exception where shareholder approval might not be necessary even though it is required for an award is when shareholder approval is essentially a formality or perfunctory. The definition of a grant date in ASC 718 includes an example of when shareholder approval would be a formality or perfunctory: management and the members of the board of directors “control enough votes to approve the arrangement.” This situation often occurs in nonpublic entities and in some public entities when the board of directors consists of members whose combined ownership comprises a majority of shareholder votes. This has been applied in practice to mean that management and board members in support of granting the awards currently hold a majority of the voting shares and are expected to continue doing so through the meeting date when shareholder approval will be obtained. If a board vote is split—that is, some board members vote against an award, but the award nonetheless is approved—we believe that in deciding whether enough board votes exist to approve the award, only the shareholder interests of those board members in favor of the award should be counted. For purposes of this assessment, control is determined based on outstanding voting shares, not on shares expected to be voted at the shareholders’ meeting.

Some assert that the past history of shareholders approving awards is sufficient to assert that approval at the next shareholder vote is probable. An entity’s past experience suggesting that approval is probable, however, does not make shareholder approval a formality or perfunctory and should not be used in establishing a grant date.

**Evaluating approval of a share-based payment award**

**Scenario 1**

Entity A’s share-based payment plan calls for shareholder approval of all individual awards granted in accordance with the plan document. The compensation committee of the board of directors is responsible for drafting and issuing each individual award. Compensation committee members currently hold a majority of the entity's voting shares and are expected to continue doing so through the next shareholder meeting date.

Because the compensation committee controls sufficient votes to approve the plan, the grant date could occur prior to shareholder approval, assuming all members of the compensation committee approve the grant and other conditions for a grant date exist, because shareholder approval is essentially a formality in this situation.

**Scenario 2**

The share-based payment plan of Entity B calls for the shareholders to approve individual awards in accordance with the plan document. The compensation committee of the board of directors' drafts, and the full board approves, each individual award. Board members do not have enough shareholder votes to approve the awards. Since the plan's inception, the full board has always approved awards granted by the compensation committee, and the entity therefore concludes that it is highly probable the shareholders will continue to do so.

The probability of shareholders approving the award, even if based on past experience, does not make shareholder approval a formality or perfunctory. As a result, a grant date does not exist, even if all other conditions are present, until the shareholders vote and approve the award.

### 4.2.3 Grantee is an employee

The grant date for an award does not exist unless the recipient meets the definition of an "employee." ASC 718 indicates an employee is an individual who is providing services and an employer-employee relationship must exist based on common law (see Section 2.2).

**Grantee is an employee**

On February 1, 20X1, an individual is hired to be Entity A's new controller and is awarded 5,000 options that will vest on February 1, 20X2. The new controller will begin the new position on May 1, 20X1.

The grant date of the award is May 1, 20X1, the day the new controller begins to provide employee services and meets the definition of an employee, as defined in ASC 718, provided all other grant-date conditions are met on that date.

An outcome in many cases of a delay, such as waiting until the grantee becomes an employee, is that the requisite service period (vesting period) often is shorter than the period written in the award agreement. In this example, the employer determines that the written vesting period is 12 months starting February 1, but, since the grant date is not until May 1, the requisite service period is only 9 months beginning on May 1. There is no 'catch-up" entry for the period prior to May 1, so the employer recognizes the compensation cost for the options on a straight-line basis over the nine-month period from May 1, 20X1 through February 1, 20X2.

For more on the requisite service period, see Section 6.2.

### 4.2.4 Entity is obligated to issue awards

In a share-based transaction with an employee, the employer is obligated to issue the equity instrument or to transfer assets to the employee contingent on the employee rendering the service required during the requisite service period. An agreement is generally reached during the award approval process and is in place by the time the preceding conditions required to establish a grant date have been met.

### 4.2.5 Employee is affected by subsequent changes in share price

The last condition required to establish a grant date for an employee award is that the employee is affected by subsequent changes in the share price. In other words, the grant date does not occur until the employee begins to "benefit from," or to be "adversely affected by," subsequent changes in the price of the employer's equity shares. Therefore, if an employee is granted options whereby the exercise price is based on the entity's share price at a future date, the grant date cannot exist before that future date.

**Employee is affected by subsequent changes in share price**

**Scenario 1**

On February 1, 20X1, an individual is hired to be Entity A's new controller and is awarded 5,000 options that will vest on February 1, 20X2. The new controller will begin the position on May 1, 20X1. The exercise price of the controller's award is the share price on the first anniversary of the controller's hire date.

The grant date of the award is February 1, 20X2, because the controller will not be affected by subsequent changes in the price of the employer's shares until then. The award does not provide a sufficient basis to understand the nature of its compensatory and equity relationships until February 1, 20X2.

**Scenario 2**

On February 1, 20X1, an individual is hired to be Entity A's new controller and is awarded 5,000 options that will vest on February 1, 20X2. The new controller will begin the position on May 1, 20X1. The exercise price of the controller's award is the lower of the share price on February 1, 20X1 or on the first anniversary of the controller's hire date.

A "look-back" share option provides that the exercise price is the lower of either the grant-date share price or the share price on the employee's one-year anniversary date. In this case, the employee knows the exercise price cannot exceed the share price on the grant date and that it may even be lower. Knowing this information about the exercise price and the current share price is sufficient to understanding the compensatory and equity relationship established by the award, because it meets the first of the two criteria to either "benefit from" or "be adversely affected by" share-price changes. The employee would not "be adversely affected by" decreases in the share price during the first year, but would benefit from increases in the share price during that period. ASC 718 provides that such an exposure to changes in the share price meets this condition for establishing a grant date.

For more on "look-back" awards, see Section 4.2.1.

### 4.3 Service inception date

As defined, the service inception date is usually, but not always, the grant date. The service inception date is when the employee begins to provide the services required, which is called the beginning of the "requisite service period." In general terms, the cost of an award is expensed over the requisite service period, which is discussed more in Section 6.2. The service inception date is important because of its impact on when an employer begins to recognize the costs of the award. Some awards are structured in a way that requires careful consideration of the terms and conditions in order to determine the service inception date, and grantors should keep in mind as they draft award agreements that service inception dates (and therefore cost recognition) could be different than originally expected.

> The **service inception date** is the date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date (see Example 6 [see paragraph 718-10-55-107]).

Example 6 of ASC 718 provides an example when the grant date and the service inception date fall on the same date.

**Example 6: Service Inception Date and Grant Date (excerpt)**

**ASC 718-10-55-110**

For example, Entity T offers a position to an individual on April 1, 20X5 that has been approved by the chief executive officer and board of directors. In addition to salary and other benefits, Entity T offers to grant 10,000 shares of Entity T stock that vest upon the completion of 5 years of service (the market price of Entity T's stock is $25 on April 1, 20X5). The share award will begin vesting on the date the offer is accepted. The individual accepts the offer on April 2, 20X5, but is unable to begin providing services to Entity T until June 2, 20X5 (that is, substantive employment begins on June 2, 20X5). The individual also does not receive a salary or participate in other employee benefits until June 2, 20X5. On June 2, 20X5, the market price of Entity T stock is $40. In this Example, the service inception date is June 2, 20X5, the first date that the individual begins providing substantive employee services to Entity T. The grant date is the same date because that is when the individual would meet the definition of an employee. The grant-date fair value of the share award is $400,000 (10,000 × $40).

Although the service inception date coincides with the grant date in the example above, the service inception date in other fact patterns may differ from the grant date. ASC 718 clearly states that the service inception date cannot precede the grant date unless all of the following conditions exist:

- The award is authorized.
- Service begins before a mutual understanding of the key terms and conditions of the award is reached (for example, one of the terms, such as the exercise price, is not yet known).
- Either
  - The award does not include a substantive future service period as of the grant date, or

– The award has a performance or market condition that must be satisfied during a service period preceding the grant date and following the inception of the arrangement; if the performance or market condition is not met during that period, the award will be forfeited.

**Example 6: Service Inception Date and Grant Date (excerpt)**

**ASC 718-10-55-108**

This Topic distinguishes between service inception date and grant date. The service inception date is the date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date precedes the grant date if all of the following criteria are met:

a. An award is authorized. (Compensation cost would not be recognized before receiving all necessary approvals unless approval is essentially a formality [or perfunctory].)

b. Service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached.

c. Either of the following conditions applies:

   1. The award's terms do not include a substantive future requisite service condition that exists at the grant date (see paragraph 718-10-55-113 for an example illustrating that condition).

   2. The award contains a market or performance condition that if not satisfied during the service period preceding the grant date and following the inception of the arrangement results in forfeiture of the award (see paragraph 718-10-55-114 for an example illustrating that condition).

Example 6 in ASC 718-10 continues with two examples where the service inception date precedes the grant date. In these examples, all conditions outlined in ASC 718-10-55-108 above are satisfied.

**Example 6: Service Inception Date and Grant Date (excerpt)**

**ASC 718-10-55-113**

If an award's terms do not include a substantive future requisite service condition that exists at the grant date, the service inception date can precede the grant date. For example, on January 1, 20X5, an employee is informed that an award of 100 fully vested options will be made on January 1, 20X6, with an exercise price equal to the share price on January 1, 20X6. All approvals for that award have been obtained as of January 1, 20X5. That individual is still an employee on January 1, 20X6, and receives the 100 fully vested options on that date. There is no substantive future service period associated with the options after January 1, 20X6. Therefore, the requisite service period is from the January 1, 20X5, service inception date through the January 1, 20X6, grant date, as that is the period during which the employee is required to perform service in exchange for the award. The relationship between the exercise price and the current share price that provides a sufficient basis to understand the equity relationship established by the award is known on January 1, 20X6. Compensation cost would be recognized during 20X5 in accordance with the preceding paragraph.

**ASC 718-10-55-114**

If an award contains either a market or a performance condition, which if not satisfied during the service period preceding the grant date and following the date the award is given results in a forfeiture of the award, then the service inception date may precede the grant date. For example, an authorized award is given on January 1, 20X5, with a two-year cliff vesting service requirement commencing on that date. The exercise price will be set on January 1, 20X6. The award will be forfeited if Entity T does not sell 1,000 units of product X in 20X5. In this Example, the employee earns the right to retain the award if the performance condition is met and the employee renders service in 20X5 and 20X6. The requisite service period is two years beginning on January 1, 20X5. The service inception date (January 1, 20X5) precedes the grant date (January 1, 20X6). Compensation cost would be recognized during 20X5 in accordance with paragraph 718-10-55-112.

**Grant Thornton insights: Service inception date and performance conditions**

While most service condition (service vesting) awards have a service inception date coinciding with the grant date, many performance condition awards do not. Both the service inception date and grant date concepts in ASC 718 can lead to accounting outcomes for performance awards that were not contemplated during the award's design.

In recent years, performance-based awards have become more commonplace and grantors should carefully understand the impact of how performance conditions are designed. For instance, some performance-based awards cover several years of performance, and the results of one year impact the next year. Or, the award could be spread over a series of performance years, each of which stands alone for accounting purposes. (see Section 5.2 for a discussion of performance conditions)

Entities should recognize the challenge of balancing their objectives to properly incentivize employees through complex performance targets and performance periods, with how those award terms impact a host of accounting issues. Unintended accounting outcomes could arise, in particular, a delay in the grant date and the uncertainty as to the award's fair value when the future grant date is reached. Or variable accounting might be the result, requiring remeasurement of the award's fair value each period, when the service inception date precedes the grant date and the award is remeasured each period until the grant date occurs.

We recommend that grantors take a more or less holistic view of their employee awards and carefully identify and quantify the potential accounting impact as the award terms are drafted.

### 4.3.1 Service inception date before grant date

As discussed in the introduction to this section, when the service inception date precedes the grant date, the employer must recognize compensation cost based on the fair value of the award at the reporting dates that occur before the grant date. This practice is often referred to as variable accounting because the fair value changes each period and the current fair value is the basis for compensation cost to date. When the grant date occurs, a final remeasurement of fair value is calculated and cumulative compensation cost is adjusted to reflect the fair value at that grant date as well as the pro rata portion of the vesting period that has elapsed as of that date.

**ASC 718-10-35-6 (excerpt)**

If the service inception date precedes the grant date (see paragraph 718-10-55-108), accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date).

### 4.3.2 Service inception date after grant date

The service inception date may also begin after the grant date if both

- An award consists of several separately vesting tranches (portions), each of which has a separate performance condition
- The terms of the award, including the performance target for each tranche, are established at inception

Because the employer and employee share a mutual understanding of the key terms and conditions, which are known at inception, the grant date and the measurement date occur at inception for all tranches as long as all other conditions required to establish a grant date have been met. If each tranche has its own independent performance condition for a stated period of service, each tranche will have its own service inception date and requisite service period, but will use the initial measurement-date fair value. Contrast this example with an otherwise similar award that has performance targets set in the future, for example, each year's target is set on January 1 of that year. In this case, the grant date would not occur for each subsequent year until the respective target is set. See Section 5.2 for examples of performance condition awards.

# 5. Impact of service, performance and market conditions on measurement

The terms of a share-based payment award generally include either a service, performance, or market condition (or combination of the three) that must be met for the employee to “earn” the award. These conditions may impact the award’s exercise price and requisite service period, among other factors. The rest of this section discusses each type of condition in more detail.

Figure 5.1 provides an overview of service, performance, and market conditions and their impact on measurement as well as compensation cost.

**Figure 5.1: Conditions, impact on fair value, and when recognized as compensation cost**

| Condition that affects vesting or exercisability | Is the condition incorporated into grant-date fair value? | Does the condition impact whether measured compensation cost will be recognized? | Example |
|---|---|---|---|
| Service | No | Yes, if the requisite service period of an award is based on a substantive service condition, compensation cost will only be recognized to the extent the service condition is satisfied. | A stock option that vests if the employee provides five years of service to the entity |
| Performance | No | Yes, compensation cost is recognized only if it is probable (likely to occur) that the performance condition will be satisfied. | A stock option that vests if the entity completes an IPO or another defined change of control event<br><br>A stock option that vests upon attaining a specified EPS target |
| Market | Yes | Yes, compensation cost is recognized regardless of whether the market condition is met, as long as the employee provides the requisite service. | A stock option that can be exercised when the entity’s stock price exceeds a specified amount<br><br>A stock option that can be exercised |

| | |
|---|---|
| | when the entity achieves a specified rate of return to shareholders |

## 5.1 Service conditions

A service condition requires the employee to render service for the requisite service period that is determined based on the terms of the award. For example, an award that vests upon the completion of three years of employee service contains a service condition. A service condition also must be “substantive,” and judgment is required to determine whether what is required of the employee is substantive.

Although ASC 718 does not define substantive, as discussed in Section 6.2.5, ASC 718 provides guidance on awards that are granted to employees who are eligible to retire and yet continue to vest in an award over a service period. That guidance notes that because the employee in this situation could retire, the service required is not substantive, and the award’s cost should be recognized immediately. Other issues regarding “substantive” service conditions might arise when, for example, a terminated executive must continue to provide defined services to retain and continue to vest in an award. The ongoing services are often not considered to be substantive if they require the executive to be available to answer potential questions from his or her successor; to spend a few hours per month on entity matters; or to meet other requirements that are relatively minor when considered within the context of the award.

The existence of a service condition does not directly impact the award’s fair value because the service condition (that is, the probability that the employee will complete the requisite service period) is not an input to the valuation. However, a service condition could indirectly impact the fair value of an award that is valued using a valuation model. For example, in a Black Scholes stock option valuation calculation, one input is the “expected term” that is determined, in part, by referring to the employee’s requisite service period and to how long after vesting the employee will exercise the award. The service condition indirectly impacts the fair value in this situation, but the existence of the service condition itself has no impact on the valuation.

The basic principle of recognizing share-based payment awards is that an employer recognizes compensation cost for the service condition award if the employee meets or fulfills the service condition, which is most often achieved simply by remaining employed for the stated period. Other forms of service conditions include death or disability, which are accounted for using the guidance on service conditions, although they are certainly not a form of service.

A **service condition** is a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee’s death, disability, or termination without cause is a service condition.

**ASC 718-10-30-12 (excerpt)**

Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered).

**Award with a service condition**

Entity A grants its CEO 1,000 share options. The grant-date fair value of the award is $10,000. The options will vest once the CEO completes five years of service with Entity A.

Entity A will recognize compensation cost over the five-year period, unless the service is not provided (for example, the CEO resigns after three years), in which case, the entity would no longer recognize compensation cost and would reverse the cost that had previously been recognized. If the CEO completes the five-year requisite service period but thereafter does not exercise the options, compensation expense would not be reversed.

## 5.2 Performance conditions

The guidance in ASC 718 provides a number of common examples of performance conditions included in share-based payment awards, including:

- Attaining a specified return on assets
- Obtaining regulatory approval for a specific product
- Selling shares in an IPO
- Consummating a change in control
- Attaining a growth rate in EPS that exceeds the average growth rate in EPS of other entities in the industry

As noted in the Master Glossary definition of performance condition below, the condition must be based either on the employer's own operations or activities or on the employee's performance. The condition may also be based on the entity's performance as a whole or on the performance of only a part of the entity, such as a subsidiary's performance. Although what qualifies as a performance condition may appear to be rather broadly defined, if the condition is not based on the employer's own operations or activities or on the employee's performance, the condition may be viewed as another type of condition that causes liability classification (see Section 3.2). A simple example of another type of condition is an award that vests based on the price of oil, which is not a performance (or market) condition, even if the entity buys or sells oil and the price impacts profitability.

A **performance condition** is a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both of the following:

a. An employee's rendering service for a specified (either explicitly or implicitly) period of time

b. Achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities)

Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. A performance target might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division or an individual employee.

As noted in the definition, the condition must be either based on the employer's own operations or activities or on the employee's performance. If the award does not contain a market condition and the condition is not based on the employer's own operations or activities or on the employee's performance, the condition may cause liability classification (see Section 3.2.4).

For awards with a performance condition that affects vesting or the exercisability of options, compensation cost is recognized only if it is "probable" that the performance condition will be satisfied. For this purpose, the meaning of "probable" in the ASC Master Glossary is that "the future event or events are likely to occur."

**ASC 718-10-25-20 (excerpt)**

Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved.

For some liquidity events, such as an IPO, the event is not deemed probable of occurring until the event takes place. For more on this, see Section 5.2.2 below.

If satisfaction of the performance condition does not meet the threshold of probability discussed above, compensation cost for the award is not recognized.

**ASC 718-10-30-12 (excerpt)**

Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered).

### Award with a performance condition

Entity A grants its CEO 1,000 share options. The grant-date fair value of the awards is $10,000. The options will vest if, and only if, the market share for Entity A's Product X doubles from 5 percent of sales at the award date to 10 percent five years later. Market share statistics are published quarterly by an industry trade group. Doubling the market share is a performance condition that does not impact the grant-date fair value. At the grant date, Entity A expects to meet the market share target at the end of year four (that is, achievement is probable) and therefore begins to recognize annual expense equal to $10,000 divided by 4, or $2,500, per year. The four-year period is the implicit service period for recognizing expense.)

Entity A re-evaluates the probability of achieving the target, as well as when it might be achieved, as part of each closing process in each reporting period. Following are illustrative potential accounting outcomes related to this award, although the mix of changing probability and timing can occur in a number of other ways:

- *Ongoing estimates of probability of achievement and timing do not change over time:* In this case, Entity A continues to recognize the expense over the four years so that when the target is reached and the share options vest, all compensation expense will have been recognized.
- *Estimates of probability and timing change so that achievement is no longer probable:* For example, if at the end of year two Entity A learns of a competitor's new product that will impede its achievement of the market share target within the five-year period, all previously recognized cost would be reversed at that time. In other words, since achievement is no longer probable, no expense should be recognized. Although Entity A would continue to assess probability and timing each period, the award ultimately would not vest if the market share target is not met.
- *Same facts as in second bullet above, except that at the end of year three, Entity A reconsiders probability and timing and a reaches a different conclusion:* The competitor's new product did not have the anticipated impact, and the market share target again is probable of achievement at the end of year five. As of the end of year three, Entity A records a cumulative expense equal to three-fifths of the original fair value, or $6,000 and, going forward, expenses the remaining $4,000 over years four and five until the performance condition is achieved. The share options vest and the entire expense is recognized when the market share target is met.

These simple examples of potential outcomes highlight an important aspect of accounting for performance awards: The entity granting the awards must have robust procedures and controls in place to appropriately update its estimates of probability and timing. Making proper judgments each reporting period is critical to when and how much expense should be recognized. As illustrated, changes in those judgments can cause a series of reversals of compensation and / or cumulative catch-up expense over the period of performance.

### 5.2.1 Conditions that affect vesting or exercisability versus affecting other factors

As discussed above, when a performance condition impacts whether an award will vest or become exercisable, the condition is not factored into the grant-date fair value of the award.

However, ASC 718 states that provisions that affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors should be considered in measuring the award's grant-date fair value, for example, doubling an award if the entity's revenue target is achieved. The compensation cost ultimately recognized is equal to the grant-date fair value of the award that coincides with the actual outcome of the performance condition.

**ASC 718-10-30-15 (excerpt)**

Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

When an award contains conditions, including multiple performance conditions, that affect factors other than vesting or exercisability, ASC 718 requires the entity to estimate the grant-date fair value for each possible outcome. The final compensation cost should reflect the grant-date fair value of the performance condition that is ultimately satisfied.

**ASC 718-10-25-20 (excerpt)**

If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions.

Example 2 in ASC 718-20 demonstrates how to account for awards with multiple performance conditions that impact factors other than vesting or exercisability.

**Example 2: Share Option Award under Which the Number of Options to Be Earned Varies**

**ASC 718-20-55-36**

This Example shows the computation of compensation cost if Entity T grants an award of share options with multiple performance conditions. Under the award, employees vest in differing numbers of options depending on the amount by which the market share of one of Entity T's products increases over a three-year period (the share options cannot vest before the end of the three-year period). The three-year explicit service period represents the requisite service period. On January 1, 20X5, Entity T grants to each of 1,000 employees an award of up to 300 10-year-term share options on its common stock. If market share increases by at least 5 percentage points by December 31, 20X7, each employee vests in at least 100 share options at that date. If market share increases by at least 10 percentage points, another 100 share options vest, for a total of 200. If market share increases by more than 20 percentage points, each employee vests in all 300 share options. Entity T's share price on January 1, 20X5, is $30 and other assumptions are the same as in Example 1 (see paragraph 718-20-55-4). The grant-date fair value per share option is $14.69. While the vesting conditions in this Example and in Example 1 (see paragraph 718-20-55-4) are different, the equity instruments being valued have the same estimate of grant-date fair value. That is a consequence of the modified grant-date method, which accounts for the effects of vesting requirements or other restrictions that apply during the vesting period by recognizing compensation cost only for the instruments that actually vest. (This discussion does not refer to awards with market conditions that affect exercisability or the ability to retain the award as described in paragraphs 718-10-55-60 through 55-63).

**ASC 718-20-55-37**

The compensation cost of the award depends on the estimated number of options that will vest. Entity T must determine whether it is probable that any performance condition will be achieved, that is, whether the growth in market share over the 3-year period will be at least 5 percent. Accruals of compensation cost are initially based on the probable outcome of the performance conditions—in this case, different levels of market share growth over the three-year vesting period—and adjusted for subsequent changes in the estimated or actual outcome. If Entity T determines that no performance condition is probable of achievement (that is, market share growth is expected to be less than 5 percentage points), then no compensation cost is recognized; however, Entity T is required to reassess at each reporting date whether achievement of any performance condition is probable and would begin recognizing compensation cost if and when achievement of the performance condition becomes probable.

**ASC 718-20-55-38**

Paragraph 718-10-25-20 requires accruals of cost to be based on the probable outcome of performance conditions. Accordingly, this Topic prohibits Entity T from basing accruals of compensation cost on an amount that is not a possible outcome (and thus cannot be the probable outcome). For instance, if Entity T estimates that there is a 90 percent, 30 percent, and 10 percent likelihood that market share growth will be at least 5 percentage points, at least 10 percentage points, and greater than 20 percentage points, respectively, it would not try to determine a weighted average of the possible outcomes because that number of shares is not a possible outcome under the arrangement.

**ASC 718-20-55-39**

The following table shows the compensation cost that would be recognized in 20X5, 20X6, and 20X7 if Entity T estimates at the grant date that it is probable that market share will increase at least 5 but less than 10 percentage points (that is, each employee would receive 100 share options). That estimate remains unchanged until the end of 20X7, when Entity T's market share has increased over the 3-year period by more than 10 percentage points. Thus, each employee vests in 200 share options.

**ASC 718-20-55-40**

As in Example 1, Case A (see paragraph 718-20-55-10), Entity T experiences actual forfeiture rates of 5 percent in 20X5, and in 20X6 changes its estimate of forfeitures for the entire award from 3 percent to 6 percent per year. In 20X6, cumulative compensation cost is adjusted to reflect the higher forfeiture rate. By the end of 20X7, a 6 percent forfeiture rate has been experienced, and no further adjustments for forfeitures are necessary. Through 20X5, Entity T estimates that 913 employees (1,000 × .973) will remain in service until the vesting date. At the end of 20X6, the number of employees estimated to remain in service is adjusted for the higher forfeiture rate, and the number of employees estimated to remain in service is 831 (1,000 × .943). The compensation cost of the award is initially estimated based on the number of options expected to vest, which in turn is based on the expected level of performance and the fair value of each option. That amount would be adjusted as needed for changes in the estimated and actual forfeiture rates and for differences between estimated and actual market share growth. The amount of compensation cost recognized (or attributed) when achievement of a performance condition is probable depends on the relative satisfaction of the performance condition based on performance to date. Entity T determines that recognizing compensation cost ratably over the three-year vesting period is appropriate with one-third of the value of the award recognized each year.

**Share Option with Performance Condition—Number of Share Options Varies**

| Year | Total Value of Award | Pretax Cost for Year | Cumulative Pretax Cost |
|---|---|---|---|
| 20X5 | $1,341,197 ($14.69 x 100 x 913) | $447,066 ($1,341,197 ÷ 3) | $ 447,066 |
| 20X6 | $1,220,739 ($14.69 x 100 x 831) | $366,760 [($1,220,739) x 2/3) - $447,066] | $ 813,826 |
| 20X7 | $2,441,478 ($14.69 x 200 x 831) | $1,627,652 ($2,441,478 - $813,826) | $2,441,478 |

**When a performance condition affects the number of awards each employee will receive**

An entity grants options to 3,000 employees. The number of options each employee will receive varies, depending on the average annual increase in EBITDA over four years:

- If EBITDA increases an average of 5 percent a year, each employee receives 100 options.
- If EBITDA increases an average of 8 percent a year, each employee receives 200 options.
- If EBITDA increases an average of 10 percent a year, each employee receives 300 options.
- If EBITDA increases an average of 15 percent a year, each employee receives 400 options.

The award's requisite service period is the four-year explicit service period. At the grant date, the entity determines that it is probable that EBITDA will increase, on average, by 5 percent a year, and it accrues 25 percent of the grant-date fair value of 300,000 options (3,000 employees × 100 options). At the end of year two, the entity determines that it is probable that EBITDA will increase, on average, by 8 percent a year. At the end of that year, the entity recognizes the cumulative effect of the change in the probable outcome of the award on the current and prior periods. The entity recognizes 50 percent of the grant-date fair value of 600,000 options (3,000 employees × 200 options), less the cumulative cost previously recognized. The cumulative effect of the change in the estimate of the expected outcome of the performance condition is recognized in year two because the change in estimate affects the quantity of awards expected to vest.

Example 3 in ASC 718-20 demonstrates a situation in which a performance condition affects the exercise price or contractual term of an award. In this situation, there is more than one award to value at the grant date because employees may receive more than one possible award. The grant-date fair value is estimated for each potential outcome of the award based on the performance condition.

### Example 3: Share Option Award under Which the Exercise Price Varies

**ASC 718-20-55-41**

This Example illustrates the guidance in paragraph 718-10-30-15.

**ASC 718-20-55-42**

This Example shows the computation of compensation cost if Entity T grants a share option award with a performance condition under which the exercise price, rather than the number of shares, varies depending on the level of performance achieved. On January 1, 20X5, Entity T grants to its chief executive officer 10-year share options on 10,000 shares of its common stock, which are immediately vested and exercisable (an explicit service period of zero). The share price at the grant date is $30, and the initial exercise price also is $30. However, that price decreases to $15 if the market share for Entity T's products increases by at least 10 percentage points by December 31, 20X6, and provided that the chief executive officer continues to be employed by Entity T and has not previously exercised the options (an explicit service period of 2 years, which also is the requisite service period).

**ASC 718-20-55-43**

Entity T estimates at the grant date the expected level of market share growth, the exercise price of the options, and the expected term of the options. Other assumptions, including the risk-free interest rate and the service period over which the cost is attributed, are consistent with those estimates. Entity T estimates at the grant date that its market share growth will be at least 10 percentage points over the 2-year performance period, which means that the expected exercise price of the share options is $15, resulting in a fair value of $19.99 per option. Option value is determined using the same assumptions noted in paragraph 718-20-55-7 except the exercise price is $15 and the award is not exercisable at $15 per option for 2 years.

**ASC 718-20-55-44**

Total compensation cost to be recognized if the performance condition is satisfied would be $199,900 (10,000 x $19.99). Paragraph 718-10-30-15 requires that the fair value of both awards with service conditions and awards with performance conditions be estimated as of the date of grant. Paragraph 718-10-35-3 also requires recognition of cost for the number of instruments for which the requisite service is provided. For this performance award, Entity T also selects the expected assumptions at the grant date if the performance goal is not met. If market share growth is not at least 10 percentage points over the 2-year period, Entity T estimates a fair value of $13.08 per option. Option value is determined using the same assumptions noted in paragraph 718-20-55-7 except the award is immediately vested.

### ASC 718-20-55-45

Total compensation cost to be recognized if the performance goal is not met would be $130,800 (10,000 × $13.08). Because Entity T estimates that the performance condition would be satisfied, it would recognize compensation cost of $130,800 on the date of grant related to the fair value of the fully vested award and recognize compensation cost of $69,100 ($199,900 – $130,800) over the 2-year requisite service period related to the condition. Because of the nature of the performance condition, the award has multiple requisite service periods that affect the manner in which compensation cost is attributed. Paragraphs 718-10-55-67 through 55-79 provide guidance on estimating the requisite service period.

### ASC 718-20-55-46

During the two-year requisite service period, adjustments to reflect any change in estimate about satisfaction of the performance condition should be made, and, thus, aggregate cost recognized by the end of that period reflects whether the performance goal was met.

## 5.2.2 Performance conditions associated with liquidity events

As discussed in Section 5.2 above, compensation cost for an award with a performance condition is recognized when it is probable that the performance condition will be met. “Probable” means “likely to occur” in U.S. GAAP.

In practice, performance conditions affecting vesting or exercisability associated with certain liquidity events, such as an IPO or a change of control, are not considered probable until the liquidity event occurs. If the performance condition is based on satisfying a liquidity event that offers a specified return to investors, achievement of the return is excluded from the probability assessment since it is a market condition. Such a vesting requirement would therefore consist of a performance condition (the liquidity event occurring) and a market condition (achieving a specified return).

### Performance condition based on an IPO

Entity A grants its CEO 1,000 share options on January 1, 20X1 that will vest upon an IPO of Entity A’s shares. At March 31, 20X1, the process of issuing shares to the public is well underway so that Entity A deems it highly probably that the final offering date will be April 15, 20X1. The actual effective date of the IPO is April 25, 20X1.

Entity A does not recognize compensation cost for the 1,000 share options granted to its CEO as of March 31, 20X1. In practice, the liquidity event is not deemed probable until it actually occurs, and, in this fact pattern, Entity A recognizes the cost of the award on April 25, 20X1.

### Grant Thornton insights: Performance condition based on a liquidity event

The guidance in ASC 718 does not address how to approach the probability of performance conditions contingent on a liquidity event or another significant contingent event, such as a change in control. The occurrence of such events is highly dependent on factors beyond an entity’s control.

In practice, an entity should refer to the business combination guidance in ASC 805-20-55-50 and 55-51 that addresses when to recognize the liability for contractual termination benefits resulting from an acquisition. Paragraph 55-51 states:

> The liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination shall not be recognized when it is probable that the business combination will be consummated; rather it shall be recognized when the business combination is consummated.

We believe that entities should apply the concept of recognizing the accounting impact only upon consummation in Paragraph 55-51 to performance conditions contingent on liquidity and similar significant events, in part, because recognizing the accounting impact earlier might lead to an entity having to reverse the entries if the event ultimately fails to occur, and reversal might be in a later accounting period.

The language in Paragraph 55-51 originated in EITF Issue No. 96-5, *Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination.* The issue is whether a target entity should accrue for these benefits when the change of control becomes probable. The EITF consensus was for the entity to wait until the transaction is consummated before accounting for the transaction.

### 5.2.3 Reassessing whether a performance condition is probable

An entity is required to reassess at each reporting date whether satisfying a performance condition is probable, and to begin recognizing compensation cost when achievement of the performance condition becomes probable. Again, the ultimate compensation cost should reflect the actual results—that is, zero compensation cost if the performance condition is not met and compensation cost for whichever performance condition is ultimately satisfied.

**Reassessing whether a performance condition is probable**

The vice president of marketing is awarded 10,000 shares that vest if annual sales revenue increases, on average, 3 percent a year over the next four years. The requisite service period for the award is four years, based on the explicit four-year service period.

*Year one: not probable* – At the end of year one, the entity has determined that achievement of the revenue target is not probable, so no cost is recognized for the shares in year one.

*Year two: probable* – The entity determines at the end of year two that achievement of the performance condition for the four-year period is probable and recognizes 50 percent of the grant-date fair value of the award at the end of year two (representing 2 of the 4 years of the requisite service period).

*Years three and four: probable* – If achievement of the revenue target remains probable for years three and four and is ultimately achieved, 25 percent of the grant-date fair value would be recognized in each of years three and four.

### 5.2.4 Performance conditions achieved after the requisite service period

Under certain arrangements that specify both a period of service and a performance target, an employee can achieve a performance target after completing the requisite service. An entity must account for performance targets as performance conditions if the targets could be achieved after the requisite service period and affect vesting.

In the past, some entities concluded that some cost should be expensed during the requisite service period if a performance target can be achieved after the required service—especially if an employee could leave after the service period but still vest if the performance target ultimately is met. Those entities used the probability of achievement as an input to the fair value of the award. Other entities did not recognize expense in the requisite service period because they concluded that because a performance condition does not impact fair value and is therefore not an input to the valuation of the awards. To address this diversity in practice, the FASB amended the guidance in 2014 by issuing ASU 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could be Achieved after the Requisite Service Period*. The amendments require entities to account for arrangements if the performance target can be achieved after the requisite service period consistently with other awards that have performance conditions. In other words, the performance target does not impact the award's fair value, and compensation cost is recognized when achievement of the target becomes probable to the extent that the requisite service has been rendered, even if the cost is recognized after that service was rendered.

In application, a performance target that is probable of achievement by the end of the requisite service period requires recognizing the compensation cost over the requisite service period, which, in this case, is only the time during which the employee must provide service.

In contrast, despite the existence of an explicit service period (typically a number of years), compensation cost is not recognized if it is not probable that the performance target will not be achieved in that time frame, even if all of the required service is provided. In practice, fact patterns frequently arise where, for example, an award vests when the entity granting the awards is sold. These are examples of performance conditions that may be met after the required service is provided.

#### Performance condition met after requisite service period

An award with a 10-year contractual life requires both three years of service and the sale of the entity. After the three years, the employee does not need to provide any more services (and could even leave the entity) but still would vest in the award if, within the 10-year period, the entity is sold. In this case, the performance target does not impact the fair value of the award, and no cost is recognized in the three-year requisite service period, unless the sale occurs in that time period.

Assume that the employee provides three years of service and terminates employment in year six. Since the sale of the entity has not occurred in any of those years, the entity has recognized no expense. In year seven, however, the entity is sold and the award then vests. As discussed in Section 5.2.2, the related compensation expense is recognized only when the sale occurs. Therefore, the entity recognizes the cost of the award in year seven when the sale is completed.

### ASC 718-10-30-28

In some cases, the terms of an award may provide that a performance target that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. A performance target that affects vesting and that could be achieved after an employee's requisite service period shall be accounted for as a performance condition. As such, the performance target shall not be reflected in estimating the fair value of the award at the grant date. Compensation cost shall be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost for which requisite service has not yet been rendered shall be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period shall reflect the number of awards that are expected to vest based on the performance target and shall be adjusted to reflect those awards that ultimately vest. An entity that has an accounting policy to account for forfeitures when they occur in accordance with paragraph 718-10-35-3 shall reverse compensation cost previously recognized, in the period the award is forfeited, for an award that is forfeited before completion of the requisite service period. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

A share-based payment award becomes **vested** at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

The stated vesting provisions of an award often establish the requisite service period, and an award that has reached the end of the requisite service period is vested. However as indicated in the definition of requisite service period, the stated vesting period may differ from the requisite service period in certain circumstances. Thus the more precise (but cumbersome) terms would be options, shares, or awards for which the requisite service has been rendered and end of the requisite service period.

## 5.3 Market conditions

A market condition is a condition that relates to an entity achieving any one or a combination of the following items:

- A specified share price
- A specified threshold over the entity's share price
- A specified share price in relation to a similar equity security

Some examples of market conditions include:

- Entity A achieving a stock price of $10 per share
- Entity A achieving a 30 percent return on its stock to shareholders
- Entity A achieving a stock price increase greater than Entity B in the same industry
- Entity A achieving a return on its stock to shareholders greater than the three-year average return of entities listed in the Standard & Poor's 500

A **market** condition is a condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of either of the following:

a. A specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares

b. A specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities). The term similar as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

A market condition is reflected in the grant-date fair value of an award, and a complex valuation technique, such as a lattice model or a Monte Carlo simulation as discussed in Section 7, typically is necessary to determine the fair value. Further, compensation cost is recognized for an award with a market condition, provided the requisite service period is satisfied, regardless of whether the market condition is ever satisfied.

### ASC 718-10-30-14

Some awards contain a market condition. The effect of a market condition is reflected in the grant-date fair value of an award. (Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this Topic, are path-dependent options.) Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied.

### Awards with a market condition

Entity A grants its CEO 10,000 options on January 1, 20X1. Those shares are exercisable on December 31, 20X1 if the CEO remains employed and if Entity A's share price reaches $10 per share by December 31, 20X1. Because the award contains a market condition, the grant-date fair value of the award reflects the market condition. Entity A recognizes the award as compensation expense throughout 20X1, regardless of whether the market condition is met, assuming that the CEO provides the requisite service between January 1, 20X1 and December 31, 20X1.

**Grant Thornton insights: Terminology related to investor returns in award agreements**

Terminology in awards may cause confusion when entities are determining the appropriate accounting for those awards, especially wording such as "return on investment," "return of investment," and similar wording describing how an investor realizes returns or gains from its investment in an entity. Therefore, entities should carefully consider the substance of awards because, depending on how an award vests, the accounting might fall under the performance condition guidance discussed in Section 5.2, or under the market condition guidance discussed in Section 5.3.

In recent years, many awards include terms calling for vesting if a stockholder receives a "return on investment" in the form of distributed cash that equals a multiple of the original investment (for example, an award that vests if an investor who paid in $100 receives a distribution of $200, a 100 percent "return"). But it's important to note that this award does not include a market condition, despite the use of the wording "return on investment." Instead, this award has a performance condition because it is based on cash distributed and not on the value of the stock.

In contrast, a market condition would exist if the award vests based on a "return on investment" defined as a combination of cash distributed and appreciation of the fair value of the stock. For example, an award vests if the combination of cash distributed and appreciation of the stock's fair value yields a 30 percent return on the original investment. This award contains a market condition because the change in the stock's fair value is encompassed by the definition of a market condition.

## 5.4 Other conditions that are not service, performance, or market conditions

When an award includes a condition that is not a service, performance, or market condition (for example, the award is indexed to the price of soybeans or oil), the award is classified as a liability. For more on liability accounting, see Section 3.2.4.

## 5.5 Awards with multiple conditions

An award may contain a performance condition and a market condition that must both be met for the award to vest. In this case, the entity reflects the market condition in the grant-date fair value of the award, and recognizes compensation cost if the performance condition is met—regardless of whether the market condition is satisfied—assuming the requisite service has been provided. The accounting for these awards can be complex, and ASC 718 provides guidance and a comprehensive illustration of the accounting to reflect the interaction of performance and market conditions.

**ASC 718-10-25-21**

If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no compensation cost shall be recognized if the requisite service is not rendered. Paragraphs 718-10-

55-60 through 55-63 provide guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).

**ASC 718-10-55-60**

An employee's share-based payment award becomes vested at the date that the employees' right to receive or retain equity shares, other equity instruments, or assets under the award is no longer contingent on satisfaction of either a performance condition or a service condition. This Topic distinguishes among market conditions, performance conditions, and service conditions that affect the vesting or exercisability of an award (see paragraphs 718-10-30-12 and 718-10-30-14). Exercisability is used for market conditions in the same context as vesting is used for performance and service conditions. Other conditions affecting vesting, exercisability, exercise price, and other pertinent factors in measuring fair value that do not meet the definitions of a market condition, performance condition, or service condition are discussed in paragraph 718-10-55-65.

**ASC 718-10-55-61**

Analysis of the market, performance, or service conditions (or any combination thereof) that are explicit or implicit in the terms of an award is required to determine the requisite service period over which compensation cost is recognized and whether recognized compensation cost may be reversed if an award fails to vest or become exercisable (see paragraph 718-10-30-27). If exercisability or the ability to retain the award (for example, an award of equity shares may contain a market condition that affects the employee's ability to retain those shares) is based solely on one or more market conditions compensation cost for that award is recognized if the employee renders the requisite service, even if the market condition is not satisfied. An award containing one or more market conditions may have an explicit, implicit, or derived service period. Paragraphs 718-10-55-69 through 55-79 provide guidance on explicit, implicit, and derived service periods. If exercisability (or the ability to retain the award) is based solely on one or more market conditions, compensation cost for that award is reversed if the employee does not render the requisite service, unless the market condition is satisfied prior to the end of the requisite service period, in which case any unrecognized compensation cost would be recognized at the time the market condition is satisfied. If vesting is based solely on one or more performance or service conditions, any previously recognized compensation cost is reversed if the award does not vest (that is, the requisite service is not rendered). Examples 1 through 4 (see paragraphs 718-20-55-4 through 55-50) provide illustrations of awards in which vesting is based solely on performance or service conditions.

**ASC 718-10-55-62**

Vesting or exercisability may be conditional on satisfying two or more types of conditions (for example, vesting and exercisability occur upon satisfying both a market and a performance or service condition). Vesting also may be conditional on satisfying one of two or more types of conditions (for example, vesting and exercisability occur upon satisfying either a market condition or a performance or service condition). Regardless of the nature and number of conditions that must be satisfied, the existence of a market condition requires recognition of compensation cost if the requisite service is rendered, even if the market condition is never satisfied.

**ASC 718-10-55-63**

Even if only one of two or more conditions must be satisfied and a market condition is present in the terms of the award, then compensation cost is recognized if the requisite service is rendered, regardless of whether the market, performance, or service condition is satisfied (see Example 5 [paragraph 718-10-55-100] provide an example of such an award).

The difficulty lies in determining whether the requisite service has been rendered for an award with multiple conditions. See Section 6.2 for a discussion of the requisite service period.

Example 6 in ASC 718-20 illustrates how to account for an award with a performance condition for vesting (that is, the award vests only if the condition is achieved) as well as a market condition because movement in the entity's share price impacts the number of shares ultimately earned by the grantee. The example may seem complicated, but it reaches a rather straightforward, twofold conclusion:

- Expense is recognized solely based on achievement of the performance condition, regardless of whether the market condition is met.
- The fair value of the award reflects the impact of the market condition.

### Example 6: Share Unit with Performance and Market Conditions

**ASC 718-20-55-61**

This Example illustrates the guidance in paragraphs 718-10-25-20 through 25-21, 718-10-30-27 and 718-10-35-4.

**ASC 718-20-55-62**

Entity T grants 100,000 share units to each of 10 vice presidents (1 million share units in total) on January 1, 20X5. Each share unit has a contractual term of three years and a vesting condition based on performance. The performance condition is different for each vice president and is based on specified goals to be achieved over three years (an explicit three-year service period). If the specified goals are not achieved at the end of three years, the share units will not vest. Each share unit is convertible into shares of Entity T at contractual maturity as follows:

a. If Entity T's share price has appreciated by a percentage that exceeds the percentage appreciation of the S&P 500 index by at least 10 percent (that is, the relative percentage increase is at least 10 percent), each share unit converts into 3 shares of Entity T stock.

b. If the relative percentage increase is less than 10 percent but greater than zero percent, each share unit converts into 2 shares of Entity T stock.

c. If the relative percentage increase is less than or equal to zero percent, each share unit converts into 1 share of Entity T stock.

d. If Entity T's share price has depreciated, each share unit converts into zero shares of Entity T stock.

**ASC 718-20-55-63**

Appreciation or depreciation for Entity T's share price and the S&P 500 index is measured from the grant date.

**ASC 718-20-55-64**

This market condition affects the ability to retain the award because the conversion ratio could be zero; however, vesting is based solely on the explicit service period of three years, which is equal to the contractual maturity of the award. That set of circumstances makes the derived service period irrelevant in determining the requisite service period; therefore, the requisite service period of the award is three years based on the explicit service period.

**ASC 718-20-55-65**

The share units' conversion feature is based on a variable target stock price (that is, the target stock price varies based on the S&P 500 index); hence, it is a market condition. That market condition affects the fair value of the share units that vest. Each vice president's share units vest only if the individual's performance condition is achieved; consequently, this award is accounted for as an award with a performance condition (see paragraphs 718-10-55-60 through 55-63). This Example assumes that all share units become fully vested; however, if the share units do not vest because the performance conditions are not achieved, Entity T would reverse any previously recognized compensation cost associated with the nonvested share units.

**ASC 718-20-55-66**

The grant-date fair value of each share unit is assumed for purposes of this Example to be $36. Certain option-pricing models, including Monte Carlo simulation techniques, have been adapted to value path-dependent options and other complex instruments. In this case, the entity concludes that a Monte Carlo simulation technique provides a reasonable estimate of fair value. Each simulation represents a potential outcome, which determines whether a share unit would convert into three, two, one, or zero shares of stock. For simplicity, this Example assumes that no forfeitures will occur during the vesting period. The grant-date fair value of the award is $36 million (1 million × $36); management of Entity T expects that all share units will vest because the performance conditions are probable of achievement. Entity T recognizes compensation cost of $12 million ($36 million ÷ 3) in each year of the 3-year service period; the following journal entries are recognized by Entity T in 20X5, 20X6, and 20X7.

| | | |
|---|---|---|
| Compensation cost | $12,000,000 | |
| Additional paid-in capital | | $12,000,000 |
| To recognize compensation cost. | | |
| Deferred tax asset | $ 4,200,000 | |
| Deferred tax benefit | | $ 4,200,000 |

To recognize the deferred tax asset for the temporary difference related to compensation cost ($12,000,000 × .35 = $4,200,000).

**ASC 718-20-55-67**

Upon contractual maturity of the share units, four outcomes are possible; however, because all possible outcomes of the market condition were incorporated into the share units' grant-date fair value, no other entry related to compensation cost is necessary to account for the actual outcome of the market condition. However, if the share units' conversion ratio was based on achieving a performance condition rather than on satisfying a market condition, compensation cost would be adjusted according to the actual outcome of the performance condition (see Example 4 [paragraph 718-20-55-47]).

### Grant Thornton insights: Awards with performance and market conditions

In recent years, we have seen an increasing number of employee share-based awards with characteristics similar to those in Example 6: a performance condition(s) drives vesting, but a market condition(s) is embedded in the award terms. The words "market multiplier" are an example of how these awards are currently being described. These awards tend to be difficult to value because there often are several different potential outcomes for the market condition, and the timing of expense recognition can also be difficult to determine due to how performance conditions are expressed.

Entities should expect to invest an appropriate amount of time and resources determining the correct accounting for these complex awards.

# 6. Expense attribution

## 6.1 Recognition principle

In exchange for share-based payment awards, employers receive employee services from the grantees of those awards. The grantor (typically an employer) recognizes the measured compensation cost for share-based awards as it receives those services. The corresponding credit is an increase in equity or in a liability, depending on whether the share-based payment award is classified in equity or as a liability. See Section 3 for guidance on the classification of share-based payment awards.

### 6.1.1 Classification of share-based compensation cost

The grantor generally expenses the compensation cost recognized for share-based payment awards, but ASC 718 does not specify how to classify the expense in the income statement. However, in ASC 718-10-S99-1, which codifies SAB Topic 14.F, *Classification of Compensation Expense Associated with Share-Based Payment Arrangements,* the SEC staff states that the expense should be reported in the same income statement line or lines as cash compensation paid to the same employees, such as compensation expense or cost of sales. Further, the staff believes that an entity could consider disclosing the compensation cost included in financial statement line items, in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within Management's Discussion and Analysis (MD&A).

The recognition of share-based compensation cost will not always result in an immediate charge in the income statement. Employee services may be part of the cost to construct, develop, or acquire another asset, such as inventory; property, plant, or equipment; certain computer software development costs; loan origination costs; capitalized exploration costs; contract assets; or other assets that include capitalized payroll costs. In this case, the grantor initially capitalizes the compensation cost as part of that asset. The cost ultimately is recognized in the income statement as the asset is derecognized through depreciation, amortization, or cost of sales, for example.

Entities that accrue liabilities, such as losses on contracts with customers and warranties, should consider share-based compensation cost for the employees whose wages are included in the accrual.

Entities that capitalize some of their payroll costs should consider whether they need to implement a process to identify and quantify share-based compensation costs that should be capitalized and to track when those capitalized costs should be included in the income statement. When accounting for compensation costs that can be capitalized within inventory, the SEC staff notes in ASC 718-10-S99-1 (which codifies SAB Topic 14.I, *Capitalization of Compensation Cost Related to Share-Based Payment Arrangements)* that registrants may reflect the effect of share-based payment awards on inventory through a period-end adjustment to inventory. The staff observed that using this methodology, in contrast to incorporating the cost in the inventory costing system, should not impact management's ability to determine that internal controls are effective.

## 6.2 Requisite service period

Under ASC 718, a grantor recognizes compensation cost for a share-based payment award over the award's "requisite service period." For an award classified as a liability, a grantor continues to recognize changes in the award's fair value (or changes in the intrinsic value or calculated value for certain nonpublic entities) subsequent to the end of the requisite service period in the period when the changes in value occur.

Entities are required to make their best estimate of the requisite service period at the grant date (or service inception date if it precedes the grant date) and recognize compensation cost over that period. The requisite service period is the period that an employee must provide services to the entity in order to receive the share-based payment award. In other words, if the employee does not provide the services over the requisite service, no compensation cost is recognized. As stated above, it is critical for an entity to identify the appropriate requisite service period because that is also the period over which the compensation cost is recognized. This period may be explicit, implicit, or derived, depending on the terms of the arrangement (see Sections 6.2.1, 6.2.2, and 6.2.3, respectively).

The **requisite service period** is the period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the requisite service. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

The initial estimate of an award's requisite service period requires an analysis of

- All explicit, implicit, and derived service periods, including any provisions that make explicit or implicit service periods nonsubstantive
- The nature of service, performance, and / or market conditions and how they are combined (for example, whether both the service and performance conditions have to be satisfied for vesting to occur or whether only one is required for vesting).
- The probability that performance or service conditions will be satisfied

**ASC 718-10-30-25**

An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

**ASC 718-10-30-26**

The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions

b. All explicit, implicit, and derived service periods

c. The probability that performance or service conditions will be satisfied.

While determining the requisite service period may be straightforward for some awards (for example, an award with only an explicit service condition, often referred to as "time-based vesting"), an award with performance and / or market conditions, or with multiple explicit, implicit, and derived service periods, may require more analysis.

**ASC 718-10-35-5 (excerpt)**

The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value (see paragraph 718-10-55-71). An award may have one or more explicit, implicit, or derived service periods; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards.

Many awards, such as those with performance or market conditions also have stated—or explicit—time-based service conditions. The guidance in ASC 718-10-30-26 clearly states that a grantor should evaluate all attributes of an award that impact the requisite service period. To illustrate, in the case of an award with a market condition and a service condition, an entity generally will determine both a derived service period (see Section 6.2.3) based on the market condition and an explicit service period (see Section 6.2.1) based on time. Depending on the terms of the award, the requisite service period might be either the derived service period or the explicit service period. After identifying any explicit, implicit, or derived service periods, an entity should then determine only one requisite service period for accounting purposes.

Some awards use the term "performance condition" or "performance target" to describe metrics defined by an entity's share price, internal rate of return, or other metric based on the value of the specific entity. These metrics generally are not considered performance conditions, but typically qualify as market conditions for accounting purposes. This distinction is important because of the differences in market and performance condition accounting guidance. In other words, an entity should consider the *substance* of the terms of an award, regardless of the award's wording and terminology.

The rest of this section discusses these considerations and their impact on determining the requisite service period.

### 6.2.1 Explicit service period

A service period is "explicit" when it is stated in the terms of the award. Explicit service periods usually exist in awards that have a service condition requiring the grantee to provide service to the grantor for a specified period of time to earn the award. In the absence of other conditions that impact vesting, the explicit service period in an award often is the requisite service period for accounting purposes.

A service period that is explicitly stated in the terms of a share-based payment award is an **explicit service period**. For example, an award stating that it vests after three years of continuous employee service from a given date (usually the grant date) has an explicit service period of three years.

### 6.2.2 Implicit service period

The service period is "implicit" when it is not explicitly stated in the award, but can be inferred from an analysis of the terms of the award. An implicit service period is most often associated with performance conditions and is determined based on estimates of when a target will be reached. As discussed in Section 5.2, a "performance condition" relates to the achievement of a specified target defined by the employer's own operations or activities, such as an option that vests if the employer's growth rate increases a certain amount or if regulatory approval is obtained for a product. A performance condition may also refer to the same performance measure of another entity or group of entities, such as a vesting condition requiring the entity to attain an increase in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry.

A service period that is not explicitly stated in the terms of a share-based payment award but that may be inferred from an analysis of those terms and other facts and circumstances is an **implicit service period**. For instance, if an award of share options vests upon the completion of a new product design and it is probable that the design will be completed in 18 months, the implicit service period is 18 months.

**Implicit service period: sales representative award**

An award provides for a sales representative's options to vest when a predetermined sales target is achieved. The grantor estimates at the grant date that the sales representative will reach the target in 24 months. If the grantor concludes that it is probable that the grantee will reach the target at the end of those two years, the implicit service period is two years and represents the requisite service period for cost recognition.

### 6.2.3 Derived service period

A "derived" service period is a service period for an award with a *market condition*. The service period is inferred, or derived, from the application of a valuation technique that takes into consideration the market condition and generally represents the requisite service period for cost recognition. A "market condition" relates to the achievement of a specified price of the issuer's shares, a specified amount of intrinsic value indexed solely to the issuer's shares, or a specified price of the issuer's share in terms of a similar equity security or index of similar securities. The valuation modeling involved with most market condition awards is relatively complex. In contrast to an explicit service period that is an *input* to a valuation model, the derived service period is an *output* of the model. For guidance on the acceleration of vesting of deep out-of-the-money options, see Section 8.9.

The **derived service period** is the service period for an award with a market condition that is inferred from the application of certain valuation techniques used to estimate fair value. For example, the derived service period for an award of share options that the employee can exercise only if the share price increases by 25 percent at any time during a 5-year period can be inferred from certain valuation techniques. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of satisfaction (as inferred from the valuation technique). If the derived service period is three years, the estimated requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition was satisfied at an earlier date. Compensation cost would not be recognized beyond three years even if after the grant date the entity determines that it is not probable that the market condition will be satisfied within that period. Further, an award of fully vested, deep out-of-the-money share options has a derived service period that must be determined from the valuation techniques used to estimate fair value.

**Derived service period**

An award provides that an employee (grantee) can exercise the options of its share-based payment award only if the employer's (grantor) share price increases 25 percent or more above the grant-date share price within five years. The derived service period is inferred from a valuation technique that considers the share-price vesting provision. In other words, the derived service period is an output of the valuation modelling. The guidance in ASC 718 provides that, in a lattice model, the derived service period would be the duration of the median share path of the share paths on which the market condition is satisfied. The duration is the period from the first day of the service period until the expected date of satisfaction, as inferred from the valuation technique. In a lattice model, the duration is the period from the first day of service until the date the market condition is satisfied on the median share path.

If the model results in a derived service period of 36 months for the share to increase 25 percent, compensation is expensed over that period unless the 25 percent increase occurs earlier, in which case, the expense is accelerated.

The period of recognition may not be longer than 36 months even if the share price does not increase 25 percent over 36 months. For example, if the share price has not risen as expected after two years and the grantor now believes the target might be achieved after 45 months instead of the originally derived 36 months, the grantor would not extend the requisite service period beyond 36 months.

Moreover, if the share price in this example never reaches the target 25 percent increase by the end of the five-year period, the grantor could not reverse the expense. The only time the grantor could reverse the expense is if the grantee does not provide service for the entire 36-month derived service period, for example, by resigning before the 36 months elapse. Note that the employee in this example is terminating service before the end of the derived service period, not the end of five years. In this situation, an employee resignation and forfeiture after 32 months would lead to reversing the expense because the employee did not work the entire requisite service period of 36 months. On the other hand, an employee resigning after 40 months does not lead to a reversal of expense because the requisite service period of 36 months was fulfilled by the employee before termination.

### 6.2.4 Noncompete and clawback provisions

Employee awards may contain provisions that require employees to return vested awards if a specified contingent event occurs, which is called a "clawback" provision. For example, a noncompete provision in an award may require the grantee to return vested shares if the employee is hired by a competitor within three years after the vesting date and causes a violation of a noncompete agreement.

### ASC 718-20-35-2

A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (see paragraph 718-10-55-8), shall be accounted for if and when the contingent event occurs. Example 10 (see paragraph 718-20-55-84) provides an illustration of an award with a clawback feature.

As noted in Section 7.1, a contingent feature such as a clawback is not included in the grant-date fair value of the award. Instead, the clawback is accounted for if and when the contingent event occurs. Such a situation is described in ASC 718-20, Example 10.

### Example 10: Share Award with a Clawback Feature

**ASC 718-20-55-84**

This Example illustrates the guidance in paragraph 718-20-35-2.

**ASC 718-20-55-85**

On January 1, 20X5, Entity T grants its chief executive officer an award of 100,000 shares of stock that vest upon the completion of 5 years of service. The market price of Entity T's stock is $30 per share on that date. The grant-date fair value of the award is $3,000,000 (100,000 × $30). The shares become freely transferable upon vesting; however, the award provisions specify that, in the event of the employee's termination and subsequent employment by a direct competitor (as defined by the award) within three years after vesting, the shares or their cash equivalent on the date of employment by the direct competitor must be returned to Entity T for no consideration (a clawback feature). The chief executive officer completes five years of service and vests in the award. Approximately two years after vesting in the share award, the chief executive officer terminates employment and is hired as an employee of a direct competitor. Paragraph 718-10-55-8 states that contingent features requiring an employee to transfer equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration) are not considered in estimating the fair value of an equity instrument on the date it is granted. Those features are accounted for if and when the contingent event occurs by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains the contingent feature ($3,000,000) and the fair value of the consideration received. This guidance does not apply to cancellations of awards of equity instruments as discussed in paragraphs 718-20-35-7 through 35-9. The former chief executive officer returns 100,000 shares of Entity T's common stock with a total market value of $4,500,000 as a result of the award's provisions. The following journal entry accounts for that event.

| | | |
|---|---|---|
| Treasury stock | $4,500,000 | |
| Additional paid-in capital | | $1,500,000 |
| Other income | | $3,000,000 |

To recognize the receipt of the consideration as a result of the clawback feature.

**ASC 718-20-55-86**

If instead of delivering shares to Entity T, the former chief executive officer had paid cash equal to the total market value of 100,000 shares of Entity T's common stock, the following journal entry would have been recorded.

| | | |
|---|---|---|
| Cash | $4,500,000 | |
| Additional paid-in capital | | $1,500,000 |
| Other income | | $3,000,000 |

To recognize the receipt of the consideration as a result of the clawback feature.

Example 10 does not discuss whether the three-year term of the noncompete provision, in effect, results in an in-substance service period. Most noncompete provisions in practice do not result in a service period and, therefore, there is no period of time after employment over which to recognize some cost of the award. Other noncompete provisions may result in in-substance service periods, though they are rarely encountered in practice.

Example 11 in ASC 718-20, shown below, indicates that, in limited circumstances, a noncompete provision may function as an in-substance service period even though the award has no explicit requisite service period. The FASB reached this conclusion based on the particular facts and circumstances described in Example 11, including the legal enforceability of the agreement and the entity's intent to enforce it, the magnitude of the value of the award relative to the employee's other compensation, and the severe impact the noncompete provision would have on the employee's ability to obtain employment elsewhere. The fact pattern and conclusion in Example 11 are uncommon in practice. The FASB staff has indicated that most noncompete provisions are expected to be accounted for as contingent clawback provisions as described in Example 10.

### Example 11: Certain Noncompete Agreements and Requisite Service

**ASC 718-20-55-87**

Paragraphs 718-10-25-3 through 25-4 require that the accounting for all share-based payment transactions with employees or others reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. Some share-based compensation arrangements with employees may contain noncompete provisions. Those noncompete provisions may be in-substance service conditions because of their nature. Determining whether a noncompete provision or another type of provision represents an in-substance service condition is a matter of judgment based on relevant facts and circumstances. This Example illustrates a situation in which a noncompete provision represents an in-substance service condition.

**ASC 718-20-55-88**

Entity K is a professional services firm in which retention of qualified employees is important in sustaining its operations. Entity K's industry expertise and relationship networks are inextricably linked to its employees; if its employees terminate their employment relationship and work for a competitor, the entity's operations may be adversely impacted.

**ASC 718-20-55-89**

As part of its compensation structure, Entity K grants 100,000 restricted share units to an employee on January 1, 20X6. The fair value of the restricted share units represents approximately four times the expected future annual total compensation of the employee. The restricted share units are fully vested as of the date of grant, and retention of the restricted share units is not contingent on future service to Entity K. However, the units are transferred to the employee based on a 4-year delayed-transfer schedule (25,000 restricted share units to be transferred beginning on December 31, 20X6, and on December 31 in each of the 3 succeeding years) if and only if specified noncompete conditions are satisfied. The restricted share units are convertible into unrestricted shares any time after transfer.

**ASC 718-20-55-90**

The noncompete provisions require that no work in any capacity may be performed for a competitor (which would include any new competitor formed by the employee). Those noncompete provisions lapse with respect to the restricted share units as they are transferred. If the noncompete provisions are not satisfied, the employee loses all rights to any restricted share units not yet transferred. Additionally, the noncompete provisions stipulate that Entity K may seek other available legal remedies, including damages from the employee. Entity K has determined that the noncompete is legally enforceable and has legally enforced similar arrangements in the past.

**ASC 718-20-55-91**

The nature of the noncompete provision (being the corollary condition of active employment), the provision's legal enforceability, the employer's intent to enforce and past practice of enforcement, the delayed-transfer schedule mirroring the lapse of noncompete provisions, the magnitude of the award's fair value in relation to the employee's expected future annual total compensation, and the severity of the provision limiting the employee's ability to work in the industry in any capacity are facts that provide a preponderance of evidence suggesting that the arrangement is designed to compensate the employee for future service in spite of the employee's ability to terminate the employment relationship during the service period and retain the award (assuming satisfaction of the noncompete provision). Consequently, Entity K would recognize compensation cost related to the restricted share units over the four-year substantive service period.

**ASC 718-20-55-92**

Example 10 (see paragraph 718-20-55-84) provides an illustration of another noncompete agreement. That Example and this one are similar in that both noncompete agreements are not contingent upon employment termination (that is, both agreements may activate and lapse during a period of active employment after the vesting date). A key difference between the two Examples is that the award recipient in that Example must provide five years of service to vest in the award (as opposed to vesting immediately). Another key difference is that the award recipient in that Example receives the shares upon vesting and may sell them immediately without restriction as opposed to the restricted share units, which are transferred according to the delayed-transfer schedule. In that Example, the noncompete provision is not deemed to be an in-substance service condition. In making a determination about whether a noncompete provision may represent an in-substance service condition, the provision's legal enforceability, the entity's intent to enforce the provision and its past practice of enforcement, the employee's rights to the instruments such as the right to sell them, the severity of the

> provision, the fair value of the award, and the existence or absence of an explicit employee service condition are all factors that shall be considered. Because noncompete provisions can be structured differently, one or more of those factors (such as the entity's intent to enforce the provision) may be more important than others in making that determination. For example, if Entity K did not intend to enforce the provision, then the noncompete provision would not represent an in-substance service condition.

At the 2005 AICPA National Conference on Current SEC and PCAOB Developments,[3] the SEC staff noted that the FASB reached its conclusion in Example 11 because, based on the facts pertaining to the employee, the entity, and the noncompete provision, the employee was in essentially the same position as if the award contained a substantive stated vesting period. In most cases the employee would receive the shares at the end of the noncompete period only if still employed by the entity at that time.

In the SEC staff's view, the fact that a noncompete provision is substantive would not, in and of itself, lead to a conclusion that an in-substance requisite service period exists. The SEC staff also believes that a noncompete agreement which creates a substantive service period would not be a common occurrence. To assess whether a noncompete provision results in an in-substance requisite service period, an entity should evaluate the facts and circumstances considering the FASB's intended application of Example 11. In particular, entities should consider the following circumstances:

- The specific terms of the share-based payment award
- The terms of the related noncompete arrangements
- The entity's past practice regarding the enforcement of noncompete provisions
- Past employees' actions regarding the terms of noncompete provisions, if relevant to the current assessment
- The circumstances of the employees receiving the awards

If an SEC registrant believes it has a fact pattern that results in a noncompete provision creating an in-substance requisite service period in an award, the registrant is encouraged to discuss the facts with the SEC staff before reaching a final determination.

At its meeting on September 13, 2005, the FASB Statement 123R Resource Group reached a consensus on another issue that involved a noncompete provision. If an entity issues a new award with a noncompete provision when an employee terminates service, the award should generally be

[3] https://www.sec.gov/news/speech/spch120505sb.htm.

accounted for as compensation for prior service with a potential clawback feature. The fair value of the award would be expensed immediately, and a contingent gain accounted for if the clawback occurs because of a breach of the noncompete provision.

### 6.2.5 Retirement-eligible provisions and similar award terms

An award with an explicit service condition may have other provisions indicating that the explicit service condition is nonsubstantive. Some entities, for example, have provisions stipulating that an award will continue to vest if the employee retires or that vesting will accelerate if the employee becomes eligible for retirement based on the entity's personnel policies, such as retirement at age 65 or at age 55 with a specified number of years of service. If these provisions exist and the employee reaches retirement age, the individual is no longer required to provide services to earn the award, even if he or she continues to work at the entity. Therefore, when awards have nonsubstantive service conditions because of provisions for retirement-eligible employees, the requisite service period excludes any period during which the employee is eligible for retirement. The period over which compensation cost is recognized is therefore from the grant date (or service inception date if it precedes the grant date) until the date when the employee reaches retirement age.

If the employee has reached retirement age at the grant date, the award does not contain a service condition for vesting. The award is effectively vested on the grant date, and its entire fair value should be recognized as compensation cost on the grant date.

#### *Award terms similar to retirement-eligible provisions*

This section discusses the ASC 718 guidance for awards granted to employees who are or will be eligible for retirement based on the employer's policies before the end of the requisite service period. The concepts in this guidance are also applied to awards in which the terms allow for an employee to leave employment but continue to vest, regardless of whether the employee is eligible to retire based on the employer's policies. To illustrate, an award allowing a grantee to terminate employment at any time and to continue to vest in the award in substance has no service condition for vesting. Therefore, by applying the retirement-eligible guidance, the cost of this award would be recognized as compensation cost on the grant date, similarly to the accounting when a grantee is eligible to retire based on the employer's policies as of the grant date. There are variations of that fact pattern, such as an award with four-year vesting that allows the grantee to terminate employment after two years and to continue to vest, which would have a two-year—not a four-year—requisite service period.

#### *Guidance on retirement-eligible provisions*

Example 1 in ASC 718-10-55-87 illustrates the estimation of the requisite service period as applied to retirement-eligible provisions.

**Example 1: Estimating the Requisite Service Period (excerpt)**

**ASC 718-10-55-87**

Assume that Entity A uses a point system for retirement. An employee who accumulates 60 points becomes eligible to retire with certain benefits, including the retention of any nonvested share-based payment awards for their remaining contractual life, even if another explicit service condition has not been satisfied. In this case, the point system effectively accelerates vesting. On January 1, 20X5, an employee receives at-the-money options on 100 shares of Entity A's stock. All options vest at the end of 3 years of service and have a 10-year contractual term. At the grant date, the employee has 60 points and, therefore, is eligible to retire at any time.

**ASC 718-10-55-88**

Because the employee is eligible to retire at the grant date, the award's explicit service condition is nonsubstantive. Consequently, Entity A has granted an award that does not contain a service condition for vesting, that is, the award is effectively vested, and thus, the award's entire fair value should be recognized as compensation cost on the grant date. All of the terms of a share-based payment award and other relevant facts and circumstances must be analyzed when determining the requisite service period.

**Retirement-eligible award**

In 20X0, ABC Corp. issued options to executives and employees under the 20X0 Incentive Plan that will vest at the end of four years and expire in ten years. The Plan defines retirement as reaching the age of 62.5 years. Any option held by a grantee who retires on or after reaching the age of 62.5 years remains outstanding and is subject to the terms and conditions of the Plan, as though the grantee's employment had not ceased.

In 20X3, ABC Corp. modifies the 20X0 the Plan to change the definition of retirement. Under the modified retirement definition, a grantee will be deemed to have retired from ABC Corp. if the individual has been a full-time employee of ABC Corp. for at least 15 years prior to the end-of-service date. If the termination of employment with ABC Corp. is deemed a retirement, the options in the employee's share-based award will continue to vest and can be exercised as though the terminated individual is still an employee of ABC Corp. through the ten-year term of the options.

Under the original plan, ABC Corp. evaluated each award when granted to determine whether the employee is close to or past retirement so that the requisite service period would be less than the stated service period in the award.

Under the modified plan terms, ABC Corp. must re-evaluate each existing award to determine whether the employee has already served 15 years and is therefore eligible for retirement or will reach that point before the stated vesting period.

ABC determines whether this modification has an accounting impact by applying the guidance in ASC 718-20-35 (see Section 8.) The unrecognized compensation cost, including any incremental cost resulting from the modification is expensed immediately for those employees who are eligible for retirement upon this modification, while the cost for those who will become eligible earlier than under the original terms is recognized prospectively over the new, shorter requisite service period ending on the eligibility date. (For guidance on changes in the requisite service period, see Section 6.2.7.)

### GT insights: Considering retirement-eligible provisions

In ASC 718, the unit of account is the individual share-based award.

Because of the special rules for determining the requisite service period for awards with retirement-eligible provisions, entities issuing such awards should establish procedures to ensure that they identify those individual awards affected by the retirement-eligible provisions and apply the proper accounting using the appropriate requisite service periods.

In addition, some entities have different personnel policies for employees of different rank or responsibility. For example, certain executives may have an earlier or later retirement date than other employees. Part of this results from employment law and regulations applicable to nonexecutives. Because the unit of account in ASC 718 is the individual award, entities should apply the retirement-eligibility guidance in this case based on each employee's classification.

### 6.2.6 Award with multiple explicit, implicit, and / or derived service periods

An award may have multiple explicit, implicit, and / or derived service periods, but it can have only one requisite service period, unless the award has in-substance multiple awards. An example of an award that is accounted for as in-substance multiple awards is an award with graded vesting that includes a different requisite service period for each separately vesting portion. (See Sections 6.3 and 6.4.1 for further discussion about awards that have in-substance multiple awards.)

Awards have multiple service periods when there is more than one condition requiring service and there are several possible combinations of conditions to consider. Some examples are multiple performance conditions, a service condition and one or more performance conditions, or a market condition and a service and / or performance condition(s).

When an award contains multiple service periods, the initial estimate of the requisite service period requires an entity to analyze the award's terms and conditions: vesting and exercisability conditions; all explicit, implicit, and derived service periods; and the probability that performance and / or service conditions will be satisfied. Once the grantor has identified the award's relevant terms and conditions, ASC 718-10-55-69 through 55-79, as well as 55-92 through 55-106, provide guidance for determining the requisite service period in these types of situations.

For an award with multiple conditions, an entity should look for operative words such as "and" and "or" in the award's terms and conditions when determining the requisite service period. For example, an award with two conditions that states "*and* both conditions must be met" likely will have a different requisite service period than an otherwise identical award whose terms instead call for one *or* the other condition to be met. The interplay of the conditions as well as their impact on the requisite service period and compensation cost is summarized in Figure 6.1.

**Figure 6.1 – Interplay of various conditions and impact on requisite service period and compensation cost**

| Service condition(s) | Performance condition(s) | Market condition(s) | 'And' wording in award: Both (all) of the conditions must be met | 'Or' wording in award: Any of the conditions must be met | Is it probable the conditions will be satisfied? | Requisite service period | Impact on compensation cost |
|---|---|---|---|---|---|---|---|
| X | X | | X | | Both conditions are probable of achievement | The longer of the explicit service period or the implicit service period | Recognize compensation cost over the requisite service period. |
| X | X | | X | | Not probable the performance condition will be achieved | | No compensation cost is recognized |
| X | X | | | X | Both conditions are probable of achievement | The shorter of the explicit service period or the implicit service period | Recognize compensation cost over the requisite service period |
| X | X | | | X | Not probable the performance condition will be achieved | The explicit service period is the requisite service period | Recognize compensation cost over the requisite service period |
| X | X | X | X | | Probable the performance condition or both performance and market conditions will be met | Requisite service period is the longer of the explicit, implicit, or derived service period | Recognize compensation cost if the performance condition is met, regardless of whether the market condition is met |
| | X | X | X | | Not probable the performance condition will be achieved | | No compensation cost is recognized |
| | X | X | | X | Probable the performance condition or both conditions will be met | The requisite service period is the shorter of the explicit, implicit, or derived | Recognize compensation cost if the performance condition is met, regardless of whether the |

| Service condition(s) | Performance condition(s) | Market condition(s) | 'And' wording in award: Both (all) of the conditions must be met | 'Or' wording in award: Any of the conditions must be met | Is it probable the conditions will be satisfied? | Requisite service period | Impact on compensation cost |
|---|---|---|---|---|---|---|---|
| | | | | | | service period | market condition is met |
| | X | X | | X | Not probable the performance condition will be achieved | The derived service period is the requisite service period | Recognize compensation cost over the derived service period |

In summary, for awards with a service condition and one or more performance conditions:

- If *both* a service condition and one or more performance conditions must be satisfied to vest in an award, the entity should first determine if satisfaction of the service condition and the required performance condition(s) are probable:
  - If both the service condition and the performance condition(s) are probable of achievement, the initial estimate of the requisite service period is the *longer* of the explicit (service condition) service period or the implicit (performance condition) service period(s).
  - If satisfaction of the service condition or the required performance condition(s) is *not* probable, no compensation should be recognized unless all condition(s) required for vesting become probable of achievement.
- If *either* a service condition or one or more performance conditions must be satisfied to vest in an award and if
  - Both the service condition and the performance condition(s) are probable of achievement, the requisite service period is the *shorter* of the explicit or implicit service period.
  - The achievement of the performance condition(s) is not probable, the explicit service period is the requisite service period.

For awards with a market condition and a performance or service condition:

- If *both* a market condition and a performance or service condition must be satisfied to vest in an award and if
  - It is probable the performance or service condition will be satisfied, the initial estimate of the requisite service period is generally the *longest* of the implicit, explicit, or derived (market condition) service period.
  - Satisfaction of the performance or service condition is not probable, no compensation should be recognized unless the performance or service condition becomes probable of achievement.

- If *either* a market condition or a performance or service condition must be satisfied to vest in an award and if
  - The performance or service condition is probable of achievement, the initial estimate of the requisite service period is generally the *shortest* of the implicit, explicit, or derived service periods.
  - The achievement of the performance or service condition is not probable, the derived service period is the requisite service period.

### *Impact of multiple conditions that include a market condition*

In practice, the existence of a market condition among multiple other conditions presents challenges when determining the proper accounting because compensation cost is recognized if the award's other conditions are achieved, even if the market condition is not achieved.

For an award that contains multiple service, performance, and market conditions and *all* conditions must be satisfied for the award to vest, compensation cost is recognized based on the expected achievement of the vesting conditions in the award. Because the definition of "vest" in ASC 718-20-20 only includes service and performance conditions, compensation cost is recognized even if the market condition is not achieved because a market condition is a nonvesting condition.

In ASC 718-10-55-62, the FASB states that compensation cost should be recognized if the requisite service is rendered, even if the award's market condition is not satisfied (see Section 5.5). The words "requisite service is rendered" in the last sentence in that guidance means that the required service and / or performance conditions have been achieved.

**Multiple conditions that include a market condition**

**ASC 718-10-55-62**

Vesting or exercisability may be conditional on satisfying two or more types of conditions (for example, vesting and exercisability occur upon satisfying both a market and a performance or service condition). Vesting also may be conditional on satisfying one of two or more types of conditions (for example, vesting and exercisability occur upon satisfying either a market condition or a performance or service condition). Regardless of the nature and number of conditions that must be satisfied, the existence of a market condition requires recognition of compensation cost if the requisite service is rendered, even if the market condition is never satisfied.

**ASC 718-10-55-63 [excerpt]**

Even if only one of two or more conditions must be satisfied and a market condition is present in the terms of the award, then compensation cost is recognized if the requisite service is rendered, regardless of whether the market, performance, or service condition is satisfied.

### *Market and performance conditions*

In recent years, entities have structured share-based awards so that the employee vests in the award based on performance conditions, but the number of instruments earned by meeting these conditions varies based on the inclusion of a market condition. These awards may be labeled as performance awards with a "market multiplier" or by using other terminology. Frequent issues most entities wrestle with are how to value the award and how to determine the pattern and amount of compensation expense.

ASC 718-20-55-62 presents a comprehensive example of how to approach this type of award. An important point in the example is that the market condition impacts the fair value of the award, but the recognition of cost depends solely on the achievement of the performance condition.

### Example 6: Share Unit with Performance and Market Conditions

**ASC 718-20-55-62**

Entity T grants 100,000 share units to each of 10 vice presidents (1 million share units in total) on January 1, 20X5. Each share unit has a contractual term of three years and a vesting condition based on performance. The performance condition is different for each vice president and is based on specified goals to be achieved over three years (an explicit three-year service period). If the specified goals are not achieved at the end of three years, the share units will not vest. Each share unit is convertible into shares of Entity T at contractual maturity as follows:

a. If Entity T's share price has appreciated by a percentage that exceeds the percentage appreciation of the S&P 500 index by at least 10 percent (that is, the relative percentage increase is at least 10 percent), each share unit converts into 3 shares of Entity T stock.

b. If the relative percentage increase is less than 10 percent but greater than zero percent, each share unit converts into 2 shares of Entity T stock.

c. If the relative percentage increase is less than or equal to zero percent, each share unit converts into 1 share of Entity T stock.

d. If Entity T's share price has depreciated, each share unit converts into zero shares of Entity T stock.

**ASC 718-20-55-63**

Appreciation or depreciation for Entity T's share price and the S&P 500 index is measured from the grant date.

**ASC 718-20-55-64**

This market condition affects the ability to retain the award because the conversion ratio could be zero; however, vesting is based solely on the explicit service period of three years, which is equal to the contractual maturity of the award. That set of circumstances makes the derived service period irrelevant in determining the requisite service period; therefore, the requisite service period of the award is three years based on the explicit service period.

**ASC 718-20-55-65**

The share units' conversion feature is based on a variable target stock price (that is, the target stock price varies based on the S&P 500 index); hence, it is a market condition. That market condition affects the fair value of the share units that vest. Each vice president's share units vest only if the individual's performance condition is achieved; consequently, this award is accounted for as an award with a performance condition (see paragraphs 718-10-55-60 through 55-63). This Example assumes that all share units become fully vested; however, if the share units do not vest because the performance conditions are not achieved, Entity T would reverse any previously recognized compensation cost associated with the nonvested share units.

**ASC 718-20-55-66**

The grant-date fair value of each share unit is assumed for purposes of this Example to be $36. Certain option-pricing models, including Monte Carlo simulation techniques, have been adapted to value path-dependent options and other complex instruments. In this case, the entity concludes that a Monte Carlo simulation technique provides a reasonable estimate of fair value. Each simulation represents a potential outcome, which determines whether a share unit would convert into three, two, one, or zero shares of stock. For simplicity, this Example assumes that no forfeitures will occur during the vesting period. The grant-date fair value of the award is $36 million (1 million × $36); management of Entity T expects that all share units will vest because the performance conditions are probable of achievement. Entity T recognizes compensation cost of $12 million ($36 million ÷ 3) in each year of the 3-year service period; the following journal entries are recognized by Entity T in 20X5, 20X6, and 20X7.

| | | |
|---|---|---|
| Compensation cost | $12,000,000 | |
| Additional paid-in capital | | $12,000,000 |
| To recognize compensation cost. | | |

| | | |
|---|---|---|
| Deferred tax asset | $ 4,200,000 | |
| Deferred tax benefit | | $ 4,200,000 |
| To recognize the deferred tax asset for the temporary difference related to compensation cost ($12,000,000 x .35 = $4,200,000). | | |

**ASC 718-20-55-67**

Upon contractual maturity of the share units, four outcomes are possible; however, because all possible outcomes of the market condition were incorporated into the share units' grant-date fair value, no other entry related to compensation cost is necessary to account for the actual outcome of the market condition. However, if the share units' conversion ratio was based on achieving a performance condition rather than on satisfying a market condition, compensation cost would be adjusted according to the actual outcome of the performance condition (see Example 4 [paragraph 718-20-55-47]).

### *Market and service conditions*

At its May 26, 2005 meeting, the Statement 123R Resource Group addressed the accounting for an award that had a market condition and a service condition. In this example, the award would vest either in five years or when the market price doubled. Assume that the fair value of the award with only a service condition is $8 and the fair value of the award with both the service condition and the market condition is $6. In this situation, the award would vest at the end of five years, but it could vest earlier if the market condition is satisfied earlier. The market condition has a derived service period of three years. The 123R Resource Group concluded that an entity should account for this award similar to awards where either a market condition, or a performance or service condition, must be satisfied to vest in the award, although it initially seemed counterintuitive to some members. The fair value of the award should take into consideration all the award’s features, including the market condition that may serve to shorten the expected term of the award. Therefore, the fair value of the award is $6, and the requisite service period is the shorter of the explicit or derived service period, which in this example would be three years.

### 6.2.7 Change in initial estimate of requisite service period

An entity should revise its initial estimate of the requisite service period for an award as necessary based on changes in facts and circumstances. If there is a change in the expected or actual outcomes of service or performance conditions, an entity may need to adjust the initial estimate of the requisite service period based on the new information.

**ASC 718-10-35-7**

An entity shall adjust that initial best estimate in light of changes in facts and circumstances. Whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of the conditions identified in paragraph 718-10-30-26 and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied. Paragraphs 718-10-55-69 through 55-79 provide guidance on adjusting the initial estimate of the requisite service period.

If an award contains a market condition and a performance or service condition and the initial estimate of the requisite service period is the market condition's derived service period, the requisite period should not change unless either of the following occurs:

- The market condition (for example, a market-price trigger that affects an award's exercisability) is satisfied before the end of the derived service period. This will shorten the award's requisite service period, and any unrecognized compensation cost should be recognized immediately.
- Satisfying the market condition is no longer the basis for determining the requisite service period (for example, because a performance condition that satisfies the award's vesting requirement becomes probable of achievement and the implicit service period is shorter than the derived service period).

**ASC 718-10-55-77**

As indicated in paragraph 718-10-55-75, the initial estimate of the requisite service period based on an explicit or implicit service period shall be adjusted for changes in the expected and actual outcomes of the related service or performance conditions that affect vesting of the award. Such adjustments will occur as the entity revises its estimates of whether or when different conditions or combinations of conditions are probable of being satisfied. Compensation cost ultimately recognized is equal to the grant-date fair value of the award based on the actual outcome of the performance or service conditions (see paragraph 718-10-30-15). If an award contains a market condition and a performance or a service condition and the initial estimate of the requisite service period is based on the market condition's derived service period, then the requisite service period shall not be revised unless either of the following criteria is met:

a. The market condition is satisfied before the end of the derived service period

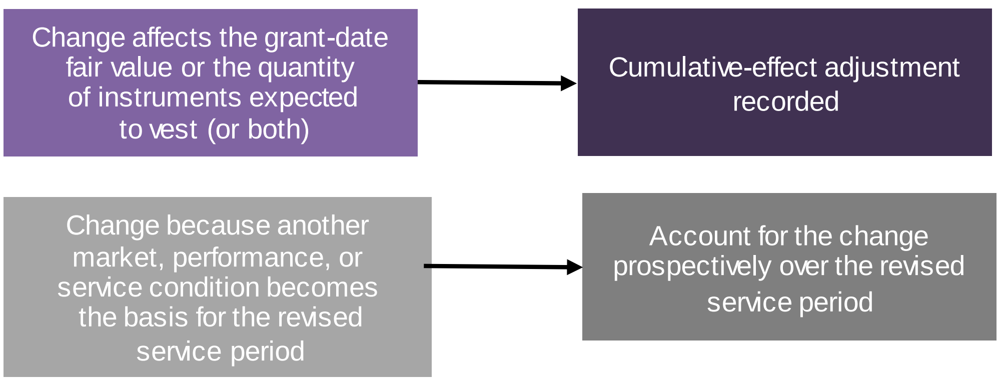
b. Satisfying the market condition is no longer the basis for determining the requisite service period.

If the initial estimate of the requisite service period changes, there are two possible accounting results:

- Account for the change prospectively
- Recognize the cumulative effect of the change as an adjustment to compensation expense in the period the estimate changes

If the change affects the grant-date fair value or the quantity of instruments expected to vest (or both), the cumulative effect of the change on current and prior periods is recognized in the period of change. When compensation cost is already being attributed over the requisite service period, the estimated requisite service period (over which cost is being recognized) may change solely because another market, performance, or service condition becomes the basis for the revised requisite service period. In that case, the grantor recognizes the unrecognized compensation cost, if any, on the date of the change prospectively over the revised requisite service period, without a cumulative-effect adjustment.

**Figure 6.2 – Change in initial estimate of the requisite service period**




### ASC 718-10-55-78

How a change to the initial estimate of the requisite service period is accounted for depends on whether that change would affect the grant-date fair value of the award (including the quantity of instruments) that is to be recognized as compensation. For example, if the quantity of instruments for which the requisite service is expected to be rendered changes because a vesting condition becomes probable of satisfaction or if the grant-date fair value of an instrument changes because another performance or service condition becomes probable of satisfaction (for example, a performance or service condition that affects exercise price becomes probable of satisfaction), the cumulative effect on current and prior periods of those changes in estimates shall be recognized in the period of the change. In contrast, if compensation cost is already being attributed over an initially estimated requisite service period and that initially estimated period changes solely because another market, performance, or service condition becomes the basis for the requisite service period, any unrecognized compensation cost at that date of change shall be recognized prospectively over the revised requisite service period, if any (that is, no cumulative-effect adjustment is recognized).

### ASC 718-10-55-79

To summarize, changes in actual or estimated outcomes that affect either the grant-date fair value of the instrument awarded or the quantity of instruments for which the requisite service is expected to be rendered (or both) are accounted for using a cumulative effect adjustment, and changes in estimated requisite service periods for awards for which compensation cost is already being attributed are accounted for prospectively only over the revised requisite service period, if any.

### *Cliff vesting and graded vesting awards with service-only conditions*

In a very simple award, all of the instruments in that award vest on the last day of the vesting period, which is known as "cliff vesting." In this straightforward situation, the entity recognizes any compensation cost on a straight-line basis over the requisite service period.

**Cliff vesting**

Entity A grants 1,000 options to its employee on January 1, 20X1 that vest in four years. As the awards vest on the last day of the vesting period and the employee provided services throughout the vesting period, all 1,000 options vest on the last day of the four-year period.

The structure of many awards is not that straightforward, however, because portions of the instruments included in the awards vest in different periods, known as "graded vesting."

**Graded vesting**

Entity A grants 1,000 options to its employee on January 1, 20X1 that vest in different periods. Twenty-five percent of the total options vest each year over a four-year period. As of January 1, 20X2, 250 of the 1,000 options granted have vested.

For employee awards with only service conditions and graded vesting, an entity makes an accounting policy decision about how to recognize compensation cost. The policy should be applied consistently, and a subsequent change in policy is considered a change in accounting principle that must be accounted for under ASC 250, *Accounting Changes and Error Corrections*, subject to preferability, among other considerations. The election is available regardless of the valuation technique used for the award (in other words, regardless of whether a separate fair value is estimated for the options in each separately vesting portion or whether a single fair value is estimated that applies to all options in the award).

Entities issuing employee awards with graded vesting that have only service conditions (that is, no performance or market conditions) must select one of the following two methods for recognizing compensation cost and must apply the method consistently for all awards with graded vesting that have only service conditions:

- Straight-line attribution
- Graded vesting attribution

An important aspect of the guidance in ASC 718-10-35 is that the percentage of grant-date fair value recognized at any date must equal at least the portion of the award that is vested at that date. Therefore, entities that use the straight-line attribution method for awards with graded vesting should have a control in place to ascertain at each reporting date whether the cumulative cost recognized for the grant is at least equal to the grant-date fair value of the awards vested at that date. In other words, the accounting outcome is not necessarily “straight-line”—meaning that the cost recognized may be higher in earlier periods—if more instruments vest early in the requisite service period. This higher cost is necessary to meet the requirement in the last sentence of ASC 718-10-35-8.

**ASC 718-10-35-8**

An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:

a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards

b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. Example 1, Case B (see paragraph 718-20-55-25) provides an illustration of the accounting for an award with a graded vesting schedule.

### 6.3.1 Straight-line attribution policy

Under the straight-line attribution method for service-only, graded vesting awards granted to employees, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. However, the percentage of grant-date fair value recognized at any date must equal at least the portion of the award that is vested at that date. Therefore, as previously indicated, entities that use the straight-line attribution method for awards with graded vesting should have a control in place to ascertain at each reporting date whether the cumulative cost recognized for the grant is at least equal to the grant-date fair value of the awards vested at that date.

**Straight-line attribution: employee service-only, graded vesting award**

If more awards vest in the early part of the requisite service period, the grantor recognizes more than the pro-rata straight-line cost. For example, an award vests 50 percent at the end of year one, 25 percent at the end of year two, and 25 percent at the end of year three. The grantor recognizes compensation cost for 50 percent of the options that vest at the end of year one in the first year in order meet the requirement in ASC 718 to recognize cost that equals at least the portion of the grant-date value of the award vested at that date. The grantor then recognizes compensation cost for the options that vest at the end of years two and three over the remaining two-year requisite service period.

On the other hand, when more share options in an award vest in the later part of the requisite service period, the grantor recognizes cost on a straight-line basis. For example, an award vests over a seven-year period, with 50 percent vesting at the end of year five, 10 percent vesting at the end of year six, and 40 percent vesting at the end of year seven. The grantor recognizes compensation cost on a straight-line basis over seven years, which meets the requirement to recognize cost at least equal to the portion of the grant-date fair value of the award vested at each year-end. If the recognized cost exceeds the portion vested through year six, this would have no impact on cost recognition because recognition has been (a) straight-line in accordance with the policy election, and (b) at least equal to what has vested to date.

### 6.3.2 Graded vesting attribution policy

Under a graded vesting attribution model, compensation cost is recognized on a straight-line basis over the requisite service period for each separately vesting portion of the grant as if the grant consisted of multiple awards that have the same service inception date but different requisite service periods. This method accelerates the recognition of compensation cost. In computing compensation cost, the entity must determine the number of awards expected to vest separately for each vesting period. In the period a portion of the award becomes 100 percent vested, the entity must also adjust the cumulative recognized compensation cost for that portion of the award to the number of awards that have vested, taking into account actual forfeitures.

When a portion of equity-classified, graded-vesting options vest, an entity should ensure that

- The number of awards expected to vest has been adjusted to the actual number of options vested
- Compensation cost recognized at least equals the grant-date fair value of the vested awards

### 6.3.3 Contrasting straight-line and graded vesting attribution accounting policies

Example 1, Case B, in ASC 718-20 illustrates both straight-line and graded vesting attribution policies for employee service-only, graded vesting awards. The example first illustrates graded vesting attribution and then applies straight-line attribution to the same facts.

**Example 1: Accounting for Share Options with Service Conditions**

**Case B: Share Options with Graded Vesting**

**ASC 718-20-55-25**

Paragraph 718-10-35-8: provides for the following two methods to recognize compensation cost for awards with graded vesting:

a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards (graded vesting attribution method)

b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award), subject to the limitation noted in paragraph 718-10-35-8.

**ASC 718-20-55-26**

The choice of attribution method for awards with graded vesting schedules is a policy decision that is not dependent on an entity's choice of valuation technique. In addition, the choice of attribution method applies to awards with only service conditions.

**ASC 718-20-55-27**

The accounting is illustrated below for both methods and uses the same assumptions as those noted in Case A except for the vesting provisions.

**ASC 718-20-55-28**

Entity T awards 900,000 share options on January 1, 20X5, that vest according to a graded schedule of 25 percent for the first year of service, 25 percent for the second year, and the remaining 50 percent for the third year. Each employee is granted 300 share options. The following table shows the calculation as of January 1, 20X5, of the number of employees and the related number of share options expected to vest. Using the expected 3 percent annual forfeiture rate, 90 employees are expected to terminate during 20X5 without having vested in any portion of the award, leaving 2,910 employees to vest in 25 percent of the award (75 options). During 20X6, 87 employees are expected to terminate, leaving 2,823 to vest in the second 25 percent of the award. During 20X7, 85 employees are expected to terminate, leaving 2,738 employees to vest in the last 50 percent of the award. That results in a total of 840,675 share options expected to vest from the award of 900,000 share options with graded vesting.

| Year | Number of Employees | | Number of vested share options | |
|---|---|---|---|---|
| | Total at date of grant | 3,000 | | |
| 20X5 | 3,000 – 90 (3,000 x .03) = | 2,910 | 2,910 x 75 (300 x 25%) = | 218,250 |
| 20X6 | 2,910 – 87 (2,910 x .03) = | 2,823 | 2,823 x 75 (300 x 25%) = | 211,725 |
| 20X7 | 2,823 – 85 (2,823 x .03) = | 2,738 | 2,738 x 150 (300 x 50%) = | 410,700 |
| Total vested option | | | | 840,675 |

**ASC 718-20-55-29**

The value of the share options that vest over the three-year period is estimated by separating the total award into three groups (or tranches) according to the year in which they vest (because the expected life for each tranche differs). The following table shows the estimated compensation cost for the share options expected to vest. The estimates of expected volatility, expected dividends, and risk-free interest rates are incorporated into the lattice, and the graded vesting conditions affect only the earliest date at which suboptimal exercise can occur (see paragraph 718-20-55-8 for information on suboptimal exercise). Thus, the fair value of each of the 3 groups of options is based on the same lattice inputs for expected volatility, expected dividend yield, and risk-free interest rates used to determine the value of $14.69 for the cliff-vesting share options (see paragraphs 718-20-55-7 through 55-9). The different vesting terms affect the ability of the suboptimal exercise to occur sooner (and affect other factors as well, such as volatility), and therefore there is a different expected term for each tranche.

| Year | Vested Options | Value per Option | Compensation Cost |
|---|---|---|---|
| 20X5 | 218,250 | $13.44 | $ 2,933,280 |
| 20X6 | 211,725 | 14.17 | 3,000,143 |
| 20X7 | 410,700 | 14.69 | 6,033,183 |
| | 840,675 | | 11,966,606 |

**ASC 718-20-55-30**

Compensation cost is recognized over the periods of requisite service during which each tranche of share options is earned. Thus, the $2,933,280 cost attributable to the 218,250 share options that vest in 20X5 is recognized in 20X5. The $3,000,143 cost attributable to the 211,725 share options that vest at the end of 20X6 is recognized over the 2-year vesting period (20X5 and 20X6). The $6,033,183 cost attributable to the 410,700 share options that vest at the end of 20X7 is recognized over the 3-year vesting period (20X5, 20X6, and 20X7).

**ASC 718-20-55-31**

The following table shows how the $11,966,606 expected amount of compensation cost determined at the grant date is attributed to the years 20X5, 20X6, and 20X7.

| | Pretax Cost to be Recognized | | |
|---|---|---|---|
| | **20X5** | **20X6** | **20X7** |
| Share options vesting in 20X5 | $2,933,280 | $ - | $ - |
| Share options vesting in 20X6 | 1,500,071 | 1,500,072 | - |
| Share options vesting in 20X7 | 2,011,061 | 2,011,061 | 2,011,061 |
| Cost for the year | $6,444,412 | $3,511,133 | $ 2,011,061 |
| Cumulative cost | $6,444,412 | $9,955,545 | $11,966,606 |

**ASC 718-20-55-32**

Entity T could use the same computation of estimated cost, as in the preceding table, but could elect to recognize compensation cost on a straight-line basis for all graded vesting awards. In that case, total compensation cost to be attributed on a straight-line basis over each year in the 3-year vesting period is approximately $3,988,868 ($11,966,606 ÷ 3). Entity T also could use a single weighted-average expected life to value the entire award and arrive at a different amount of total compensation cost. Total compensation cost could then be attributed on a straight-line basis over the three-year vesting period. However, this Topic requires that compensation cost recognized at any date must be at least equal to the amount attributable to options that are vested at that date. For example, if 50 percent of this same option award vested in the first year of the 3-year vesting period, 436,500 options [2,910 × 150 (300 × 50%)] would be vested at the end of 20X5. Compensation cost amounting to $5,866,560 (436,500 × $13.44) attributable to the vested awards would be recognized in the first year.

**ASC 718-20-55-33**

Compensation cost is adjusted for awards with graded vesting to reflect differences between estimated and actual forfeitures as illustrated for the cliff-vesting options, regardless of which method is used to estimate value and attribute cost.

**ASC 718-20-55-34**

Accounting for the tax effects of awards with graded vesting follows the same pattern illustrated in paragraphs 718-20-55-20 through 55-23. However, unless Entity T identifies and tracks the specific tranche from which share options are exercised, it would not know the recognized compensation cost that corresponds to exercised share options for purposes of calculating the tax effects resulting from that exercise. If an entity does not know the specific tranche from which share options are exercised, it should assume that options are exercised on a first-vested, first-exercised basis (which works in the same manner as the first-in, first-out [FIFO] basis for inventory costing).

**Graded attribution**

The following table illustrates the percentage of the total cost of an award recognized in the first year of an award using graded attribution for an employee service-only, graded vesting award. Assume that an award of 1,000 options granted to an employee on January 1, 20X1 vests 25 percent a year over a four-year period. The following vesting would be attributed to 20X1 (the first year) as a percentage of the total cost of the award.

| | | |
|---|---|---|
| Tranche vesting in 20X1 (one-year requisite service) | 100% of 25% of the award | 25.0% |
| Tranche vesting in 20X2 (two-year requisite service) | 50% of 25% of the award | 12.5% |
| Tranche vesting in 20X3 (three-year requisite service) | 33⅓% of 25% of the award | 8.3% |
| Tranche vesting in 20X4 (four-year requisite service) | 25% of 25% of the award | 6.3% |
| Compensation cost to be recognized in 20X1 (percentage of the total cost of the award) | | 52.1% |

## 6.3 Single award or multiple awards

Some awards are granted that contain multiple vesting provisions, requiring separate accounting treatment.

### 6.4.1 Awards with performance conditions and multiple tranches

Determining the grant date, the service inception date, and the requisite service period for awards with multiple separately vesting tranches requires careful evaluation if there is a separate performance condition for each tranche. Slight differences in how performance conditions are structured can affect how cost is recognized for the award.

The grant date depends on when the performance targets are determined. The requisite service period depends on whether the performance targets of different tranches are independent, dependent on each other, or can be substituted for each other.

When performance targets are established at the inception of the arrangement and the award has multiple service periods (for example, separate annual periods), each tranche has the same grant date at inception. Each tranche is accounted for as a separate award, however, with its own service inception date, grant-date fair value, and requisite service period, because the arrangement specifies for each tranche an independent performance condition for a stated period of service. This scenario is illustrated in Case A of Example 3 below.

If the arrangement instead requires the grantor to establish annual performance targets at the beginning of each calendar year for a multiyear award, the grant date for each tranche will not be the inception-date fair value, but will be January 1 of each award year. Each tranche therefore has its own service inception date, grant-date fair value (based on when the targets are set), and requisite service period, as illustrated in Case B of Example 3 below.

If an award calls for various tranches to vest only if performance targets related to previous tranches are satisfied, the awards have the same grant date, but each tranche has its own explicit service period, as illustrated in Case C of Example 3 below.

### Example 3: Share-Based Payment Award with a Performance Condition and Multiple Service Periods

**ASC 718-10-55-92**

The following Cases illustrate share-based payment awards with a performance condition (see paragraphs 718-10-25-20 through 25-21; 718-10-30-27; and 718-10-35-4) and multiple service dates:

a. Performance targets are set at the inception of the arrangement (Case A).

b. Performance targets are established at some time in the future (Case B).

c. Performance targets established up front but vesting is tied to the vesting of a preceding award (Case C).

**ASC 718-10-55-93**

Cases A, B, and C share the following assumptions:

a. On January 1, 20X5, Entity T enters into an arrangement with its chief executive officer relating to 40,000 share options on its stock with an exercise price of $30 per option.

b. The arrangement is structured such that 10,000 share options will vest or be forfeited in each of the next 4 years (20X5 through 20X8) depending on whether annual performance targets relating to Entity T's revenues and net income are achieved.

#### Case A: Performance Targets Are Set at the Inception of the Arrangement

**ASC 718-10-55-94**

All of the annual performance targets are set at the inception of the arrangement. Because a mutual understanding of the key terms and conditions is reached on January 1, 20X5, each tranche would have a grant date and, therefore, a measurement date, of January 1, 20X5. However, each tranche of 10,000 share options should be accounted for as a separate award with its own service inception date, grant-date fair value, and 1-year requisite service period, because the arrangement specifies for each tranche an independent performance condition for a stated period of service. The chief executive officer's ability to retain (vest in) the award pertaining to 20X5 is not dependent on service beyond 20X5, and the failure to satisfy the performance condition in any one particular year has no effect on the outcome of any preceding or subsequent period. This arrangement is similar to an arrangement that would have provided a $10,000 cash bonus for each year for satisfaction of the same performance conditions. The four separate service inception dates (one for each tranche) are at the beginning of each year.

### Case B: Performance Targets Are Established at Some Time in the Future

#### ASC 718-10-55-95

If the arrangement had instead provided that the annual performance targets would be established during January of each year, the grant date (and, therefore, the measurement date) for each tranche would be that date in January of each year (20X5 through 20X8) because a mutual understanding of the key terms and conditions would not be reached until then. In that case, each tranche of 10,000 share options has its own service inception date, grant-date fair value, and 1-year requisite service period. The fair value measurement of compensation cost for each tranche would be affected because not all of the key terms and conditions of each award are known until the compensation committee sets the performance targets and, therefore, the grant dates are those dates.

### Case C: Performance Targets Established up Front but Vesting Is Tied to the Vesting of a Preceding Award

#### ASC 718-10-55-96

If the arrangement in Case A instead stated that the vesting for awards in periods from 20X6 through 20X8 was dependent on satisfaction of the performance targets related to the preceding award, the requisite service provided in exchange for each preceding award would not be independent of the requisite service provided in exchange for each successive award. In contrast to the arrangement described in Case A, failure to achieve the annual performance targets in 20X5 would result in forfeiture of all awards. The requisite service provided in exchange for each successive award is dependent on the requisite service provided for each preceding award. In that circumstance, all awards have the same service inception date and the same grant date (January 1, 20X5); however, each award has its own explicit service period (for example, the 20X5 grant has a one-year service period, the 20X6 grant has a two-year service period, and so on) over which compensation cost would be recognized. Because this award contains a performance condition, it is not subject to the attribution guidance in paragraph 718-10-35-8.

### When a performance condition affects the number of awards each employee will receive

On January 1, 20X6, Tech Entity grants its CEO 40,000 options that will vest over four years. Ten thousand of those options will vest based on an EBITDA target specified for each year. In each of the four situations, Tech Entity considers the following questions:

- What is the *grant date* for each separately vesting tranche?
- What is the *service inception date* for each tranche?
- What is the *requisite service period* for each tranche?

The answers for each situation depend on both

- *When* performance conditions are established
- *Whether* conditions for different tranches are interdependent

**Situation A**

EBITDA targets for all years are set on January 1, 20X6. Each tranche vests only if the EBITDA target for that year is achieved. Failure to satisfy a target in one year has no impact on the outcome of any other year.

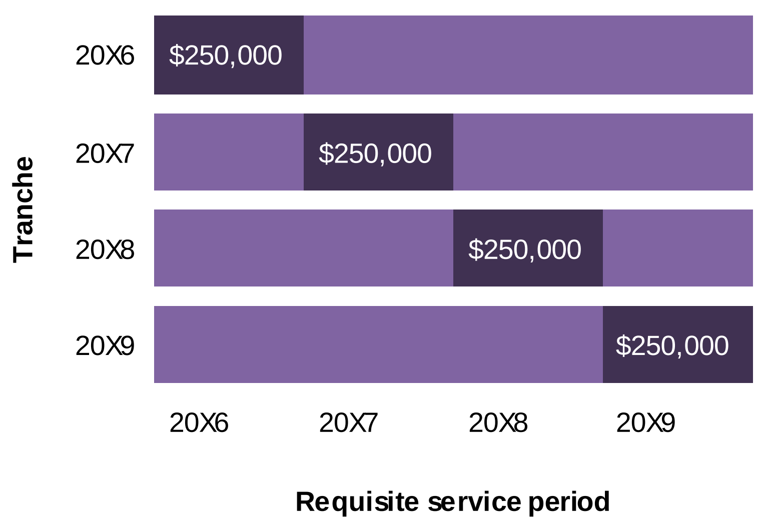
The grant date for all tranches is January 1, 20X6, as this is the date when all parties reached a mutual understanding of key terms and conditions.

Each tranche has its own service inception date (the beginning of the year over which the performance condition must be satisfied).

The cost recognition period for each tranche is the one-year requisite service period beginning January 1 of the tranche year.

Because each tranche has an independent performance condition (meaning it is not dependent on satisfying a target for any other tranche) for a stated period of service (one year), the service inception date is delayed until January 1 of the tranche year.

The options have a grant-date fair value of $25. Each tranche consists of 10,000 options. Tech Entity determines that the achievement of all performance conditions is probable at inception. Achievement of all performance conditions remains probable throughout the term of the award and is ultimately achieved.




**Situation B**

The facts are the same as in Situation A except the EBITDA target for each tranche is set in January of each tranche year.

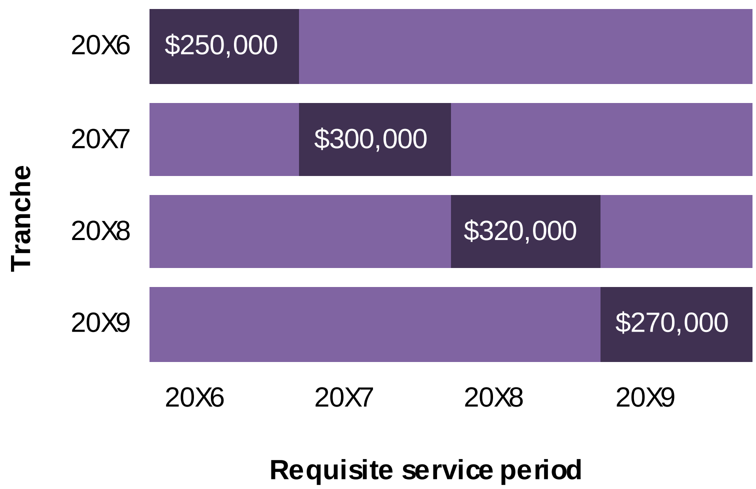
The grant date for measuring the fair value of each tranche is January of the tranche year when the EBITDA target is set because a mutual understanding of key terms and conditions for that tranche is not reached until then.

The service inception date is unchanged from Situation A. Each tranche has its own service inception date (the beginning of the year over which the performance condition must be satisfied).

The grant-date fair value of each tranche is recognized over the tranche's one-year requisite service period if it is probable that the target will be satisfied, because there is no requirement to satisfy the condition of another tranche to vest in the current tranche.

The grant-date fair value of options (determined in January of each year) is $25 for the 20X6 tranche, $30 for the 20X7 tranche, $32 for the 20X8 tranche, and $27 for the 20X9 tranche.

Tech Entity determines that the achievement of all performance conditions is probable at inception, remains probable throughout the term of the award, and it is ultimately achieved.




**Situation C**

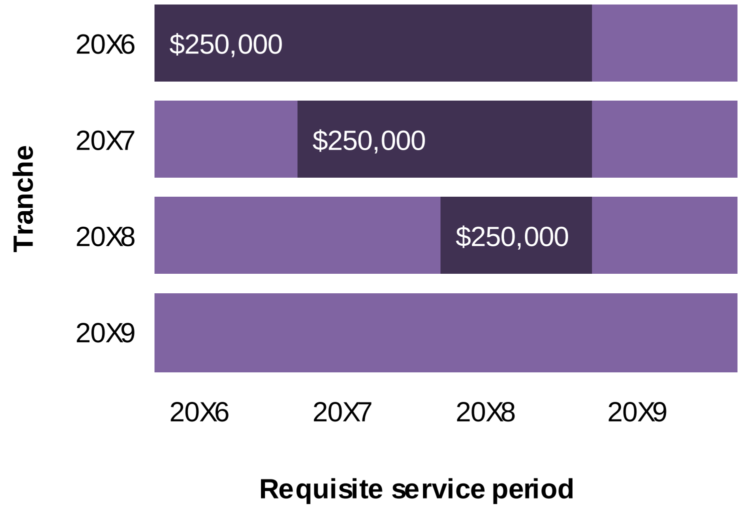
The facts are the same as in Situation A except that a failure to satisfy a current-year target can be overcome if a subsequent-year target is satisfied.

For example, if the EBITDA targets for 20X6 and 20X7 are not satisfied but the 20X8 target is satisfied, the 20X6, 20X7, and 20X8 tranches vest at the end of 20X8.

The grant date is January 1, 20X6 for all tranches. Each tranche has its own service inception date (the beginning of the year over which the performance condition must be satisfied). The requisite service period now extends to the end of the first period in which a target is achieved. The requisite service period for each tranche begins on January 1 of the tranche year and ends at the completion of the first year for which the target is achieved. The entity begins recognizing compensation cost when satisfaction of some future target is probable.

The grant-date fair value of options is $25 for all tranches, because all targets are established on January 1, 20X6. Tech Entity determines on January 1, 20X6 that 20X8 is the first target probable of being achieved, which remains probable. The 20X8 target is ultimately achieved.

Tech Entity determines on January 1, 20X9 that the 20X9 EBITDA target is not probable of achievement, and it ultimately is not achieved.



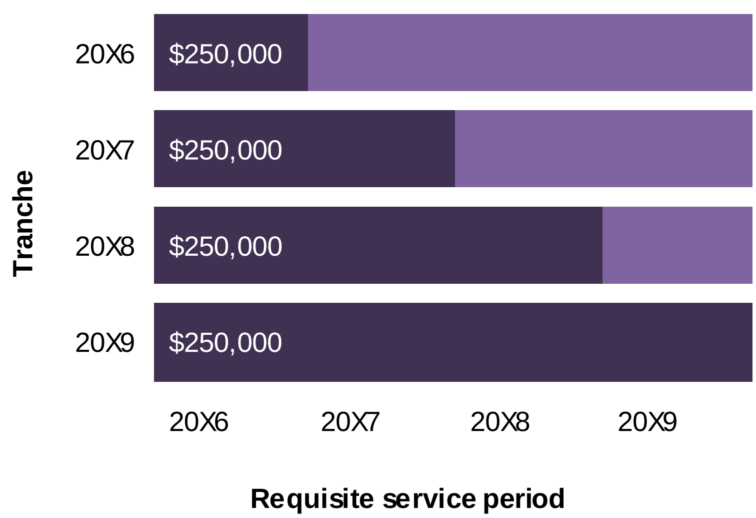

**Situation D**

Situation D is the same as Situation A, except that satisfying the performance target for each tranche depends on satisfying the performance targets for all preceding awards as well as satisfying the current year's EBITDA target.

The grant date is January 1, 20X6 for all tranches. The service inception date is January 1, 20X6 for all tranches, as achieving the target for each award depends on achieving the target for each previous award. The requisite service period for each tranche includes the requisite service period of each previous award.

The grant-date fair value of options is $25 for all tranches because all targets are established on January 1, 20X6.

Tech Entity determines in January 20X6 that achievement of all targets is probable, which remains probable throughout the term of the award and is ultimately achieved.



### 6.4.2 Awards with a service condition and multiple tranches

An entity may grant an award with a service condition and various tranches whereby the service provided by the employee in one year's tranche is independent of the service provided in a later year's tranche. As demonstrated in Example 4 in ASC 718-10-55, the terms of the share-based compensation arrangement provide evidence that each tranche compensates the employee for one year of service, and each tranche is accounted for as a separate award with its own service inception date, grant date, and one-year service period.

**Example 4: Share-Based Payment Award with a Service Condition and Multiple Service Periods**

**ASC 718-10-55-97**

The following Cases illustrate the guidance in paragraph 718-10-30-12 to determine the service period for awards with multiple service periods:

a. Exercise price established at subsequent dates (Case A)

b. Exercise price established at inception (Case B).

**Case A: Exercise Price Established at Subsequent Dates**

**ASC 718-10-55-98**

The chief executive officer of Entity T enters into a five-year employment contract on January 1, 20X5. The contract stipulates that the chief executive officer will be given 10,000 fully vested share options at the end of each year (50,000 share options in total). The exercise price of each tranche will be equal to the market price at the date of issuance (December 31 of each year in the five-year contractual term). In this Case, there are five separate grant dates. The grant date for each tranche is December 31 of each year because that is the date when there is a mutual understanding of the key terms and conditions of the agreement—that is, the exercise price is known and the chief executive officer begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares (see paragraphs 718-10-55-80 through 55-83 for additional guidance on determining the grant date). Because the awards' terms do not include a substantive future requisite service condition that exists at the grant date (the options are fully vested when they are issued), and the exercise price (and, therefore, the grant date) is determined at the end of each period, the service inception date precedes the grant date. The requisite service provided in exchange for the first award (pertaining to 20X5) is independent of the requisite service provided in exchange for each consecutive award. The terms of the share-based compensation arrangement provide evidence that each tranche compensates the chief executive officer for one year of service, and each tranche shall be accounted for as a separate award with its own service inception date, grant date, and one-year service period; therefore, the provisions of paragraph 718-10-35-8 would not be applicable to this award because of its structure.

**Case B: Exercise Price Established at Inception**

**ASC 718-10-55-99**

If the arrangement described in Case A provided instead that the exercise price for all 50,000 share options would be the January 1, 20X5, market price, then the grant date (and, therefore, the measurement date) for each tranche would be January 1, 20X5, because that is the date at which there is a mutual understanding of the key terms and conditions. All tranches would have the same service inception date and the same grant date (January 1, 20X5). Because of the nature of this award, Entity T would make a policy decision pursuant to paragraph 718-10-35-8 as to whether it considers the award as in-substance, multiple awards each with its own requisite service period (that is, the 20X5 grant has a one-year service period, the 20X6 grant has a two-year service period, and so on) or whether the entity considers the award as a single award with a single requisite service period based on the last separately vesting portion of the award (that is, a requisite service period of five years). Once chosen, this Topic requires that accounting policy be applied consistently to all similar awards.

# 7. Fair value

All entities are required to recognize in their financial statements the cost of share-based payment awards granted to employees. Under ASC 718, an entity is required to determine that cost by estimating the fair value of the share-based instruments it is obligated to issue to its employees when the employees have satisfied the requisite service period (the period over which an employee is required to provide services in exchange for the share-based payment award), as well as met any other conditions necessary to earn the award. Therefore, an entity determines the cost of employee share-based awards by estimating the fair value of the share-based instruments that will be issued rather than directly measuring the fair value of the employee services the entity will receive in exchange for the award. The portion of the fair value of a share-based award attributable to employee service is the instrument's fair value on the grant date after considering any amount the employee pays for the instrument (for example, the option exercise price or the share purchase price). Employees are not often required to pay a portion of the share price when granted a restricted share. In that situation, the cost attributable to employee service is the entire fair value of the award.

**ASC 718-10-30-2**

A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Topic, a calculated value or intrinsic value) of the equity instruments issued.

**ASC 718-10-30-3**

An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this Topic. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

The fair value of share-based payment awards is not determined under the provisions of ASC 820, *Fair Value Measurement*, because the guidance in ASC 718 and related interpretive pronouncements are excluded from the scope of ASC 820. The fair value of share-based payment awards is determined under the measurement guidance in ASC 718 and related pronouncements, which are discussed in this section.

In SAB Topic 14.C, *Valuation Methods,* which is codified in ASC 718-10-S99-1, the SEC staff clarified that a public entity is not required to use external valuation professionals to determine the fair value of share-based payment awards if the entity's employees have the requisite expertise to perform the valuation. In addition, the Statement 123R Resource Group concluded on July 21, 2005 that nonpublic entities could either use employees with the requisite expertise to determine the fair value of share-based payment awards or hire external valuation professionals. The assessment of whether an employee has the requisite expertise depends on an entity's specific situation.

## 7.1 Fair-value-based measurement method

Although the objective in ASC 718 is to measure employee share-based payment awards at fair value, the guidance specifies a "fair-value-based measurement method" that entities are required to use when estimating the value of employee awards. That method differs in some respects from the fair value method described in ASC 820 because, as described below, some features and conditions of the awards are excluded when estimating fair value under ASC 718. For convenience, both this guide and ASC 718 use the term "fair value" to refer to the fair-value-based measurement method required for employee awards. The fair-value-based measurement method requires an entity to use a fair value hierarchy and fair value measurement techniques, such as appropriate valuation models for options.

Under ASC 718, fair value is determined based on the substance of an award, regardless of how the award is structured. For example, if shares are transferred to an employee in exchange for a nonrecourse note secured only by those shares, the transaction is the same as granting the employee an option to purchase the shares and would therefore be accounted for as an option grant. See Section 7.7 regarding nonrecourse loans.

Under the fair-value-based measurement method, the fair value of an award should reflect all substantive characteristics of the instrument, except those characteristics that are explicitly excluded by ASC 718. Explicitly excluded features under ASC 718 include:

- Service conditions
- Performance conditions
- Restrictions that apply during the vesting period
- Reload features
- Certain contingent features, such as clawbacks related to noncompete agreements

### *Service or performance conditions*

Service conditions and performance conditions affecting vesting or exercisability are often embedded in employee awards, but should be ignored in determining the fair value of the awards. Instead, an entity should recognize the cost of an award if the service or performance conditions are met, and should not recognize the cost of an award that is forfeited because the required service or performance conditions are not met. In other words, the guidance states that entities should ultimately recognize the cost only for awards if the service and performance conditions are met and precludes reducing the cost of an award to reflect a service and / or performance condition. This is what the second sentence of ASC 718-10-30-13 means.

**ASC 718-10-30-12**

Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered). Examples 1 through 2 (see paragraphs 718-20-55-4 through 55-40) and Example 1 (see paragraph 718-30-55-1) provide illustrations of how compensation cost is recognized for awards with service and performance conditions.

**ASC 718-10-30-13**

The fair-value-based method described in paragraphs 718-10-30-6 and 718-10-30-10 through 30-14 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. This Topic refers to the required measure as fair value.

In contrast to service or performance conditions, market conditions impact the fair value of employee share-based awards as discussed below under “Market conditions.” (For more about market conditions, see Section 5.3.)

### *Restrictions that apply during the vesting period*

#### Nontransferability

A ”restriction” on share-based instruments issued to employees affects the estimate of fair value only if the restriction remains in effect after the employee’s requisite service period ends.

A **restriction** is a contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time.

Restrictions that remain in effect, such as the nontransferability of vested options or the prohibited sale of vested shares for a period of time, are taken into account in estimating an award’s fair value as follows:

- The effect of vested options that cannot be transferred or hedged on fair value is considered by the requirement to use the option’s expected life rather than its contractual life when valuing the option. An entity determines the options expected life after considering the employee’s expected exercise and post-vesting employment termination behavior. In SAB Topic 14.D.2, *Certain Assumptions Used in Valuation Methods – Expected Term,* which is codified in ASC 718-10-S99-1, the SEC staff confirmed that no additional reduction in the option term or other discount in the estimated fair value is appropriate for those particular factors.
- A vested share that the employee is contractually or governmentally prohibited from selling after having a vested right to it (for example, the employee is not permitted to sell the share until a year after it becomes vested) should be measured at the same amount as similarly restricted shares issued to third parties.
- Restrictions on the transferability of unvested options and a prohibition on the sale of unvested shares are not taken into account in determining the award’s fair value.

### ASC 718-10-30-10

To satisfy the measurement objective in paragraph 718-10-30-6, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and postvesting employment termination behavior in estimating fair value (referred to as an option's expected term).

### ASC 718-10-30-11

A restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

### ASC 718-10-55-12

An estimate of the amount at which instruments similar to employee share options and other instruments granted to employees would be exchanged would factor in expectations of the probability that the requisite service would be rendered and the instruments would vest (that is, that the performance or service conditions would be satisfied). However, as noted in paragraph 718-10-55-4, the measurement objective in this Topic is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. Therefore, the estimated fair value of the instruments at grant date does not take into account the effect on fair value of vesting conditions and other restrictions that apply only during the requisite service period. Under the fair-value-based method required by this Topic, the effect of vesting conditions and other restrictions that apply only during the requisite service period is reflected by recognizing compensation cost only for instruments for which the requisite service is rendered.

The use of a value other than the fair value of an unrestricted share is limited to shares that the employee is prohibited from selling. If sales of vested shares are not prohibited but are subject to certain limitations, such as sales of securities subject to SEC Rule 144A that are limited to qualified institutional buyers, the shares are valued at the fair value of an unrestricted share. Most restrictions seen in practice are limitations, not prohibitions, on the sale of shares and would not therefore be considered for a discount from the value of an unrestricted share.

At the 2007 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff reminded registrants that any discount on a restricted vested award should be specific to the security and should not be derived from a general rule of thumb. ASC 718-10-55-5 states that "if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged." Further, the SEC staff believes that, absent objective evidence of the fair value of similarly restricted shares, the quoted market price of unrestricted shares is the best evidence of the fair value of restricted shares.

At the 2015 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff again stressed these concepts and encouraged financial statement preparers to consult with the staff if a fact pattern warrants incorporating a significant discount in the grant-date fair value measurement of an award with post-vesting restrictions.

The SEC staff also clarified at the 2007 conference that management should consider only the attributes of a share-based payment award itself—that is, attributes that a market participant, not a specific employer, would consider—in valuing a security issued in a share-based payment arrangement. Some entities have argued in favor of taking a significant discount on certain share-based payment awards, because the securities were issued to executives who were subject to higher taxes than other employees. The staff believes that it would be difficult to substantiate that an assumption reflecting an attribute of a specific holder, rather than an attribute of the award itself, would be appropriate. The staff does not, therefore, believe that such a discount is consistent with the fair value measurement objective in ASC 718.

### *Market conditions*

Some employee awards contain market conditions that affect the award's exercise price, exercisability, or another related factor. A market condition relates to the achievement of a specified price of the issuer's shares, a specified amount of intrinsic value indexed solely to the issuer's shares, or a specified price of the issuer's shares relative to the price of a similar (or index of a similar) equity security, as discussed in Section 5.3. Compensation cost is recognized for employee awards with market conditions as long as the employee satisfies the requisite service period, regardless of whether the market condition is ever satisfied.

An entity reflects the impact of a market condition in the estimation of an award's fair value. The existence of a market condition reduces the fair value of the award, because it is a contingency that must be attained before the award can be exercisable. The techniques used to value awards with market conditions are complex to incorporate potential stock price activity, among other variables. As a result, the Black-Scholes-Merton method is not sufficient to determine fair value when market conditions are present because it likely does not incorporate assumptions such as those related to the exercisability of the award.

**ASC 718-10-30-14**

Some awards contain a market condition. The effect of a market condition is reflected in the grant-date fair value of an award. (Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this Topic, are path-dependent options.) Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied.

**Option with a market condition**

Entity A issues an employee option that can be exercised only if the entity's share price increases at least as much as its major competitor's share price (on a percentage basis) over a two-year period. Entity A considers the market condition when estimating the option's fair value. Compensation cost is recognized if the employee provides service for two years, even if the entity's share price did not increase as much as its competitor's during that period and the option therefore never becomes exercisable.

### *Reload features*

Employee options sometimes have an embedded "reload" feature that automatically grants the employee a new option if the employee exercises the original option using the entity's shares that the employee had previously acquired instead of cash.

A **reload feature** provides for automatic grants of additional options whenever an employee exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price. At the time of exercise using shares, the employee is automatically granted a new option, called a reload option, for the shares used to exercise the previous option.

A reload option is not included in estimating an award's grant-date fair value. Instead, reload options that are issued when an employee exercises the original option are accounted for as separate awards.

**ASC 718-10-30-23**

The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

### *Clawback and other contingent features*

Employee awards sometimes include a contingent feature that requires the employee to return to the employer equity instruments earned or realized gains from the sale of equity instruments acquired in a share-based payment arrangement. An example is a clawback feature included in a grant of fully vested shares that requires the employee to return the equity shares to the employer if the employee terminates employment and begins to work for a competitor. Employers do not include clawbacks and other contingent features in the award's grant-date fair value. Instead, they are accounted for if and when the contingent event occurs by recognizing (1) the consideration received in the appropriate balance sheet account, and (2) a credit in the income statement equal to the lesser of the compensation cost previously recognized for the award and the fair value of the consideration received. If the fair value of the consideration exceeds the previously recognized cost, the excess should be recognized as paid-in capital. That accounting assumes that the contingent feature is not related to the entity's or the employee's performance and that the entity does not have discretion in enforcing the contingent feature. Other accounting practices may apply if either of those conditions exists.

For example, an award with a clawback provision related to the entity, or the employee, not satisfying revenue or market share goals would be accounted for as a performance condition. Unlike award provisions accounted for as contingent features, the existence of a performance condition affects the period over which compensation cost is recognized.

To be accounted for as a contingent feature that does not affect the grant date of the award, the clawback or other contingency must be clearly understood by the employee, as discussed in Section 4.2. If an entity has discretion in imposing the clawback provision, the compensatory nature of the award may not be mutually understood, resulting in a deferral of the award's grant date until the contingency is resolved. If that occurs, the fair value of the award would be remeasured every period until the contingency either is resolved or expires.

**ASC 718-10-30-24**

A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (see paragraph 718-10-55-8), shall not be reflected in estimating the grant-date fair value of an equity instrument.

## 7.2 Exceptions from the requirement to use the fair-value-based measurement method

ASC 718 recognizes that, in certain situations, entities may not be able to determine the fair value of an option award. The guidance includes an exception from the requirement to estimate awards at fair value in only two limited circumstances, *neither of which is optional:*

- If an entity is required to use calculated value
- Use of variable intrinsic accounting

### *Calculated value*

The guidance in ASC 718 requires a nonpublic entity to use the calculated value method to estimate the value of its options and similar instruments if it is not practicable to reasonably estimate the expected volatility of its share price (for example, if it cannot identify similar public entities whose average volatility could be used as a surrogate for its own share price volatility). The calculated value method consists of substituting the historical volatility of an appropriate industry sector index for the entity's own expected volatility in the valuation model used to estimate the value of its options.

### ASC 718-10-30-20

A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). Throughout the remainder of this Topic, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value. Paragraphs 718-10-55-51 through 55-58 and Example 9 (see paragraph 718-20-55-76) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

## *Variable intrinsic value*

ASC 718 allows all entities (that is, both public and nonpublic entities) to use the variable intrinsic value method to estimate share price, but only in rare circumstances. There is a strong presumption in ASC 718 that entities can determine the fair value of option awards, including those with complex provisions. As a result, the variable intrinsic value method is infrequently used, especially because starting in the 2000s, entities have been required to perform fair-value calculations for a number of different reasons, such as goodwill impairment testing. Therefore, an assertion that fair value cannot be determined is difficult to support (see relevant implementation guidance in ASC 718-10-55, 718-20-55, and 718-30-55).

If a public or nonpublic entity is unable to reasonably estimate an option's fair value (or calculated value) on the grant date because the option is exceedingly complex, the entity should initially account for the option based on its grant-date intrinsic value, and then remeasure and report the option at its current intrinsic value as of each reporting date. An entity is required to continue using the variable intrinsic value method for these awards, even if it subsequently determines that it can reasonably estimate their fair value. An award subject to variable intrinsic value should be remeasured each period until it is exercised or settled or it expires unexercised. The final cost of the awards is therefore the option's intrinsic value on the date it is exercised or settled or it expires.

### ASC 718-10-30-21

It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. Section 718-10-55 illustrates techniques for estimating the fair values of several instruments with complicated features. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

### ASC 718-10-30-22

An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value (see paragraph 718-20-35-1 for measurement after issue date).

### 7.2.1 Liability awards: accounting policy choice for nonpublic entities

Nonpublic entities have a choice of methods for accounting for share-based payment awards that are classified as liabilities. They can account for them at fair value (or calculated value, if applicable) or at intrinsic value. Therefore, a nonpublic entity that grants awards requiring liability classification must make a policy decision about the method it will use to account for these awards and apply that policy consistently to all share-based payment liability awards that are issued.

A nonpublic entity using calculated value for equity-classified awards must choose either calculated value or intrinsic value to measure employee awards classified as liabilities. Even if the entity can later reasonably estimate fair value, a liability award originally measured at calculated value must continue to be (1) accounted for at either calculated value or intrinsic value, whichever the entity has elected, and (2) remeasured each reporting date until settlement (or until the award no longer requires classification as a liability).

**ASC 718-30-35-2**

A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value. Consistent with the guidance in paragraph 718-10-30-20, a nonpublic entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value (see Examples 8 through 9 [paragraphs 718-20-55-71 through 55-83]).

The guidance in ASC 718 specifies that the fair-value-based method is preferable when valuing liability-classified awards. Regardless of the method selected for valuing a liability-classified award, an entity should remeasure the amount in each period until the award is settled, at which time, it is adjusted to the amount paid to settle the liability.

The amendments in ASU 2016-09 were designed to simplify the accounting for share-based payments in several areas. One simplification which was codified in ASC 718-30-30-2A allows nonpublic entities to elect to measure liability-classified awards at intrinsic value rather than at fair value, without evaluating whether the change is “preferable” under ASC 250. The ASU is effective for nonpublic entities for fiscal years beginning after December 15, 2017 and for interim periods within fiscal years beginning after December 15, 2018. Nonpublic entities could early adopt the amendments for reporting periods if the financial statements had not yet been made available for issuance. Nonpublic entities would adopt the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the date of initial adoption, by adjusting the carrying amount of liability-classified awards that have not been settled as of the effective date from fair value to intrinsic value.

### ASC 718-30-30-2A

A nonpublic entity can make the accounting policy election in paragraph 718-30-30-2 to change its measurement of all liability-classified awards from fair value to intrinsic value in accordance with the transition provisions in paragraph 718-10-65-10. Those transition provisions do not require a nonpublic entity to evaluate whether the change in accounting policy is preferable under Topic 250 on accounting changes and error corrections.

### Grant Thornton insights: One-time accounting policy election to apply intrinsic value method

Issued in 2004, Statement 123(R) allowed nonpublic entities to elect to measure all liability-classified awards at fair value or at intrinsic value upon adopting the new guidance. During the FASB's project to simplify the accounting for share-based awards, culminating in ASU 2016-09, certain nonpublic entities and practitioners informed the Board that they were not aware of that election and had continued to use fair value to measure liability-classified awards. Since ASC 718-30-35-4 specifies that the fair-value-based method is preferable, nonpublic entities have been precluded from demonstrating that a change in accounting policy from fair value to intrinsic value is preferable under ASC 250.

As part of its simplification initiative, the Board decided in ASU 2016-09 to offer nonpublic entities a one-time election to change their accounting policy upon adopting the new guidance, without evaluating whether the new valuation method is preferable under ASC 250.

An entity with liability-classified awards at the effective date of ASU 2016-09 that did not make the one-time election to measure the awards at intrinsic value rather than fair value is precluded from changing its policy in the future, because the guidance in ASC 718 specifies that the fair-value-based method is preferable. If, however, an entity did not have liability-classified awards at the effective date and has not had a policy in the past with regard to measuring liability-classified awards, the entity may elect the intrinsic value in a future period when it grants its first such award.

### ASC 718-30-35-4

Regardless of the measurement method initially selected under paragraph 718-10-30-20, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under Topic 250. Example 1 (see paragraph 718-30-55-1) provides an illustration of accounting for an instrument classified as a liability using the fair-value-based method. Example 2 (see paragraph 718-30-55-12) provides an illustration of accounting for an instrument classified as a liability using the intrinsic value method.

### 7.2.2 Definition of nonpublic entity

A **nonpublic entity** is any entity other than one that meets any of the following criteria:

a. Has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally
b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market
c. Is controlled by an entity covered by the preceding criteria.

An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity.

An entity that does not have publicly traded equity but that is a subsidiary of an entity that does have publicly traded equity would be considered a public entity for purposes of applying the guidance in ASC 718. In addition, an entity loses its nonpublic status when it initially files in preparation for a public offering of equity securities.

At its meeting on September 13, 2005, the FASB's Statement 123R Resource Group reached a consensus indicating that the following entities would not qualify as nonpublic entities under the definition and would therefore be considered public entities:

- An entity that does not have publicly traded equity securities but is controlled by a private equity fund whose parent is a public entity. This situation, which is not uncommon, requires careful evaluation to determine whether the private equity fund is a subsidiary of a public entity, because both the private equity fund and the parent of the private equity fund may not consolidate their respective subsidiaries, but rather account for them at fair value under the guidance in ASC 946, *Financial Services – Investment Companies*.
- A U.S. subsidiary whose parent has equity securities that trade publicly in a foreign jurisdiction

Subsidiaries of public entities are considered public entities for the purposes of applying ASC 718. Therefore, many entities that do not have their own publicly traded equity securities are nonetheless considered to be public entities. These entities do not meet the definition of a nonpublic entity and therefore will not be able to use the calculated value method or elect to use the intrinsic value method to account for liability-classified awards.

## 7.3 Fair-value hierarchy for share-based payment awards

As noted above, the measurement objective for share-based payment *equity* awards granted to employees is the grant-date fair value of the awards that the employer will be obligated to issue when the employee has rendered the services required during the requisite service period. The fair value is determined based on the share price and other factors pertinent to the award at the grant date and is not subsequently remeasured.

For *liability* awards, fair value is determined in the same manner, except that the final measurement date is not the grant date, but the date when the award is settled. (Note that this is the ultimate settlement date, not the vesting date, because liability awards generally continue to be remeasured to fair value after vesting.) Therefore, an entity should determine the fair value for liability awards as of the end of each reporting period until settlement, based on the share price and other factors pertinent to the award on the measurement date.

**ASC 718-10-55-9**

The fair value measurement objective for liabilities incurred in a share-based payment transaction with employees is the same as for equity instruments awarded to employees. However, awards classified as liabilities are subsequently remeasured to their fair values (or a portion thereof until the requisite service has been rendered) at the end of each reporting period until the liability is settled.

Conceptually, fair value is the value of a share-based instrument in a current exchange.

**Fair value** is the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Because there are not always observable values for share-based instruments, ASC 718 requires entities to determine the fair value of instruments according to the following hierarchy:

- First, if observable market prices (exchange values) in active markets are available for identical or similar equity or liability instruments, they should be used to value the equity or liability instrument. The following are examples of awards whose fair value should be based on observable market prices:
  - An observable market price of an *identical* equity instrument is available for a grant of a fully vested, unrestricted share of a public entity.
  - An observable market price of a *similar* equity instrument is available for a grant of an unvested, nontransferable share of a public entity that will be transferable (unrestricted) when fully vested.
- Second, if observable market prices for identical or similar equity or liability instruments are *not* available, fair value should be estimated by applying a valuation technique to determine the amount at which instruments would be exchanged. The valuation technique should
  - Be applied in a manner consistent with the fair-value-based measurement objective
  - Be based on generally applied principles of financial economic theory
  - Reflect all substantive characteristics of the instrument not explicitly excluded under the fair-value-based method

  Market quotes are not available for long-term, nontransferable share options because such instruments are not traded. Valuation techniques are generally required to estimate the fair value of long-term employee options.

### ASC 718-10-55-10

The definition of fair value refers explicitly only to assets and liabilities, but the concept of value in a current exchange embodied in it applies equally to the equity instruments subject to this Topic. Observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, shall be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees. Determining whether an equity or liability instrument is similar is a matter of judgment, based on an analysis of the terms of the instrument and other relevant facts and circumstances. For example, awards to employees of a public entity of shares of its common stock, subject only to a service or performance condition for vesting (nonvested shares), shall be measured based on the market price of otherwise identical (that is, identical except for the vesting condition) common stock at the grant date.

### ASC 718-10-55-11

If observable market prices of identical or similar equity or liability instruments of the entity are not available, the fair value of equity and liability instruments awarded to employees shall be estimated by using a valuation technique that meets all of the following criteria:

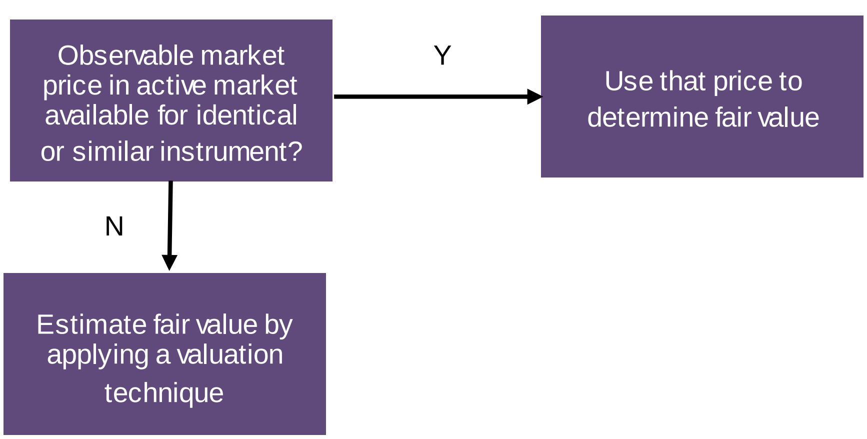
a. It is applied in a manner consistent with the fair value measurement objective and the other requirements of this Topic.

b. It is based on established principles of financial economic theory and generally applied in that field (see paragraph 718-10-55-16). Established principles of financial economic theory represent fundamental propositions that form the basis of modern corporate finance (for example, the time value of money and risk-neutral valuation).

c. It reflects all substantive characteristics of the instrument (except for those explicitly excluded by this Topic, such as vesting conditions and reload features).

That is, the fair values of equity and liability instruments granted in a share-based payment transaction shall be estimated by applying a valuation technique that would be used in determining an amount at which instruments with the same characteristics (except for those explicitly excluded by this Topic) would be exchanged.

**Figure 7. 1 – Fair value hierarchy**



## 7.4 Option valuation

The guidance in ASC 718 on option valuation applies to call options granted to employees, as well as to similar instruments. "Similar instruments" refer to other employee share-based payment awards that have "time value," which refers to the possibility that an instrument might increase in value over its remaining term due to the volatility of the underlying asset. The most common similar instrument is a share appreciation right (SAR). SARs have a time value component and must be accounted for at fair value, not intrinsic value, under ASC 718.

The guidance in this section on option valuation would therefore also apply to the valuation of SARs accounted for at fair value. The use of the term "option" in the remainder of this section refers to both options and similar instruments.

The best evidence of the fair value of employee share options is observable market prices of identical or similar instruments in an active market. However, market prices for employee share options or similar instruments are generally not available because most options are not traded, although ASC 718 notes that observable prices may become available in the future.

**ASC 718-10-30-7**

The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (see paragraph 718-10-55-10).

**ASC 718-10-30-8**

Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future.

**ASC 718-10-30-9**

As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not. Paragraphs 718-10-55-4 through 55-47 provide additional guidance on estimating the fair value of equity instruments, including the factors to be taken into account in estimating the fair value of equity share options or similar instruments as described in paragraphs 718-10-55-21 through 55-22.

### *Observable market price*

#### Market-traded instruments

In August 2005, the SEC Office of Economic Analysis (OEA) issued a memorandum on market-traded instruments that could provide a market-based measurement of the grant-date fair value of employee stock option awards. Market-traded instruments are rare, however, since entities have not generally developed them. According to the 2005 OEA memorandum, a "tracking instruments" design could meet the measurement objectives in ASC 718. Under that design, instruments sold in an open market would track the employees' returns or the issuer's obligations under a share-based payment arrangement.

Subsequently the SEC Chief Accountant released a statement indicating a level of comfort that “tracking instruments” should be possible to design.

The OEA memorandum states that a market-based instrument must incorporate the following three elements to provide a reasonable estimate of the grant-date fair value of an employee option:

- Appropriate *instrument design* that results in a market instrument that provides holders with net payments equal in value to the fair value of all or a portion of the employee option grant
- A credible *information plan* that provides market participants with entity-specific information needed to price the instruments
- A *market-pricing mechanism* for trading the instrument that encourages sufficient market participation to allow competition among willing buyers and sellers

In 2007, Zions Bancorporation held two auctions of instruments intended to measure employee share-based payments, correcting flaws in the instrument’s design and market-pricing mechanism between the first and second auction. For the second auction, which took place in May 2007, the entity analyzed the instrument’s design, the auction process, and bidder participation. It compared the auction price to the value of the entity’s options using a widely applied modeling technique. Zions Bancorp concluded that its instrument was appropriately designed, bidders were given adequate information about employees’ option exercise behavior, the auction process functioned appropriately, and the model-based assumptions implicit in the auction price were reasonable.

The SEC’s Office of the Chief Accountant issued a letter in October 2007 expressing the staff’s conclusion that Zions Bancorporation’s second auction of a tracking instrument meets the measurement objective of ASC 718. The auction price provided a reasonable estimate of the grant-date fair value of the employee options that the issuer granted concurrently with the sale of the market instruments. The Staff stated that because market-based approaches were in the development stage and no secondary market exists for these instruments to support the assumption that the clearing price is within a reasonable spread, the SEC staff said that it believes entities should benchmark the market-clearing price for these instruments. The SEC staff also advised that a substantial difference between the market price and the value derived from an option-pricing model may indicate deficiencies in the auction process that should be analyzed.

Further, the SEC staff stated that it would expect an entity to include a review that would address the following factors for any future auctions:

- If there are sufficient sophisticated bidders to constitute an active market
- Whether the bidders have sufficient information to value the investment and make an investment decision
- Whether the pattern of bidding consists of a reasonably low disparity between the lowest and highest bids among the winning bidders
- If bidders’ perceptions of material costs of holding, hedging, or trading the instrument substantially affect the valuation of the instrument

The SEC staff also indicated that Zions Bancorporation and its external auditor should evaluate the results of each auction based on an entity’s relevant facts and circumstances to ensure that the resulting price represents a reasonable estimate of fair value in accordance with ASC 718.

### Impact of ASC 815 on market-based instruments

Market-based instruments are not in the scope of ASC 718, and should be evaluated under ASC 480 and ASC 815-40 to determine whether the instruments would be classified as liabilities or as equity. Market-based instruments that require liability accounting under ASC 480 or ASC 815-40 are typically measured at fair value, with changes in fair value recognized in earnings.

Under ASC 815-40, instruments that are not indexed to the issuer's stock must be classified as liabilities. An instrument is indexed to the issuer's stock if it both (a) lacks a prohibited exercise contingency and (b) is settled at an amount equal to the difference between the fair value of a fixed number of shares and a fixed monetary amount, or is settled at a variable amount provided that the variability is due to inputs to a fixed-for-fixed option pricing model. Example 21 in ASC 815-40-55-48 illustrates a market-based instrument that fails the "fixed-for-fixed" test in ASC 815-40-15-7C because a key input to the instrument's settlement amount (actual employee stock option exercises for the period in Example 21) is not an input to the fair value of a fixed-for-fixed option or forward contract.

For instruments in the form of options, the SEC has a long-standing position that written options should be accounted for as liabilities at fair value, with changes in fair value recognized in earnings each reporting period.

### *No observable market price*

When an observable market price is not available, an entity should estimate the fair value of the option using a valuation technique described below.

## 7.5 Requirements for a valuation technique for options

Because market prices are generally not available for long-term, nontransferable employee share options, entities use a valuation technique to estimate the fair value of their employee options. The valuation technique should be one that they would use to determine the amount at which an option with substantially the same substantive characteristics (except those explicitly excluded from the fair value calculation by ASC 718) would be exchanged with a third party. In other words, the valuation model should be consistent with a model that marketplace participants would likely use to value the option. Judgment is required to identify an award's substantive characteristics and to select a valuation technique that incorporates those characteristics. For example, if an option contains a market condition (for instance, the award can be exercised if and when the share price reaches $20), the valuation technique must incorporate the market condition in the determination of fair value.

### 7.5.1 Consistent use of a valuation technique

Entities should consistently apply a valuation technique for a particular share-based payment instrument and should not change it unless a different valuation technique is expected to produce a better estimate of fair value. However, an entity that issues different types of instruments, each with a unique set of substantive characteristics, may use a different valuation technique for each type of instrument. A change in either the valuation method used, or in the method of determining assumptions used in the valuation technique, is a change in accounting estimate that will apply prospectively to new awards under ASC 250.

The SEC staff indicated in SAB Topic 14.C (ASC 718-10-S99-1), that it would not object if an entity changes its valuation technique or model, as long as the new technique or model meets the fair value measurement objective in ASC 718. The reason for the change would affect whether the new technique meets the fair value measurement objective. Changes in the model used from period to period for the sole purpose of lowering the options' fair value estimate would not meet the measurement objective in ASC 718.

A change in the valuation technique or model would not be considered a change in accounting principle and therefore would not require a preferability letter from the entity's independent accountants. The SEC staff would not, however, expect frequent changes in the valuation technique or model for a particular type of award, especially if the form of the share-based payment did not change significantly.

**ASC 718-10-55-20**

An entity shall change the valuation technique it uses to estimate fair value if it concludes that a different technique is likely to result in a better estimate of fair value (see paragraph 718-10-55-27). For example, an entity that uses a closed-form model might conclude, when information becomes available, that a lattice model or another valuation technique would provide a fair value estimate that better achieves the fair value measurement objective and, therefore, change the valuation technique it uses.

### 7.5.2 Comparison of a lattice model and a closed-form model

Valuation techniques for share options include option-pricing lattice models and closed-form models, such as the Black-Scholes-Merton model. A lattice option-pricing model, such as a binomial model, produces an estimated fair value of the option based on the assumed changes in the price of the underlying share over successive periods of time. To visualize how a binomial (or other lattice) model develops, imagine a decision tree on its side, developing from left to right instead of from top to bottom. At each new time period, each path of the decision tree (or lattice) branches into two new paths—one representing an upward movement in the share price and the other representing a downward movement in the share price. The point at which the tree (that is, the lattice) branches is referred to as a "node." The branches of the lattice are referred to as "paths" or, more precisely, "share-price paths." The lattice represents the evolution of the share's value and is used to calculate the value of the option.

The amount of the upward and downward price movements in an option-pricing lattice model is determined based on the expected volatility of the underlying share. Because the lattice represents the development of the option's value over discrete time periods during the option's term (say, monthly over a five-year term), the model can accommodate changes in the characteristics of the option that are expected to occur over time, such as changes in share- price volatility, expected dividends, and the risk-free interest rate. A lattice structure can also accommodate assumptions about employees' expected exercise and post-vesting termination behavior over the option's life, in contrast to the Black-Scholes-Merton option-pricing model, which uses only one weighted-average amount for each option characteristic.

Both the Black-Scholes-Merton model and the lattice model have been extensively validated in financial markets. They are used by valuation professionals, dealers of derivative instruments, and others to value options and similar instruments. Both models can be modified to account for the substantive characteristics of employee options and similar instruments, such as share appreciation rights. Monte Carlo simulation, a valuation technique that uses randomly generated values, can also be used to satisfy the measurement objective for instruments accounted for under ASC 718.

In working with its Option Valuation Group, comprised of valuation experts who advised the FASB while developing the guidance in ASC 718, the Board considered whether a closed-form or a lattice model would result in the best estimate of fair value for long-term employee options. A lattice model can be adapted to produce an estimated fair value based on assumed changes in the option's characteristics over successive periods of time. For example, instead of estimating fair value based on one input for the risk-free rate, the calculation could be performed using the term structure of the risk-free rate over the option's term.

Volatility and the option's term are the inputs in an option-pricing model that generally have the most significant impact on the resulting estimate of fair value. An entity can develop a lattice model that takes into account the historical exercise behavior of an entity's employees to derive the expected term of a new option. Based on historical experience (or academic studies or industry data if an entity does not have sufficient experience with past employee-option-exercise behavior), an entity could determine that the likelihood of employees exercising options early may increase as the intrinsic value of the options increases. The timing of employee exercise would also be influenced by the length of the options' vesting period. In addition, most employee options expire within a short period after an individual terminates employment; therefore, an employer's turnover experience can affect the expected option term. Analysis of the entity's data (or academic research or industry data, if necessary) on employees' exercise behavior can be used to develop rules about employees' expected exercise behavior when granting a new option. While a lattice model can be designed to use those rules to derive the options' expected term, a closed-form model cannot use such a dynamic process to determine the expected term because a single weighted-average expected life of the option has to be determined and used. In contrast, to the extent that information is available, lattice models can be modified to accommodate assumptions about how certain share characteristics—the share price volatility, the risk-free interest rate, and expected changes in dividends—are expected to change over time.

ASC 718 requires entities to select a valuation technique that best fits their circumstances and to estimate the fair value of the option that would be determined for an instrument with the same characteristics in an exchange transaction between market participants, other than characteristics that ASC 718 explicitly excludes from the fair value estimate. The FASB believes, however, that both lattice models and the Black-Scholes-Merton formula, as well as other valuation techniques, can provide a fair value estimate that meets the measurement objective in ASC 718-10-55-18.

The SEC staff stated in SAB Topic 14.C (ASC 718-10-S99-1) that it would not object to an entity using a valuation technique or model if it meets the following requirements in ASC 718:

- It must be applied in a manner consistent with the fair value measurement objective and other requirements in ASC 718.
- It must be based on principles of financial economic theory and generally be applied in that field.
- It must reflect all of the award's substantive characteristics.

For example, the staff does not expect an entity to use the lattice model simply because it is the most complex model. However, the staff observed that the Black-Scholes-Merton model would generally not be appropriate for valuing a share option that can only be exercised if a specified increase in the price of the underlying share is met because the Black-Scholes-Merton model is not designed to take into account that type of market condition, which is one of the award's substantive characteristics.

For some entities, the compensation cost recognized for employee awards under ASC 718 will be a significant expense. Those entities may want to evaluate the costs and benefits of using the more complex lattice models if sufficient, reliable information about employees' exercise and post-vesting termination behavior is available.

### ASC 718-10-55-16

A lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton formula) are among the valuation techniques that meet the criteria required by this Topic for estimating the fair values of employee share options and similar instruments. A Monte Carlo simulation technique is another type of valuation technique that satisfies the requirements in paragraph 718-10-55-11. Other valuation techniques not mentioned in this Topic also may satisfy the requirements in that paragraph. Those valuation techniques or models, sometimes referred to as option-pricing models, are based on established principles of financial economic theory. Those techniques are used by valuation professionals, dealers of derivative instruments, and others to estimate the fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities. Those techniques are used to establish trade prices for derivative instruments and to establish values in adjudications. As discussed in paragraphs 718-10-55-21 through 55-50, both lattice models and closed-form models can be adjusted to account for the substantive characteristics of share options and similar instruments granted to employees.

### ASC 718-10-55-17

This Topic does not specify a preference for a particular valuation technique or model in estimating the fair values of employee share options and similar instruments. Rather, this Topic requires the use of a valuation technique or model that meets the measurement objective in paragraph 718-10-30-6 and the requirements in paragraph 718-10-55-11. The selection of an appropriate valuation technique or model will depend on the substantive characteristics of the instrument being valued. Because an entity may grant different types of instruments, each with its own unique set of substantive characteristics, an entity may use a different valuation technique for each different type of instrument. The appropriate valuation technique or model selected to estimate the fair value of an instrument with a market condition must take into account the effect of that market condition. The designs of some techniques and models better reflect the substantive characteristics of a particular employee share option or similar instrument. Paragraphs 718-10-55-18 through 55-20 discuss certain factors that an entity should consider in selecting a valuation technique or model for its employee share options or similar instruments.

### ASC 718-10-55-18

The Black-Scholes-Merton formula assumes that option exercises occur at the end of an option's contractual term, and that expected volatility, expected dividends, and risk-free interest rates are constant over the option's term. If used to estimate the fair value of instruments in the scope of this Topic, the Black-Scholes-Merton formula must be adjusted to take account of certain characteristics of employee share options and similar instruments that are not consistent with the model's assumptions (for example, the ability to exercise before the end of the option's contractual term). Because of the nature of the formula, those adjustments take the form of weighted-average assumptions about those characteristics. In contrast, a lattice model can be designed to accommodate dynamic assumptions of expected volatility and dividends over the option's contractual term, and estimates of expected option exercise patterns during the option's contractual term, including the effect of blackout periods. Therefore, the design of a lattice model more fully reflects the substantive characteristics of a particular employee share option or similar instrument. Nevertheless, both a lattice model and the Black-Scholes-Merton formula, as well as other valuation techniques that meet the requirements in paragraph 718-10-

55-11, can provide a fair value estimate that is consistent with the measurement objective and fair-value-based method of this Topic.

## 7.6 Selecting assumptions for use in option-pricing models

Because a valuation process is used to determine an option's value in an exchange, the method of selecting each assumption should be consistent with the method that marketplace participants would likely use. Regardless of the valuation technique used, an entity is required to develop reasonable and supportable estimates for each assumption employed in an option-pricing model. "Supportable" means that the assumption is based on reasonable arguments that consider the instrument's substantive characteristics and other relevant facts and circumstances, such as historical experience.

**ASC 718-10-55-19**

Regardless of the valuation technique or model selected, an entity shall develop reasonable and supportable estimates for each assumption used in the model, including the employee share option or similar instrument's expected term, taking into account both the contractual term of the option and the effects of employees' expected exercise and post-vesting employment termination behavior. The term *supportable* is used in its general sense: capable of being maintained, confirmed, or made good; defensible. An application is supportable if it is based on reasonable arguments that consider the substantive characteristics of the instruments being valued and other relevant facts and circumstances.

Under ASC 718, a valuation technique used to estimate the fair value of an option must take into account the following characteristics, at a minimum:

- The option's exercise price
- The option's current share price
- The expected term of the option, considering both the contractual term and the effects of employees' expected exercise and post-vesting employment termination behavior
- The expected volatility of the underlying share price:
  - For the expected term of the option if the valuation technique is a closed-form model, such as the Black-Scholes-Merton model
  - For the contractual term of the option if the valuation method is a lattice or other model that derives the expected option term based on employees' expected exercise and post-vesting termination behavior
- The expected dividends on the underlying share over the expected (or contractual) term of the option
- The expected risk-free interest rate(s) for the expected (or contractual) term of the option

Those and other characteristics, such as market conditions, that are included in a fair value estimate should be based on information that is available at the time of measurement.

### ASC 718-10-55-21

If an observable market price is not available for a share option or similar instrument with the same or similar terms and conditions, an entity shall estimate the fair value of that instrument using a valuation technique or model that meets the requirements in paragraph 718-10-55-11 and takes into account, at a minimum, all of the following:

a. The exercise price of the option.

b. The expected term of the option, taking into account both the contractual term of the option and the effects of employees' expected exercise and postvesting employment termination behavior. In a closed-form model, the expected term is an assumption used in (or input to) the model, while in a lattice model, the expected term is an output of the model (see paragraphs 718-10-55-29 through 55-34, which provide further explanation of the expected term in the context of a lattice model).

c. The current price of the underlying share.

d. The expected volatility of the price of the underlying share for the expected term of the option.

e. The expected dividends on the underlying share for the expected term of the option (except as provided in paragraphs 718-10-55-44 through 55-45).

f. The risk-free interest rate(s) for the expected term of the option.

In addition, an entity is required to determine the amount for each assumption in a consistent manner from period to period, which means that an entity must establish a process for determining each input used in a valuation model and apply those processes consistently each period. For example, an entity should determine if the share price is based on the opening, average, or closing share price on the measurement date and then use the appropriate price whenever it values awards. The processes for determining how to estimate the option's expected term and expected volatility are much more involved. A change in the method of determining appropriate assumptions used in a valuation technique is a change in accounting estimate under ASC 250 and should be applied prospectively.

### ASC 718-10-55-27

Assumptions used to estimate the fair value of equity and liability instruments granted to employees shall be determined in a consistent manner from period to period. For example, an entity might use the closing share price or the share price at another specified time as the current share price on the grant date in estimating fair value, but whichever method is selected, it shall be used consistently. The valuation technique an entity selects to estimate fair value for a particular type of instrument also shall be used consistently and shall not be changed unless a different valuation technique is expected to produce a better estimate of fair value. A change in either the valuation technique or the method of determining appropriate assumptions used in a valuation technique is a change in accounting estimate for purposes of applying Topic 250, and shall be applied prospectively to new awards.

ASC 718 states that an entity's historical experience is generally the starting point for developing expectations about the future. However, information based on historical experience should be modified if available information indicates the future is reasonably expected to differ from past experience.

### ASC 718-10-55-24

Historical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience shall be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past. The appropriate weight to place on historical experience is a matter of judgment, based on relevant facts and circumstances. For example, an entity with two distinctly different lines of business of approximately equal size may dispose of the one that was significantly less volatile and generated more cash than the other. In that situation, the entity might place relatively little weight on volatility, dividends, and perhaps employees' exercise and post-vesting employment termination behavior from the predisposition (or disposition) period in developing reasonable expectations about the future. In contrast, an entity that has not undergone such a restructuring might place heavier weight on historical experience. That entity might conclude, based on its analysis of information available at the time of measurement, that its historical experience provides a reasonable estimate of expected volatility, dividends, and employees' exercise and post-vesting employment termination behavior. This guidance is not intended to suggest either that historical volatility is the only indicator of expected volatility or that an entity must identify a specific event in order to place less weight on historical experience. Expected volatility is an expectation of volatility over the expected term of an employee share option or similar instrument; that expectation shall consider all relevant factors in paragraph 718-10-55-37, including possible mean reversion. Paragraphs 718-10-55-35 through 55-41 provide further guidance on estimating expected volatility.

Therefore, when developing assumptions for a valuation model, an entity should consider how future results might differ from historical data. Other circumstances in which future results would be expected to differ from historical results might include a new product line or a new product that's key to the entity's business; significant changes in the entity's industry; changes in the life cycle of the entity; increased or decreased competition; or changes in demographics.

There is likely to be a range of reasonable estimates for an option's expected volatility, dividends, and / or expected term. If no amount within the range is more or less likely to occur than the other amounts, an entity should use an average of the amounts in the range, called the "expected value."

In a lattice model, assumptions generally are determined for a particular node or for multiple nodes during a particular time period. Application of assumptions to multiple time periods requires support.

### ASC 718-10-55-23

There is likely to be a range of reasonable estimates for expected volatility, dividends, and term of the option. If no amount within the range is more or less likely than any other amount, an average of the amounts in the range (the expected value) shall be used. In a lattice model, the assumptions used are to be determined for a particular node (or multiple nodes during a particular time period) of the lattice and not over multiple periods, unless such application is supportable.

### 7.6.1 Current share price

For many public entities, the current share price used in an option-pricing model is the closing share price on the award's measurement date. However, the share price could also be the opening or average share price on that date. An entity must decide if it will use the measurement-date opening, average, or closing share price to value its share-based awards and then use the appropriate price whenever it values awards. The use of the prior day's closing share price may be an acceptable method of determining the grant-date share price if that method is used consistently, that is, if the prior day's closing share price is always used as the grant-date share price.

#### *Estimating the fair value of nonpublic entities' shares*

Nonpublic entities face unique valuation issues in applying ASC 718 because, in most cases, observable market prices for their equity securities do not exist. As a result, when awarding an equity-classified share or option to an employee, nonpublic entities must typically calculate the fair value of their stock as of the award's grant date. The requisite expertise to determine the fair value of share-based payment awards should exist internally or entities should use the services of outside valuation professionals. The assessment of whether an employee has the requisite expertise depends on an entity's specific situation.

In many cases, a nonpublic entity has its stock appraised before granting a stock option or other share-based award. But the fair value of the award is not determined until the grant-date requirements in ASC 718 are met. The gap between the appraisal date and the accounting grant date may have unintended accounting consequences. For instance, a nonpublic entity may decide to grant at-the-money options and, as a result, values its stock as of January 1. Due to the time required to complete the appraisal and the various approval and other grant-date requirements under ASC 718, the accounting grant date might not occur until mid-February. Because the appraisal date differs from the grant date, the entity cannot assume that the appraisal price is the grant-date fair value without assessing whether certain events occurred (such as significant contracts, litigation, stock transactions, or a buyout offer) or other circumstances changed after the appraisal date that impacted the share price. Entities should consider consulting with valuation experts in these situations.

Some nonpublic entities issue share-based awards several times throughout the year and must therefore determine the fair value of their share-based awards on each grant date. Entities that frequently grant awards may either use a valuation model obtained from a valuation specialist for their particular situation or internally estimate the fair value of their stock in some other manner.

Some nonpublic entities assert that the use of a well-established industry formula is appropriate as a proxy or estimate of fair value. For example, an entity may establish sales prices using a multiple of five times net income before interest, income taxes, depreciation, and amortization, which is widely used in its industry or sector. An entity that asserts the use of the multiple is appropriate must support the underlying assertion that the multiple is a fair approximation of fair value. This determination requires judgment and an appropriate level of quantitative support.

**Grant Thornton insights: Using a model or formula**

We believe an entity should re-establish the validity of a model or formula used to calculate the fair value of its shares on each grant date to determine whether it still results in an appropriate estimate of fair value. This assessment requires an entity to evaluate entity milestones, industry developments, the competitive environment, the business environment, and other relevant factors. If the environment has changed, the entity should consider whether to consult with a valuation specialist to determine the impact of changes on the valuation. If an entity does not have an employee with the requisite valuation expertise, a valuation expert should generally be consulted periodically to redetermine the appropriate model or formula, even if the entity believes that its operations and business environment have remained relatively stable.

### 7.6.2 Risk-free interest rate

The risk-free interest rate assumption that a U.S. entity is required to use in valuing an option on its own shares depends, in part, on the type of valuation model the entity is using. If it is using a lattice model that incorporates the option's contractual term, the entity is required to use the implied yields from the U.S. Treasury zero-coupon yield curve over the contractual term of the option. If using a closed-form model, a U.S. entity is required to use the implied yield on a U.S. Treasury zero-coupon security with a remaining term equal to the expected term of the option used in the valuation model. A rate quoted in the financial press, such as *The Wall Street Journal*, is often an annual effective yield, while the rate used in the Black-Scholes-Merton formula is a continuously compounded rate. If the valuation model being used requires the continuously compounded rate as an input, an entity may convert the annual effective yield to the continuously compounded rate using an electronic spreadsheet to find the lognormal of 1 plus the annual effective yield or ln(1 + annual effective yield).

Entities based outside the United States should use the implied yield on zero-coupon government issues denominated in the currency of the market where the underlying share primarily trades. An appropriate substitute should be used if there is no zero-coupon government security or if its implied yield does not represent a risk-free interest rate.

**ASC 718-10-55-28**

Option-pricing models call for the risk-free interest rate as an assumption to take into account, among other things, the time value of money. A U.S. entity issuing an option on its own shares must use as the risk-free interest rates the implied yields currently available from the U.S. Treasury zero-coupon yield curve over the contractual term of the option if the entity is using a lattice model incorporating the option's contractual term. If the entity is using a closed-form model, the risk-free interest rate is the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term used as the assumption in the model. For entities based in jurisdictions outside the United States, the risk-free interest rate is the implied yield currently available on zero-coupon government issues denominated in the currency of the market in which the share (or underlying share), which is the basis for the instrument awarded, primarily trades. It may be necessary to use an appropriate substitute if no such government issues exist or if circumstances indicate that the implied yield on zero-coupon government issues is not representative of a risk-free interest rate.

### 7.6.3 Expected term

Although the fair value of traded options is based on the instrument's *contractual* term, entities are required to use the instrument's *expected* term to estimate the fair value of an employee share option because, unlike a traded instrument, an employee option is usually not transferable and is therefore often exercised before the end of its contractual term.

### ASC 718-10-55-29

The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable share options in that employees cannot sell (or hedge) their share options—they can only exercise them; because of this, employees generally exercise their options before the end of the options' contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the option's value because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value. In addition, some employee share options contain prohibitions on exercise during blackout periods. To reflect the effect of those restrictions (which may lead to exercise before the end of the option's contractual term) on employee options relative to transferable options, this Topic requires that the fair value of an employee share option or similar instrument be based on its expected term, rather than its contractual term (see paragraphs 718-10-55-5 and 718-10-55-21).

The "expected term" is the length of time employee options are expected to be outstanding before being exercised. ASC 718-10-55-30 defines "expected term" as the period from the service inception date (the first day of the award's requisite service period) to the date when the option is expected to be exercised or settled.

Because the option's expected term is generally shorter than its contractual life, using the expected term to value the option will result in a lower fair value. That reduction in value compensates for the fact that generally employees can neither transfer nor hedge their options. Therefore, a separate discount to the resulting fair value to reflect the employee's inability to transfer and / or hedge an option is not permitted, as the SEC staff explicitly states in SAB Topic 14.D.2 (codified in ASC 718-10-S99-1).

If an employee option is freely transferable, the contractual term, rather than the expected term, should be used in the valuation model, although this situation is rarely encountered.

In a Black-Scholes-Merton model, the expected term is a single estimated input. In contrast, in a lattice model designed to take into account employees' expected exercise and post-vesting termination behavior, the expected term is derived from the output of the lattice. Regardless of the type of valuation technique used to estimate fair value, the following requirements under ASC 718 apply:

- An option or similar instrument's expected term should be determined based on the instrument's contractual term and employees' expected exercise and post-vesting employment termination behavior, among other factors. The terms of employee options usually provide that if an employee terminates his or her employment, the remaining term of any unexercised vested options is shortened to a specified period, which is usually between 30 and 180 days. For that reason, employees' post-vesting terminations accelerate the exercise of the employees' vested options. Data about post-vesting turnover is, therefore, a significant factor in estimating an option's expected term. In contrast, pre-vesting employee terminations result in forfeiting the awards and are therefore not a factor in estimating the expected term.
- An entity is required to aggregate individual awards into relatively homogeneous groups based on employees' exercise and post-vesting termination behavior and to determine the expected term and fair value of each group based on expectations about employees' exercise behavior in that group.

### ASC 718-10-55-30

The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement). The expected term is an assumption in a closed-form model. However, if an entity uses a lattice model that has been modified to take into account an option's contractual term and employees' expected exercise and post-vesting employment termination behavior, the expected term is estimated based on the resulting output of the lattice. For example, an entity's experience might indicate that option holders tend to exercise their options when the share price reaches 200 percent of the exercise price. If so, that entity might use a lattice model that assumes exercise of the option at each node along each share price path in a lattice at which the early exercise expectation is met, provided that the option is vested and exercisable at that point. Moreover, such a model would assume exercise at the end of the contractual term on price paths along which the exercise expectation is not met but the options are in-the-money at the end of the contractual term. The terms *at-the-money*, *in-the-money*, and *out-of-the-money* are used to describe share options whose exercise price is equal to, less than, or greater than the market price of the underlying share, respectively. The valuation approach described recognizes that employees' exercise behavior is correlated with the price of the underlying share. Employees' expected post-vesting employment termination behavior also would be factored in. Expected term, which is a required disclosure (see paragraphs 718-10-50-2 through 50-2A), then could be estimated based on the output of the resulting lattice. An example of an acceptable method for purposes of financial statement disclosures of estimating the expected term based on the results of a lattice model is to use the lattice model's estimated fair value of a share option as an input to a closed-form model, and then to solve the closed-form model for the expected term. Other methods also are available to estimate expected term.

### *Identification of homogeneous groups*

The value of an option is not directly proportional to the option's expected term because the value increases at a decreasing rate as the option's term is extended. Using a weighted-average expected term for employees with different expected option exercise and termination behavior would therefore misstate the value of the entire award.

### ASC 718-10-55-33

Option value increases at a decreasing rate as the term lengthens (for most, if not all, options). For example, a two-year option is worth less than twice as much as a one-year option, other things equal. Accordingly, estimating the fair value of an option based on a single expected term that effectively averages the differing exercise and postvesting employment termination behaviors of identifiable groups of employees will potentially misstate the value of the entire award.

For that reason, ASC 718 requires entities to aggregate individual awards into relatively homogeneous employee groups based on the expected option term for the group, which is a function of the employee group's expected exercise patterns, including employees' post-vesting termination behavior.

Entities may use the following information to identify employee groups that are expected to exhibit different exercise patterns and therefore have different expected terms for their options:

- Historical data about employees' exercise behavior for previous awards, if sufficient information is available
- Academic research about the exercise patterns of different categories of employees
- Industry data as it becomes available

### Identification of homogeneous groups

An entity analyzes historical data about how its employees have exercised similar awards in the past and determines differing behaviors for three groups of employees as follows:

- Hourly employees tend to exercise options shortly after vesting if the options are in-the-money.
- Salaried employees exercise, on average, when the share price is 180 percent of the exercise price.
- Senior management tends to hold their options until close to the termination date before exercising them.

The entity determines that this behavior is expected to continue in the future for similar awards and therefore identifies three homogenous groups of employees, which results in significantly different expected terms for options held by each group.

The entity then estimates the expected term separately for each group, determining a weighted-average expected term for each group if using a Black-Scholes-Merton model or modeling the expected behavior for each group if using a lattice model. The fair value for each group is determined separately, utilizing the appropriate expected term assumption for the group if using the Black-Scholes-Merton model or the expected exercise behavior rules if using a lattice model.

In SAB Topic 14.D.2 (ASC 718-10-S99-1), the SEC staff stated that an entity may generally make a reasonable fair value estimate with as few as one or two groups of homogenous employees. Academic research suggests that two acceptable groups might comprise executives and nonexecutives.

### ASC 718-10-55-34

Aggregating individual awards into relatively homogeneous groups with respect to exercise and postvesting employment termination behaviors and estimating the fair value of the options granted to each group separately reduces such potential misstatement. An entity shall aggregate individual awards into relatively homogeneous groups with respect to exercise and postvesting employment termination behaviors regardless of the valuation technique or model used to estimate the fair value. For example, the historical experience of an employer that grants options broadly to all levels of employees might indicate that hourly employees tend to exercise for a smaller percentage gain than do salaried employees.

### *Implementation guidance for expected term*

The process an entity uses to estimate the expected term of employee options should be consistent with a method that would be used in an exchange transaction, that is, a method marketplace participants would likely use. The estimate should be reasonable and supportable, and should be determined in a consistent manner from period to period. The entity should document its process and establish controls to ensure that the process for determining the option's expected term is followed consistently in the future.

ASC 718 indicates that historical experience is generally the starting point for developing expectations about the future. The information derived from an analysis of historical experience should be modified to reflect how currently available information points to future results that may differ from past results. There is an expectation in ASC 718 that entities should consider whether data gathered about employees' historical exercise and post-vesting termination behavior for "similar" grants provides reasonable and supportable data for estimating an option's expected term. "Similar grants" are grants issued to employees that belong to the same homogeneous employee group, having similar vesting provisions and contractual terms of similar length, as well as other similar features, such as the relationship of the exercise price to the share price on the grant date.

An entity may calculate the period during which similar options have historically been outstanding by determining the historical weighted-average period of time during which previous share options remained outstanding, including both exercised options and unexercised options that expired. In analyzing employees' past exercise behavior, historical experience is relevant for grants whose contractual term has lapsed or for which all of the options have been exercised. Those grants are the only grants that provide complete data to determine the average period the awards were outstanding before being exercised. An entity must consider the unexercised awards when compiling data about exercise behavior if the grants being analyzed have outstanding unexercised awards.

An entity may not have sufficient relevant historical experience if:

- The entity has been a public entity for only a few years and does not have significant data on employee exercise behavior.
- The entity's stage of development has evolved.
- The nature of the entity's business has changed, for example, due to acquisitions or dispositions.
- A significant feature of the current options differs from that of previous grants, such as the contractual term has changed from 10 years to 5 years.
- Historical exercise behavior is limited to a period when the pattern of movement in the share price was atypical compared to long-term historical norms. For example, options might have been exercised only during a period of consistently rising share prices or during a long period in which the exercise price was above the share price so that it was not advantageous for employees to exercise their options.

**Grant Thornton insights: Data to support expected term**

If sufficient relevant historical experience on employee exercise behavior is available, organizing the data, extracting the pertinent information, and analyzing the results may be a time-consuming effort for many entities. However, once systems are developed for capturing the pertinent information, the task of updating the data on an ongoing basis is more routine.

In analyzing their employees' historical exercise behavior, entities should isolate options that are exercised around the time when an individual terminates employment or shortly thereafter if termination results in shortening the option's remaining term. Termination experience should be evaluated separately, as it has a distinct impact on when an employee exercises awards. An entity should consider termination behaviors in estimating the option's expected option term if a closed-form model is used. Termination experience should be modeled separately if a lattice model is being used.

Once an entity has developed historical information about employees' exercise and post-vesting termination behavior, it needs to consider the extent to which the historical information should be modified due to currently available information about how future behavior is expected to differ from historical behavior. For example, expected changes in the entity's stage of development, planned structural changes in the business, or changes in employee demographics might indicate that historical exercise behavior could understate or overstate expectations about an option's expected term in the future. ASC 718-10-55-24 states that entities should use judgment and consider all relevant facts and circumstances when determining how to weight historical experience when estimating an option's expected term.

Other factors that may affect expectations about employees' expected exercise behavior include

- *The length of the vesting period:* A longer vesting period usually results in a longer expected term for the option. The expected term can never be less than either the vesting period or the average expected term for options with graded vesting if the options vesting in different periods are valued using the same average expected term (for example, one-third vesting at the end of year one, one-third vesting at the end of year two, and one-third vesting at the end of year three). If an entity's historical experience is based on awards with one-year vesting, an adjustment would generally be necessary if current grants have a four-year vesting.

- *The expected volatility of the underlying share:* Options on shares with high volatility may have shorter expected terms than options on shares with low volatility for a number of reasons. First, employees might exercise their options when the intrinsic value reaches a certain percentage over the exercise price (say, 200 percent of the exercise price), and, second, the intrinsic value is likely to increase faster if the underlying shares are highly volatile. In addition, if shares are highly volatile, employees may exercise sooner to capture the option's intrinsic value before the share price begins to decline.

- *Applicable blackout periods and any arrangements employees have made related to blackout periods:* Blackout periods are periods of time when an employee is prohibited from exercising an option. If material, blackout periods can affect the expected term because either the awards cannot be exercised during those periods (or, therefore, suboptimal exercise behavior is affected) or because employees have programs in place to automatically exercise awards during blackout periods.

- *Employees' ages, length of service, and foreign vs domestic domicile:* These factors may affect the employees' expected exercise behavior.

**ASC 718-10-55-31**

Other factors that may affect expectations about employees' exercise and post-vesting employment termination behavior include the following:

a. The vesting period of the award. An option's expected term must at least include the vesting period. Under some share option arrangements, an option holder may exercise an option prior to vesting (usually to obtain a specific tax treatment); however, such arrangements generally require that any shares received upon exercise be returned to the entity (with or without a return of the exercise price to the holder) if the vesting conditions are not satisfied. Such an exercise is not substantive for accounting purposes.

b. Employees' historical exercise and post-vesting employment termination behavior for similar grants.

c. Expected volatility of the price of the underlying share. An entity also might consider whether the evolution of the share price affects an employee's exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time).

d. Blackout periods and other coexisting arrangements such as agreements that allow for exercise to automatically occur during blackout periods if certain conditions are satisfied.

e. Employees' ages, lengths of service, and home jurisdictions (that is, domestic or foreign).

If a range of possible expected terms exists for an award and none is more or less likely to occur than the other amounts, an entity should use the average of the amounts in the range, (the expected value).

Forfeiting an award or terms stemming from forfeiting awards should not be factored into the determination of an option's expected term. Under ASC 718, pre-vesting restrictions or similar terms are accounted for by recognizing compensation cost only for awards if employees render the requisite service.

If sufficient information is available about employees' expected exercise and post-vesting termination behavior, a lattice model could be designed to use the information to determine when exercise will occur on each share-price path.

**Grant Thornton insights: Designing a lattice model to use information on expected term**

If historical evidence indicates that options are exercised when the share price is 200 percent of the exercise price, an entity could modify a lattice model to include a rule that assumes exercise at the node on each share-price path where the early exercise expectation is first met, provided that the option is vested at that point. The model would assume exercise at the contractual term for price paths where the early exercise expectation is not met, provided that the options are in-the-money on that date. The entity would also modify the model to include a rule that assumes early exercise based on assumptions about employees' post-vesting termination behavior. The effect of the modeled rules on individual share paths will ultimately affect the option's value determined by the lattice model.

When using a lattice model, an entity may determine an award's expected term, which is a required disclosure, by using a Black-Scholes-Merton model, and then establish the option's value by using the lattice model as an input to the Black-Scholes-Merton model.

If an entity plans to use a closed-form model to estimate an option's value and to use employees' historical behavior to estimate the option's expected term, it should consider whether the historical periods include a variety of upward and downward share-price movements. If not, the entity may be able to use suboptimal exercise behavior based on the historical data to simulate the option's expected term using a lattice model with multiple share-price paths. The resulting expected term could be used as an input in the closed-form model.

If an entity determines its historical data on employee exercise behavior does not provide a reasonable basis on which to estimate an option's expected term, it should estimate the expected term in another manner, using relevant and supportable data, such as expected terms of similar options granted by similar entities, industry averages, and other pertinent evidence, including published academic research. Currently there is little information about employees' exercise behavior by industry.

### *SEC's simplified method for determining expected term*

The SEC staff acknowledges in SAB Topic 14.D.2 (ASC 718-10-S99-1) that an entity that concludes its historical experience does not provide a sufficient basis to estimate expected term has limited alternative sources for making the estimate. The staff therefore introduced a simplified method for computing the expected term that can be used only for "plain vanilla options."

"Plain vanilla options" are equity share options that have the following basic characteristics:

- They are granted at-the-money.
- Exercising the option is conditional only on performing service through the vesting date.
- Employees terminating service prior to vesting forfeit their options.
- Employees terminating service after vesting have a limited time to exercise their options (generally 30 to 90 days).
- The options are not transferable and cannot be hedged.

Under the simplified method, an option's expected term is the average of the vesting period and the original contractual term, as illustrated in the following example.

**SEC's simplified method for determining the expected term**

An option with a 10-year original contractual term and graded vesting over 4 years has an expected term of 6.25 years, which is calculated as follows: a 1-year vesting term for the first 25 percent vested, plus a 2-year vesting term for the second 25 percent vested, plus a 3-year vesting term for the third 25 percent vested, plus a 4-year vesting term for the last 25 percent vested, divided by 4 total years of vesting plus a 10-year contractual life, divided by 2; that is, [(1+2+3+4) ÷ 4] + 10 ÷ 2 = 6.25 years.

The simplified method is not a benchmark to evaluate the appropriateness of more refined estimates of expected term.

In 2007, the SEC staff amended Question 6 in SAB Topic 14.D.2 to permit public entities to use the simplified method only if their historical data on employees' exercise behavior does not provide a reasonable basis for estimating the expected term of the options. The SEC reasoned that after a period of time, public entities should be able to develop sufficient data to estimate an expected term rather than continue to use the simplified method for new awards. Therefore, entities with sufficient historical exercise data are therefore precluded from using the simplified method for shares granted after this amendment.

Some entities might question whether they have sufficient data on employees' exercise behavior. Question 6, as amended, provides the following examples of when an entity may lack sufficient historical option exercise data for estimating an option's expected term:

- An entity's shares have been publicly traded for only a limited time.
- An entity significantly changes the terms of its options or grants options to a different type of employee.
- An entity has experience, or expects to experience, significant structural changes in its business.

An entity may have sufficient historical exercise data for some of its share options but not for others. In these cases, the SEC staff will accept the use of the simplified method for only some, but not all, of the entity's shares, according to SAB Topic 14.D.2. The staff also notes that an entity does not need to consider using a lattice model before concluding that it is eligible to use the simplified method. In addition, the staff would not object if an entity applies the simplified method in periods before its shares are traded in a public market.

Entities using the simplified method should disclose the following information in their financial statements:

- The fact that they used the simplified method
- The reasons why they used the simplified method
- The types of options for which the simplified method was used, if not for all option grants
- The periods in which the simplified method was used, if not in all periods

The staff believes that, in the future, entities will have access to external information about employees' exercise behavior. When such information becomes widely available, the staff said that entities should no longer use the simplified method.

### *Accounting policy election for nonpublic entities to determine expected term*

Prior to the effective date of ASU 2016-09, some stakeholders questioned whether nonpublic entities could use the simplified method available to SEC registrants. At its meeting on September 13, 2005, the FASB's Statement 123R Resource Group reached a consensus indicating that nonpublic entities could also use the simplified method for estimating the expected term of plain vanilla options over the same periods that are permissible for public entities. Options granted by nonpublic entities may have repurchase features, which must be evaluated in determining whether the options meet the definition of plain vanilla options. The Statement 123R Resource Group discussed this issue and concluded that a fair value repurchase feature would likely meet the definition of plain vanilla, but that other features, such as certain book value repurchase features, would not.

As part of its improvements to share-based payment accounting in ASU 2016-09, the FASB amended the guidance in ASC 718 to allow nonpublic entities to make an entity-wide policy election to estimate the expected term for a share option or similar award that meets the following conditions:

- The award is granted at-the-money.
- The award can be exercised by the employee only for a limited time (typically 30 to 90 days) if the employee terminates service after vesting.
- The employee can only exercise, not sell or hedge, the award.
- The award does not include a market condition.

The following table illustrates the practical expedient for awards that meet the above conditions:

| Vesting dependent upon | |
|---|---|
| Service condition | Estimate expected term as the midpoint between the requisite service period and the contractual term of the award. |
| Performance condition that is probable of being achieved | Estimate the expected term as the midpoint between the requisite service period and the contractual term. |
| Performance condition that is not probable of being achieved | Estimate either the contractual term if the service period is implied (that is, the requisite service period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future) or the midpoint between the requisite service period and the contractual term if the requisite service period is stated explicitly. |

**ASC 718-10-30-20A (added by ASU 2016-09)**

For an award that meets the conditions in paragraph 718-10-30-20B, a nonpublic entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

a. If vesting is only dependent upon a service condition, a nonpublic entity shall estimate the expected term as the midpoint between the requisite service period and the contractual term of the award.

b. If vesting is dependent upon satisfying a performance condition, a nonpublic entity first would determine whether the performance condition is probable of being achieved.

  1. If the nonpublic entity concludes that the performance condition is probable of being achieved, the nonpublic entity shall estimate the expected term as the midpoint between the requisite service period (a nonpublic entity shall consider the guidance in paragraphs 718-10-55-69 through 55-79 when determining the requisite service period of the award) and the contractual term.

  2. If the nonpublic entity concludes that the performance condition is not probable of being achieved, the nonpublic entity shall estimate the expected term as either:

     i. The contractual term if the service period is implied (that is, the requisite service period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future)

ii. The midpoint between the requisite service period and the contractual term if the requisite service period is stated explicitly.

Paragraph 718-10-55-50A provides implementation guidance on the practical expedient.

**ASC 718-10-30-20B (added by ASU 2016-09)**

A nonpublic entity that elects to apply the practical expedient in paragraph 718-10-30-20A shall apply the practical expedient to a share option or similar award that has all of the following characteristics:

a. The share option or similar award is granted at the money.
b. The employee has only a limited time to exercise the award (typically 30–90 days) if the employee terminates service after vesting.
c. The employee can only exercise the award. The employee cannot sell or hedge the award.
d. The award does not include a market condition.

For liability-classified awards, an entity must update its estimate of the expected term each reporting period until the award is settled.

**ASC 718-10-55-50A (added by ASU 2016-09)**

In accordance with paragraph 718-10-30-20A, a nonpublic entity may elect a practical expedient to estimate the expected term. For liability-classified awards, an entity would update the estimate of the expected term each reporting period until settlement. The updated estimate should reflect the loss of time value associated with the award and any change in the assessment of whether a performance condition is probable of being achieved.

### 7.6.4 Expected volatility

Share-price volatility is a statistical measure of the amount an entity's share price has fluctuated, meaning upward and downward price movements) annually (historical volatility) or is expected to fluctuate annually (expected volatility).

**Volatility** is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

Entities are required to determine an expected volatility for employee awards that is equivalent to what marketplace participants would use in estimating an award's fair value. Expected volatility provides an estimate of the potential for the share price to increase over the life of the option. The expectation of an increasing share price is what gives value to an option. Therefore, an option on a share with a high volatility is worth more than an option on a share with lower volatility, all other things being equal.

Under ASC 718, a valuation technique used to estimate the fair value of an option must take into account the expected volatility of the price of the underlying share for the expected term of the option. However, if the valuation technique being used is a lattice model that has been adapted to include employees' expected exercise and post-vesting termination behavior, the valuation technique would take into account the expected volatility for the contractual term of the option.

**ASC 718-10-55-35**

As with other aspects of estimating fair value, the objective is to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option.

**ASC 718-10-55-36**

Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Because an option's value is unaffected by expected negative returns on the shares, other things equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility. This Topic does not specify a method of estimating expected volatility; rather, the following paragraph provides factors that shall be considered in estimating expected volatility. An entity's estimate of expected volatility shall be reasonable and supportable.

### *Developing a process to estimate expected volatility*

Entities are required to establish a process for estimating expected volatility that a market participant would likely use in determining the option's exchange price. Historical volatility is generally the starting point for developing expectations about future volatility. The volatility estimate must be "reasonable and supportable" under ASC 718. For example, an entity that considers how factors other than historical volatility could affect the volatility estimate would provide evidence that an estimate is reasonable.

An entity's process for estimating volatility should include identifying relevant information pertaining to the entity's share-price volatility. That process should include a procedure to review the period over which historical volatility data was gathered and to evaluate the extent to which current information indicates future volatility will differ from historical volatility, such as public announcements, future plans, and industry trends. The process should also specify how this information will be used in estimating expected volatility, including a procedure for evaluating and weighting the information.

If an entity determines it would be inappropriate to rely exclusively on historical volatility when estimating share-price volatility, it should consider all other available information. The SEC staff noted that there is no "magic formula" for assigning probabilities to available information that applies to an individual entity or an industry group. An entity's approach should be guided by the objective of determining the assumption that marketplace participants would likely use in an exchange.

The SEC staff identified two methods of computing historical volatility that are unsuitable for estimating expected volatility:

- A method that weighs the most recent periods of historical volatility much more heavily than earlier periods
- A method that uses the average of the daily high and low share prices to compute volatility

An entity should use the process it develops for estimating expected volatility consistently from period to period, incorporating new or different information that is useful in developing the estimate when it becomes available. A change in the estimation process should be accounted for under the guidance on accounting changes in ASC 250.

Factors to consider in estimating expected volatility are described below.

## Historical volatility

For many entities, determining the historical volatility of their share price, and the period over which to calculate historical volatility, will be the starting point in their process to estimate expected volatility. The guidance in ASC 718 states that the historical period should be the most recent historical period that is equal to the contractual term of the option if using a lattice model or to the expected term if using a closed-form model. The SEC staff observed, however, that a longer period may be used if an entity reasonably believes the additional historical information improves the estimate. An entity should have a reasonable basis for using an extended period of volatility data and should use the extended period consistently to the extent appropriate.

When calculating historical volatility, entities should use appropriate and regular intervals for price observations as follows:

- *Publicly traded entities:* ASC 718 indicates that publicly traded entities would likely use daily price observations in calculating their historical share-price volatility. The SEC staff observed in SAB Topic 14:D.1 (ASC 718-10-S99-1) that, to determine the appropriate frequency of price observations, an entity should consider how often its shares are traded and the length of its trading history. The staff considered daily, weekly, or monthly price observations a sufficient basis to estimate expected volatility if an entity's trading history provides enough data points for estimating share-price volatility. The minimum number of price observations (data points) needed to calculate historical volatility is not specified, but the SEC staff noted that if the expected (or the contractual) term is fewer than three years, monthly price observations would not be sufficient. The staff also noted that, if the expected (or contractual) term is fewer than two years, an entity should use daily or weekly prices for at least the length of the applicable term.
- *Thinly traded entities:* The SEC staff said that, for thinly traded shares, the use of weekly or monthly price observations would generally be more appropriate than daily price observations because the use of daily observations might cause volatility to be artificially inflated by large spreads between bid and ask prices and the lack of consistent trading.
- *Nonpublic entities:* Entities whose shares are not publicly traded but are exchanged occasionally at negotiated prices might use monthly price observations if there is sufficient historical data to provide a reasonable and supportable estimate.

If an entity changes the frequency of the price observations it uses to estimate volatility, for example, from daily observations to weekly or monthly observations, it should have a reasonable basis for the change.

In determining historical volatility, entities should consider the following factors:

- *Changes in volatility over the relevant period:* Changes in historical volatility may be identified by dividing the contractual or expected term into several segments of equal length and calculating the historical volatility for each segment. However, methods that more heavily weight recent periods than earlier periods may not be appropriate for longer-term options. SAB Topic 14.D.1 (ASC 718-10-S99-1) states that "[A] method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history."
- *A possible mean reversion tendency of the volatility:* After a period of unusually high volatility, volatility tends to return over time to a long-run average level. A mean reversion tendency may be evidenced in the segment volatility calculation described in the preceding bullet.

### Other factors to consider

In modifying historical volatility for current information that indicates future volatility may differ from historical volatility, an entity should

- Consider future events that marketplace participants would consider in estimating future volatility. For example, an entity should consider the impact of a merger that will change its future business risks in estimating expected volatility if it reasonably believes a marketplace participant would consider the merger's impact.
- Give little weight to historical information if the entity's operations have changed significantly in ways that are expected to impact share-price volatility. An example would be if riskier business segments have been added or disposed of.
- Disregard an identifiable period of time during which the share price was unusually volatile due to a situation that is not expected to recur during the option's expected or contractual term. For example, a period of extraordinary volatility in connection with a failed takeover bid that is not expected to recur should be disregarded.

  The SEC staff noted in SAB Topic 14.D.1 (ASC 718-10-S99-1) that a registrant should be able to support its conclusion that a previous period is irrelevant with one or more discrete and specific historical events that are not expected to recur during the option's expected term. The staff expects that such situations will be rare.
- Consider implied volatility if available. Implied volatility is an assumption inherent in the market prices of an entity's traded options or other financial instruments that have similar features, such as the conversion option in publicly traded convertible debt. Implied volatility is particularly useful in estimating expected volatility because it generally reflects both historical volatility and market participants' expectations of how future volatility will differ from historical volatility.

An entity should also consider the effect of its corporate and capital structure on expected volatility. Highly leveraged entities, for example, tend to have higher volatilities, all other things being equal.

The following factors should be considered by entities whose shares have not been publicly traded for a period that extends at least as long as the expected term (or contractual term if a lattice model is used) of the options being valued:

- *Public entities* whose shares have been trading for a period that is less than the option's expected or contractual term should use share prices for the longest period during which their shares have been publicly traded. The SEC staff noted in SAB Topic 14.D.1 (ASC 718-10-S99-1), however, that a minimum of two years of daily or weekly historical data may provide a reasonable basis on which to estimate expected volatility if an entity has no reason to believe that its future volatility will differ materially during the expected or contractual term from the historical volatility calculated from this past information.

- A *newly public entity* that does not have entity-specific historical or implied volatility information should base its estimate of expected volatility on the historical, expected, or implied volatility of similar entities whose share or exercise prices are publicly available. To identify similar entities, the entity should consider the industry, stage of life cycle, size, and financial leverage of similar entities. An entity that operates in multiple industries could identify a few similar entities in each industry, determine the weighted-average volatility for a group of entities from each industry, and then weight the volatilities of the various industry groups as appropriate based on its own operations.

  The SEC staff would not object to an entity using an industry sector index, such as the Nasdaq Computer Index, that represents the entity's industry, and possibly its size, to identify one or more similar entities. However, because the volatility of an industry sector index is affected by the inherent diversification in the index, entities should never substitute the volatility of an index for the expected volatility of its share price as an assumption in their valuation model.

  After identifying similar entities, an entity should continue to consider the volatilities of those entities, unless circumstances change and the identified entities are no longer similar to the entity. Until the entity has sufficient entity-specific information available, the SEC staff would not object to the registrant estimating its expected volatility based on the volatility of similar entities. As noted above, the staff believes at least two years of daily or weekly historical data would be needed to provide a reasonable basis for estimating expected volatility, but only if the entity has no reason to believe that future volatility will differ materially from its historical volatility to date.

- *Nonpublic entities* might estimate their expected volatility based on an average volatility calculated for similar public entities for an appropriate period after these entities went public. A discussion of how nonpublic entities estimate volatility, including use of the calculated value method, is provided under "Nonpublic entities that are unable to estimate volatility" (see below).

As discussed above, an entity may use peer group data on volatility in estimating its own volatility if, for example, the entity lacks sufficient historical data or its historical data needs adjustment, such as when operations have been changed or diversified. Depending on the situation, the volatility of peer entities may be used exclusively or blended with the entity's historical volatility estimation. An entity should use an appropriate peer group that is reasonably comparable to its own industry and operations and should have a reasonable basis for the extent to which it adjusts its historical data using the peer group volatility.

If an entity has a range of reasonable estimates for expected volatility and is using a closed-form valuation model to estimate volatility, it should choose the most likely estimate. However, if no estimate within the range is more or less likely to occur than the other estimates, the entity should calculate expected volatility as an average of the amounts in the range (the expected value). Lattice models can incorporate a "term structure," or range, of expected volatility rather than a single average volatility. A "term structure" is a range of expected volatilities. Incorporating a term structure of volatility requires judgment, including consideration of factors that were discussed above along with other relevant factors. If an entity is unable to develop a reasonable and supportable term structure of expected volatilities, it would use a single volatility input in the lattice model.

### Implied volatility

Entities should consider the implied volatility determined from their traded options or traded convertible debt, if any, in estimating the expected volatility of their share price. The SEC staff suggests that entities with actively traded options should take the following steps when assessing the extent to which they rely on implied volatility in estimating expected volatility:

- Consider the volume of trading in the underlying shares and traded options. Prices from active markets are more likely to reflect a marketplace participant's expectations about share-price volatility.
- To the extent possible, synchronize variables. For example, when computing implied volatility, measure the market price of the traded options and the market price of the underlying shares on the same date. That measurement should also be synchronized with the grant date of the employee options, or, if not reasonably practicable, an entity should derive implied volatility at a point in time as close to the option's grant date as is reasonably practicable.
- Use implied volatility derived from traded options that are at- or near-the-money in valuing an employee share option that is at-the-money. If it is not possible to find a traded option with the same or similar exercise prices, an entity should use multiple traded options with an average exercise price similar to the exercise price of its employee share options.
- Use the implied volatility of a traded option that has a term similar to the term of the employee option. If there are no traded options with terms similar to the option's contractual or expected term, the staff believes that entities should consider traded options with a remaining maturity of six months or greater. When using traded options with a term of less than one year, the entity is expected to consider other relevant information in estimating expected volatility. Generally, the staff expects entities to rely more heavily on the implied volatility derived from a traded option when the remaining term of the traded option most closely matches the expected (or contractual) term of an employee share option. However, the staff believes the implied volatility derived from a traded option with a term of one year or greater would not significantly differ from the implied volatility derived from a traded option with a significantly longer term.

### Exclusive reliance on historical or implied volatility in estimating expected volatility

In certain situations, the SEC staff indicated that an entity could reasonably conclude that relying exclusively on either historical or implied volatility to estimate expected volatility does, in fact, meet the stated objective of ASC 718 (see Section 2.1).

For instance, the staff would not object to an entity relying exclusively on historical volatility if the following criteria are met, provided the methodology is consistently applied:

- The entity has no reason to believe that the future volatility of its shares over the expected (or contractual) term is likely to differ from its past volatility.
- The computation of historical volatility is based on a simple average calculation.
- The entity uses a sequential period of historical data that is at least equal to the expected (or contractual) term of the share option.
- The entity uses a reasonably sufficient number of price observations, which are measured at consistent points throughout the historical period.

Stakeholders raised questions about how the unusually high share-price volatility experienced during the 2008-09 economic crisis should be considered in determining expected volatility. Although the discussion that follows took place in the context of that economic crisis, the concepts would seem to continue to be relevant, especially if similar volatility again arises in the markets.

The SEC staff indicated that an entity relying exclusively on historical volatility in estimating expected volatility should not exclude the effect of current market volatility in that estimate. This guidance is consistent with the guidance outlined in Question 4 in SAB Topic 14.D.1 (ASC 718-10-S99-1), which states that an entity is required to use a simple average calculation method to avoid the staff's objections to an entity relying exclusively on historical volatility when estimating expected volatility.

The staff said it would not object to an entity relying exclusively on *implied volatility* if the following criteria are met, provided the methodology is consistently applied:

- The entity uses a valuation model that is based on a constant volatility assumption.
- The implied volatility is derived from actively traded options.
- Market prices of both the traded options and underlying shares are measured at a similar point in time and on a date reasonably close to the option's grant date.
- The traded options have exercise prices that are both near-the-money and close to the exercise price of the employee share options.
- The remaining maturities of the traded options that are the basis for the estimate are at least one year.

The SEC staff indicated that an entity estimating expected volatility based on the implied volatility in other instruments should identify a reason, other than unusual activity in the current market (for example, the 2008-09 economic crisis), to justify a change from using implied volatility in its volatility estimate.

### *Guidance applicable to nonpublic entities*

The above discussion of methodologies for estimating expected volatility combines guidance from ASC 718 and SEC staff guidance from SAB Topic 14.D (ASC 718-10-S99-1). At its July 21, 2005 meeting, the Statement 123R Resource Group reached a consensus indicating that nonpublic entities should follow the relevant guidance on estimating expected volatility in both ASC 718 and SAB Topic 14.D. The group noted that ASC 718 does not specify which method a nonpublic entity should use to estimate expected volatility, but that SAB Topic 14.D provides guidance on when it would be appropriate for an entity to rely exclusively on historical volatility or implied volatility in making that estimate, which would apply to nonpublic entities as well. The group concluded that the method a nonpublic entity uses to estimate expected volatility will depend on the entity's specific facts and circumstances.

#### Nonpublic entities that are unable to estimate volatility

If it is not practicable for a nonpublic entity to estimate the expected volatility of its share price, ASC 718-10-30-20 requires the entity to estimate the value of its options and similar instruments using the calculated value method. Note that use of the calculated value method is not optional. It is used only if it is not practicable for an entity to estimate its share-price volatility.

**ASC 718-10-30-20**

A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). Throughout the remainder of this Topic, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value. Paragraphs 718-10-55-51 through 55-58 and Example 9 (see paragraph 718-20-55-76) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

ASC 718-10-55-55 specifically defines “not practicable” as being “unable to obtain sufficient historical information about past volatility, or other information such as that noted in paragraph 718-10-55-51, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award without undue cost and effort.”

Therefore, before using the calculated value method, a nonpublic entity must determine that it is not practicable to estimate its expected share-price volatility without undue cost and effort. To make that determination, both of the following conditions must apply:

- The nonpublic entity lacks sufficient historical information about its share-price volatility to estimate expected volatility.
- The nonpublic entity is unable to identify one or more similar entities, even after considering the similarity of entities that are components of appropriate industry sector indices.

As a result, use of the calculated value method to determine expected share-price volatility is expected to be rare.

**ASC 718-10-55-51**

Nonpublic entities may have sufficient information available on which to base a reasonable and supportable estimate of the expected volatility of their share prices. For example, a nonpublic entity that has an internal market for its shares, has private transactions in its shares, or issues new equity or convertible debt instruments may be able to consider the historical volatility, or implied volatility, of its share price in estimating expected volatility. Alternatively, a nonpublic entity that can identify similar public entities for which share or option price information is available may be able to consider the historical, expected, or implied volatility of those entities’ share prices in estimating expected volatility. Similarly this information may be used to estimate the fair value of its shares or to benchmark various aspects of its performance (see paragraph 718-10-55-25).

**ASC 718-10-55-52**

This Topic requires all entities to use the fair-value-based method to account for share-based payment arrangements that are classified as equity instruments. However, if it is not practicable for a nonpublic entity to estimate the expected volatility of its share price, paragraph 718-10-30-20 requires it to use the calculated value method. Alternatively, it may not be possible for a nonpublic entity to reasonably estimate the fair value of its equity share options and similar instruments at the date they are granted because the complexity of the award’s terms prevents it from doing so. In that case, paragraphs 718-10-30-21 through 30-22 require that the nonpublic entity account for its equity instruments at their intrinsic value, remeasured at each reporting date through the date of exercise or other settlement.

**ASC 718-10-55-53**

Relatively few small nonpublic entities offer share options to their employees, and those that do often are emerging entities that intend to make a future initial public offering. Many of those nonpublic entities that plan an initial public offering likely will be able to reasonably estimate the fair value of their equity share options and similar instruments using the guidance on selecting an appropriate expected volatility assumption provided in paragraphs 718-10-55-35 through 55-41.

**ASC 718-10-55-54**

Estimating the expected volatility of a nonpublic entity's shares may be difficult and the resulting estimated fair value may be more subjective than the estimated fair value of a public entity's options. However, many nonpublic entities could consider internal and industry factors likely to affect volatility, and the average volatility of comparable entities, to develop an estimate of expected volatility. Using an expected volatility estimate determined in that manner often would result in a reasonable estimate of fair value.

**ASC 718-10-55-55**

For purposes of this Topic, it is not practicable for a nonpublic entity to estimate the expected volatility of its share price if it is unable to obtain sufficient historical information about past volatility, or other information such as that noted in paragraph 718-10-55-51, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award without undue cost and effort. In that situation, this Topic requires a nonpublic entity to estimate a value for its equity share options and similar instruments by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price as an assumption in its valuation model. All other inputs to a nonpublic entity's valuation model shall be determined in accordance with the guidance in paragraphs 718-10-55-4 through 55-47.

**ASC 718-10-55-56**

There are many different indexes available to consider in selecting an appropriate industry sector index. For example, Dow Jones Indexes maintain a global series of stock market indexes with industry sector splits available for many countries, including the United States. The historical values of those indexes are easily obtainable from its website. An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and that also reflects, if possible, the size of the entity. If a nonpublic entity operates in a variety of different industry sectors, then it might select a number of different industry sector indexes and weight them according to the nature of its operations; alternatively, it might select an index for the industry sector that is most representative of its operations. If a nonpublic entity operates in an industry sector in which no public entities operate, then it shall select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000 because those indexes are sufficiently diversified as to be not representative of the industry sector, or sectors, in which the nonpublic entity operates.

**ASC 718-10-55-57**

A nonpublic entity shall use the selected index consistently, unless the nature of the entity's operations changes such that another industry sector index is more appropriate, in applying the calculated value method in both the following circumstances:

a. For all of its equity share options or similar instruments

b. In each accounting period.

**ASC 718-10-55-58**

The calculation of the historical volatility of an appropriate industry sector index shall be made using the daily historical closing values of the index selected for the period of time prior to the grant date (or service inception date) of the equity share option or similar instrument that is equal in length to the expected term of the equity share option or similar instrument. If daily values are not readily available, then an entity shall use the most frequent observations available of the historical closing values of the selected index. If historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity shall use the closing values for the longest period of time available. The method used shall be consistently applied (see paragraph 718-10-55-27). Example 9 (see paragraph 718-20-55-77) provides an illustration of accounting for an equity share option award granted by a nonpublic entity that uses the calculated value method.

Example 9 in ASC 718 illustrates how to account for an equity share employee award granted by a nonpublic entity that uses the calculated value method.

### Example 9: Share Award Granted by a Nonpublic Entity That Uses the Calculated Value Method

**ASC 718-20-55-76**

This Example illustrates the guidance in paragraph 718-10-30-20.

**ASC 718-20-55-77**

On January 1, 20X6, Entity W, a small nonpublic entity that develops, manufactures, and distributes medical equipment, grants 100 share options to each of its 100 employees. The share price at the grant date is $7. The options are granted at-the-money, cliff vest at the end of 3 years, and have a 10-year contractual term. Entity W estimates the expected term of the share options granted as 5 years and the risk-free rate as 3.75 percent. For simplicity, this Example assumes that no forfeitures occur during the vesting period and that no dividends are expected to be paid in the future, and this Example does not reflect the accounting for income tax consequences of the awards.

**ASC 718-20-55-78**

Entity W does not maintain an internal market for its shares, which are rarely traded privately. It has not issued any new equity or convertible debt instruments for several years and has been unable to identify any similar entities that are public. Entity W has determined that it is not practicable for it to estimate the expected volatility of its share price and, therefore, it is not possible for it to reasonably estimate the grant-date fair value of the share options. Accordingly, Entity W is required to apply the provisions of paragraph 718-10-30-20 in accounting for the share options under the calculated value method.

**ASC 718-20-55-79**

Entity W operates exclusively in the medical equipment industry. It visits the Dow Jones Indexes website and, using the Industry Classification Benchmark, reviews the various industry sector components of the Dow Jones U.S. Total Market Index. It identifies the medical equipment subsector, within the health care equipment and services sector, as the most appropriate industry sector in relation to its operations. It reviews the current components of the medical equipment index and notes that, based on the most recent assessment of its share price and its issued share capital, in terms of size it would rank among entities in the index with a small market capitalization (or small-cap entities). Entity W selects the small-cap version of the medical equipment index as an appropriate industry sector index because it considers that index to be representative of its size and the industry sector in which it operates. Entity W obtains the historical daily closing total return values of the selected index for the five years immediately before January 1, 20X6, from the Dow Jones Indexes website. It calculates the annualized historical volatility of those values to be 24 percent, based on 252 trading days per year.

**ASC 718-20-55-80**

Entity W uses the inputs that it has determined above in a Black-Scholes-Merton option-pricing formula, which produces a value of $2.05 per share option. This results in total compensation cost of $20,500 (10,000 × $2.05) to be accounted for over the requisite service period of 3 years.

**ASC 718-20-55-81**

For each of the 3 years ending December 31, 20X6, 20X7, and 20X8, Entity W will recognize compensation cost of $6,833 ($20,500 ÷ 3). The journal entry for each year is as follows.

| | | |
|---|---|---|
| Compensation cost | $ 6,833 | |
| Additional paid-in capital | | $ 6,833 |

To recognize compensation cost.

**ASC 718-20-55-82**

The share option award granted by a nonpublic entity that used the calculated value method is as follows.

**Share Option Award Granted by a Nonpublic Entity**
**That Uses the Calculated Value Method**

| Year | Total Calculated Value of Award | Pretax Cost for Year | Cumulative Pretax Cost |
|---|---|---|---|
| 20X6 | $20,500 (10,000 x $2.05) | $6,833 ($20,500 ÷ 3) | $ 6,833 |
| 20X7 | $20,500 (10,000 x $2.05) | $6,834 ($20,500 x 2/3 - $6,833) | $ 13,667 |
| 20X8 | $20,500 (10,000 x $2.05) | $6,833 ($20,500 - $13,667) | $ 20,500 |

**ASC 718-20-55-83**

Assuming that all 10,000 share options are exercised on the same day in 20Y2, the accounting for the option exercise will follow the same pattern as in Example 1, Case A (see paragraph 718-20-55-10) and will result in the following journal entry.

At exercise the journal entry is as follows.

| | | |
|---|---|---|
| Cash (10,000 x $7) | $70,000 | |
| Additional paid-in capital | $20,500 | |
| Common stock | | $90,500 |

To recognize the issuance of shares upon exercise of options and to reclassify previously recognized paid-in capital.

**Grant Thornton insights: Considerations for entities planning to go public**

An entity that is planning to go public should carefully evaluate whether determining the volatility of its share price is impracticable. The SEC staff stated in SAB Topic 14.B, "Transition from Nonpublic to Public Entity Status," which is codified in ASC 718-10-S99-1, that it "would expect an entity that becomes a public entity and had previously measured its share options under the calculated value method to be able to support its previous decision to use calculated value" and to disclose the reasons why it was not practicable for it to estimate the expected volatility of its share price, as required by ASC 718-10-50-2(f)(2)(ii). Use of the calculated value method implies, among other things, that the entity could not identify similar entities that had publicly traded shares, even after evaluating the public entities comprising an industry sector index that reflects the nonpublic entity's operations, which is how the SEC staff suggested identifying one or more similar entities.

### 7.6.5 Expected dividends

Valuation techniques require an assumption for dividends that are expected to be paid to holders of the underlying shares (expected dividends) over the option's term. Dividends are taken into account because dividend payments made to shareholders reduce the fair value of the underlying shares, and option holders generally do not receive dividends. Expected dividends used in the valuation model may be expressed as a dividend yield (a percentage of the share price) or a dividend amount.

Entities need to determine a reasonable, supportable estimate of expected dividends, meaning an estimate that is likely to be included in the valuation of an option used in a marketplace exchange. Entities should therefore develop and document a process for determining expected dividends and use that process consistently, unless new information becomes available. Current dividends would usually be the starting point, taking into consideration the entity's historical pattern of increasing (or decreasing) dividends and any other current information likely to affect future dividends.

An entity that has a pattern of regular, periodic increases in its dividend payments would incorporate that pattern into its expected dividend assumption. In that circumstance, using a fixed amount for an expected dividend equal to the entity's current dividend would not be a reasonable, supportable estimate or one that market participants would likely use in an exchange.

**ASC 718-10-55-42**

Option-pricing models generally call for expected dividend yield as an assumption. However, the models may be modified to use an expected dividend amount rather than a yield. An entity may use either its expected yield or its expected payments. Additionally, an entity's historical pattern of dividend increases (or decreases) shall be considered. For example, if an entity has historically increased dividends by approximately 3 percent per year, its estimated share option value shall not be based on a fixed dividend amount throughout the share option's expected term. As with other assumptions in an option-pricing model, an entity shall use the expected dividends that would likely be reflected in an amount at which the option would be exchanged (see paragraph 718-10-55-13).

**ASC 718-10-55-43**

As with other aspects of estimating fair value, the objective is to determine the assumption about expected dividends that would likely be used by marketplace participants in determining an exchange price for the option.

### *Options with dividend protection*

If an option is structured to protect option holders from dividend payments by reducing the option's exercise price to reflect dividend payouts, the expected dividend assumption used in estimating the option's fair value should be zero.

**ASC 718-10-55-44**

Expected dividends are taken into account in using an option-pricing model to estimate the fair value of a share option because dividends paid on the underlying shares reduce the fair value of those shares and option holders generally are not entitled to receive those dividends. However, an award of share options may be structured to protect option holders from that effect by providing them with some form of dividend rights. Such dividend protection may take a variety of forms and shall be appropriately reflected in estimating the fair value of a share option. For example, if a dividend paid on the underlying shares is applied to reduce the exercise price of the option, the effect of the dividend protection is appropriately reflected by using an expected dividend assumption of zero.

Entities sometimes pay employees dividends or dividend equivalents on the shares underlying their outstanding options. The grant-date fair value of option awards that include dividend payments on the underlying shares of the unexercised options should take into consideration both the fair value of options on dividend-paying shares as well as the fair value of a stream of dividend payments on the options until exercised. For example, the fair value of an award on the grant date might consist of two components: the estimated fair value of the options determined using a valuation technique that includes an assumption for the expected dividend payments and the present value of the estimated cash dividend payments over the options' expected term.

Dividends and dividend equivalents paid to employees on awards expected to vest should be charged to retained earnings. Dividends and dividend equivalents paid on awards that are not expected to vest should be recognized as compensation cost. To determine the amount of dividends that are not expected to vest, an entity should use the forfeiture rate it uses in estimating awards not expected to vest. If the forfeiture rate is subsequently adjusted, the entity should adjust the cumulative expense recognized for dividends paid to date in the period the forfeiture rate is changed. On the vesting date, the entity should adjust the cumulative cost of dividends charged to expense so that the amount equals the cumulative amount of dividends paid on awards actually forfeited during the vesting period. Dividends paid on vested, unexercised options should be charged to retained earnings.

If an entity's policy is to account for forfeitures when they occur in accordance with ASC 718-10-35-3, the entity should reclassify to compensation cost the amount of dividends and dividend equivalents that were previously charged to retained earnings relating to forfeited awards in the period when the forfeitures occur.

### ASC 718-10-55-45

In certain situations, employees may receive the dividends paid on the underlying equity shares while the option is outstanding. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost. If an entity's accounting policy is to estimate the number of awards expected to be forfeited in accordance with paragraph 718-10-35-3, the estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity's estimates of forfeitures. Dividends and dividend equivalents shall be reclassified between retained earnings and compensation cost in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates). If an entity's accounting policy is to account for forfeitures when they occur in accordance with paragraph 718-10-35-3, the entity shall reclassify to compensation cost in the period in which the forfeitures occur the amount of dividends and dividend equivalents previously charged to retained earnings relating to awards that are forfeited.

## 7.6.6 Credit risk

An entity may need to consider a credit-risk adjustment to an award with a cash settlement feature if the amount of the instrument's payoff increases as the price of the entity's shares decreases. The decrease in share price would likely indicate the entity's diminished ability to liquidate its liabilities.

### ASC 718-10-55-46

An entity may need to consider the effect of its credit risk on the estimated fair value of liability awards that contain cash settlement features because potential cash payoffs from the awards are not independent of the entity's risk of default. Any credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with increases in the price of the underlying share is expected to be de minimis because increases in an entity's share price generally are positively associated with its ability to liquidate its liabilities. However, a credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with decreases in the price of the entity's shares may be necessary because decreases in an entity's share price generally are negatively associated with an entity's ability to liquidate its liabilities.

### Applicable instruments

Instruments whose payoff increases as an entity's share price decreases include a put with a fixed exercise price and a share with an embedded put that has a fixed exercise price.

### 7.6.7 Dilution

According to ASC 718-10-55-50, entities need to consider whether the potential dilutive effect of employee options granted to employees should be reflected in estimating the options' fair value at the grant date.

For public entities, the FASB believes an adjustment for dilution would be rare.

Assuming the trading market is reasonably efficient, the potential dilutive effect of recurring awards of employee options, or options otherwise expected by the market, should be reflected in the share price. An exception might be a large, unexpected grant of options to employees for which the market does not expect a commensurate benefit.

For nonpublic entities, if investors who are involved in a negotiated exchange of an entity's shares lack sufficient data about the size and frequency of employee options, the dilutive effect of those options may not be reflected in share prices. Whether a nonpublic entity's fair value estimate of its employee options needs a separate adjustment may depend on how the options' fair value is determined in the valuation model. ASC 718 does not provide guidance on how to calculate an adjustment for dilution.

**ASC 718-10-55-48**

Traded options ordinarily are written by parties other than the entity that issues the underlying shares, and when exercised result in an exchange of already outstanding shares between those parties. In contrast, exercise of employee share options results in the issuance of new shares by the entity that wrote the option (the employer), which increases the number of shares outstanding. That dilution might reduce the fair value of the underlying shares, which in turn might reduce the benefit realized from option exercise.

**ASC 718-10-55-49**

If the market for an entity's shares is reasonably efficient, the effect of potential dilution from the exercise of employee share options will be reflected in the market price of the underlying shares, and no adjustment for potential dilution usually is needed in estimating the fair value of the employee share options. For a public entity, an exception might be a large grant of options that the market is not expecting, and also does not believe will result in commensurate benefit to the entity. For a nonpublic entity, on the other hand, potential dilution may not be fully reflected in the share price if sufficient information about the frequency and size of the entity's grants of equity share options is not available for third parties who may exchange the entity's shares to anticipate the dilutive effect.

### 7.6.8 Anticipated IPO and 'cheap stock'

An entity seeking to undertake an IPO should carefully consider its valuation and accounting for stock compensation arrangements, especially arrangements that require applying valuation techniques in periods near the anticipated IPO. In its reviews of IPO-related filings, the SEC staff frequently comments on stock compensation arrangements.

At the 2008 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed how the fair value of a share-based payment award classified as a liability should be estimated if an entity is in the process of going public. The awards are expected to increase in value when the IPO occurs. The staff indicated that, under the fair value measurement objective of ASC 718, the periodic remeasurement of the fair value of liability-classified awards should include the effects of significant contingencies that affect the value of the awards. The periodic remeasurements of the liability awards should therefore include the effect of the contingency related to the IPO, although the uncertainty that the IPO will occur would significantly reduce the value of that contingency in periods before the IPO takes place.

Entities anticipating an IPO should broadly consider the issue of "cheap stock." In simple terms, "cheap stock" means that an award granted before an IPO occurs might not reflect the appropriate fair value, or the typical increase in equity, that occurs as the IPO draws near. Considering "cheap stock" is especially important for entities that issue stock-based awards in the year or so before the IPO occurs. For example, assume that a private entity's equity has a fair value of $3 per share a year or two before its IPO and that the ultimate price when the IPO occurs is $10 per share. If the entity issues stock options eight months before the IPO occurs and determined that its equity had a fair value of $4 per share on the grant date, the question is whether $4 was the appropriate amount.

In 2013, the AICPA issued a Practice Aid, "Valuation of Privately-Held Company Equity Securities Issued as Compensation," which includes a discussion of valuation within the context of an anticipated IPO and is useful as entities account for stock compensation in IPO situations and well as other situations.

The SEC Division of Corporation Finance (CorpFin) staff addresses "Cheap Stock Issues" in its Financial Reporting Manual (FRM). In the FRM, the staff states that an entity should be able to reconcile the difference between the fair value of awards and their IPO price. In addition, the staff discusses share-based compensation within the context of the critical accounting estimates disclosed in a prospectus.

**SEC CorpFin Financial Reporting Manual**

**Section 7520 Valuation of Privately-Held-Company Equity Securities Issued as Compensation**

**7520.1**

In the evaluation of the assumptions used in and the results of applying an appropriate valuation methodology to estimate the fair value of the stock, the registrant should consider the proximity of the issuance to the offering, intervening events, transfer restrictions and exercise dates, and profitability and financial condition of the company at the date of the valuation. If the estimated fair value of the stock is substantially below the IPO price, the registrant should be able to reconcile the difference between them (for example, explain the events or factors that support the difference in values). The reliability of a valuation specialist's fair value determination may be affected by the timing of the valuation (contemporaneous versus retrospective) and the objectivity of the specialist (unrelated versus related-party).

**Section 9520 Share-based Compensation in IPOs** *(Last updated: 2/6/2014)*

**9520.1**

Estimates used to determine share-based compensation are often considered critical by companies going public. In particular, estimating the fair value of the underlying shares can be highly complex and subjective because the shares are not publicly traded. The staff will consider if a company performing these estimates is providing the following critical accounting estimate disclosures in its IPO prospectus:

a. The methods that management used to determine the fair value of the company's shares and the nature of the material assumptions involved. For example, companies using the income approach should disclose that this method involves estimating future cash flows and discounting those cash flows at an appropriate rate.

b. The extent to which the estimates are considered highly complex and subjective.

c. The estimates will not be necessary to determine the fair value of new awards once the underlying shares begin trading.

Companies may cross-reference to the extent that this, or other material information relevant to share-based compensation, is provided elsewhere in the prospectus.

**9520.2**

The staff may issue comments asking companies to explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO). These comments are intended to elicit analyses that the staff can review to assist it in confirming the appropriate accounting for the share-based compensation, not for the purpose of requesting changes to disclosure in the MD&A or elsewhere in the prospectus.

**9520.3**

The staff will also consider other MD&A requirements related to share-based compensation, including known trends or uncertainties including, but not limited to, the expected impact on operating results and taxes.

## 7.7 Nonrecourse loans: substance and valuation issues

Employers sometimes finance their employees' stock purchases or their exercised options. How these loans are structured, that is, whether they qualify as "recourse" or "nonrecourse" loans—has accounting consequences. If the employer has recourse only to the stock purchased, and not to the employee's other assets, the loan is considered to be "nonrecourse." In contrast, a "recourse" loan gives the employer the legal right to foreclose on the employee's other assets in the event of default. Significant judgment and analysis may be necessary to determine whether an arrangement is recourse or nonrecourse.

The purchase of stock through a nonrecourse loan is effectively the same as granting an option to buy stock. If stock is purchased or an option is exercised using a nonrecourse note and the value of the underlying shares subsequently decreases below the loan's amount, an employee can return the stock instead of repaying the loan. Put another way, the employee is in the same position as if the stock purchase or option exercise had never occurred.

Because a nonrecourse loan arrangement for purchasing stock or exercising options is, in substance, an option, an entity should account for the loan as an option and apply appropriate valuation techniques.

**ASC 718-10-25-3**

The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options.

A loan that is nonrecourse is not recorded on the balance sheet, and interest earned on the note is not recorded on the income statement, unless the interest portion of the loan is considered recourse. Instead, the exercise price of the option should include the nonrecourse principal and nonrecourse interest due on the loan. The terms of each nonrecourse loan arrangement must be considered to determine the resulting fair value, classification, and effects on earnings per share.

In contrast, purchasing shares or exercising of an option with a recourse loan is a substantive purchase or exercise. The guidance in ASC 718-10-25-3 does not explicitly address situations where a recourse note could be considered, in substance, a nonrecourse loan, nor does it address the accounting for a transaction involving an in-substance nonrecourse loan. ASC 718-10-25-4 provides that judgment is necessary in assessing "both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award."

The EITF addresses relevant facts and circumstances to consider in assessing whether a recourse loan is, in substance, a nonrecourse loan in Issue 34 of EITF Issue 00-23, "Issues related to the Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44." Under Issue 34, a loan that legally provides recourse should be considered a recourse loan, unless any one of the following conditions applies:

- The employer has legal recourse to the employee's other assets, but does not intend to seek repayment for more than the value of the shares issued.
- The employer has a history of not demanding repayment of loan amounts that exceed the fair value of the shares.
- The employee does not have sufficient assets or other means (beyond the shares) to justify the recourse nature of the loan.
- The employer has accepted a recourse note on exercise and subsequently has converted that note to a nonrecourse note.

**Grant Thornton insights: Applicability of EITF 00-23 regarding loans**

Although ASC 718 supersedes EITF Issue 00-23, we believe the facts and circumstances listed above are appropriate considerations for assessing whether a recourse note is a substantive nonrecourse loan under ASC 718.

Entities should carefully consider the terms of their loan arrangements when they are drafted, as well as potential regulatory issues, such as provisions of the Sarbanes-Oxley Act of 2002 with regard to loans made to certain executive and directors, or to individuals in equivalent positions.

# 8. Modifications

Events sometimes occur within an entity or its economic or regulatory environment that cause the entity to consider modifying outstanding share-based payment awards. Such events include, for example, an employee termination, a significant drop in the entity's share price, a change of control event, a stock split, a change in the tax law, and a change in the entity's regulatory requirements.

The evaluation begins with an understanding that any change in the terms or conditions of an award is a modification. Therefore, when a modification takes place, an entity must apply the accounting requirements for modifications as outlined in this section, unless the modification meets the scope exception in ASC 718-20-35-2A below.

## 8.1 Scope of the modification guidance and scope exception

A modification is a change in any terms or conditions of a share-based payment award. ASU 2017-09, *Scope of Modification Accounting*, (effective for all entities for periods beginning after December 15, 2017) introduced an exception to accounting for a modification. Entities must apply the accounting requirements to all modifications, except those that meet all of the following:

- The fair value, calculated value, or intrinsic value of the modified award is the same as the original award immediately before the modification.
- The vesting conditions of the modified award are the same as the original award immediately before the modification.
- The classification of the modified award is the same as the original award immediately before the modification.

Note that these criteria do not include consideration of changes to the amount of compensation cost or the timing of cost recognition. Therefore, in determining whether a change of award terms meets the exception for modification accounting, the entity ignores any impact on cost recognition. For example, when an entity changes the terms and conditions of an award that result in a Type IV modification (improbable to improbable) there is not a change in recognized compensation cost; however, the fair value (or calculated value or intrinsic value) might change and therefore, the entity must apply modification accounting.

A **modification** is a change in the terms or conditions of a share-based payment award.

### ASC 718-20-35-2A

An entity shall account for the effects of a modification as described in paragraphs 718-20-35-3 through 35-9, unless all the following are met:

a. The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification.

b. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified.

c. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified.

The disclosure requirements in paragraphs 718-10-50-1 through 50-2A and 718-10-50-4 apply regardless of whether an entity is required to apply modification accounting.

The Basis for Conclusions of ASU 2017-09 includes several examples of modification fact patterns. Figure 8.1 summarizes these examples, including when the changes result in the need to apply modification accounting and when the changes do not necessitate application of this guidance. This list is not intended to be inclusive of all potential modification fact patterns.

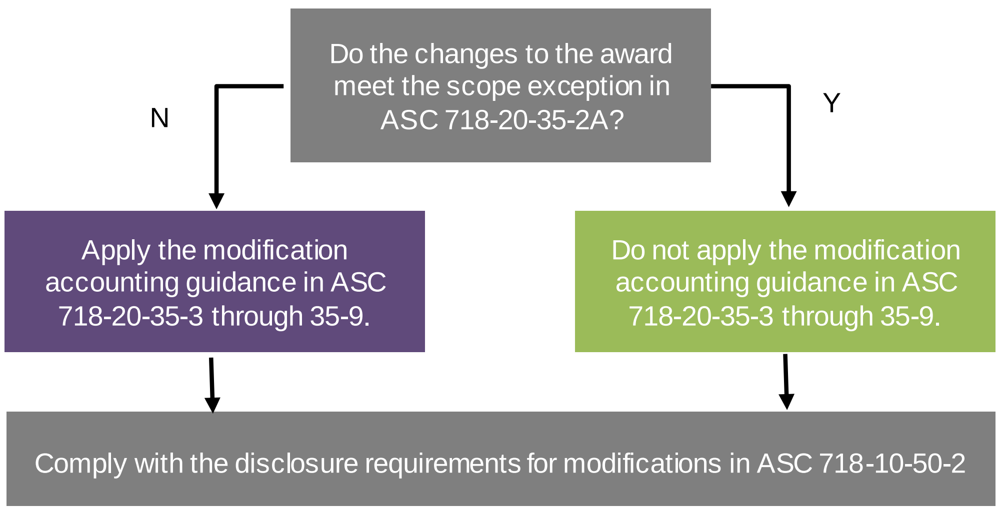
**Figure 8.1 – Common changes to share-based payment awards**

| Change | Requires modification accounting? |
|---|---|
| Change that is administrative in nature, such as a change to the entity's name, address, or plan name | No |
| Changes in an award's net settlement provisions related to tax withholdings that do not affect the classification of the award | No |
| Repricing of share options that results in a change in value of those share options | Yes |
| Changes in a service condition, performance condition, or market condition | Yes |
| Changes in an award that result in a reclassification of the award (equity to liability or vice versa) | Yes |
| Adding an involuntary termination provision in anticipation of a sale of a business unit that accelerates vesting of the award | Yes |
| Changes made solely to preserve the value of an award after an equity restructuring | Yes |
| Changes made as a result of newly effective amendments to the Codification or newly effective laws or regulations if those changes do not result in a change in the fair value, vesting conditions, or classification of the award. | Yes |

The Basis for Conclusions also notes that some stakeholders believed that changes to awards in response to Codification amendments or newly effective laws or regulations should also be excluded from modification accounting. The FASB did not agree and decided that entities with awards changed for those reasons should apply the criteria in ASC 718-20-35-2A to determine whether modification accounting is required. An example of a change stemming from Codification amendments is an entity that changes the terms of a revenue-based performance condition award after it determines the impact of adopting ASC 606, *Revenue from Contracts with Customers*. The entity's sole intention is that the changes will preserve the economics to the grantee before and after adoption. The entity's intention behind this change is irrelevant in the evaluation of whether modification accounting is required. Instead, the entity should apply the criteria in ASC 718-20-35-2A to make that determination.

Regardless of whether an entity concludes that a modification meets the scope exception in ASC 718-20-35-2A, the entity must provide the disclosures for modifications required by ASC 718-10-50-2.

**Figure 8.2 – When to provide disclosure requirements for modifications**




## 8.2 Modification accounting

If the terms or conditions of an equity award are modified and the scope exception in ASC 718-20-35-2A is not met, the modification is accounted for as the exchange of the original award for a new award.

The entity determines the fair value of the modified award on the modification date and compares the value to the fair value of the original award determined immediately before the modification occurs. If the fair value of the modified award exceeds the fair value of the original award immediately before its terms are modified, the excess is additional compensation cost. Total compensation cost is generally the sum of the grant-date fair value of the award plus the additional compensation cost resulting from the modification. The cost is recognized prospectively over the remaining requisite service period or, if the modified award is fully vested, the incremental compensation cost is recognized on the modification date.

### ASC 718-20-35-3

Except as described in paragraph 718-20-35-2A, a modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Topic over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 718-10-30-20, references to fair value throughout this Topic shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

   1. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date

   2. The incremental cost resulting from the modification.

   Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 718-20-35-1 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

### ASC 718-20-35-3A

An entity that has an accounting policy to account for forfeitures when they occur in accordance with paragraph 718-10-35-3 shall assess at the date of the modification whether the performance or service conditions of the original award are expected to be satisfied when measuring the effects of the modification in accordance with paragraph 718-20-35-3. However, the entity shall apply its accounting policy to account for forfeitures when they occur when subsequently accounting for the modified award.

Example 12, Case A, demonstrates the accounting for a modification of a vested share option.

### Example 12: Modifications and Settlements (excerpt)

**ASC 718-20-55-93**

The following Cases illustrate the accounting for modifications of the terms of an award (see paragraphs 718-20-35-3 through 35-4) and are based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5:

**Case A: Modification of Vested Share Options**

**ASC 718-20-55-94**

On January 1, 20X9, after the share options have vested, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the outstanding share options to $20. In effect, Entity T issues new share options with an exercise price of $20 and a contractual term equal to the remaining contractual term of the original January 1, 20X5, share options, which is 6 years, in exchange for the original vested share options. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange, measured as shown in the following paragraph. A nonpublic entity using the calculated value would compare the calculated value of the original award immediately before the modification with the calculated value of the modified award unless an entity has ceased to use the calculated value, in which case it would follow the guidance in paragraph 718-20-35-3(a) through (b) (calculating the effect of the modification based on the fair value). The modified share options are immediately vested, and the additional compensation cost is recognized in the period the modification occurs.

**ASC 718-20-55-95**

The January 1, 20X9, fair value of the modified award is $7.14. To determine the amount of additional compensation cost arising from the modification, the fair value of the original vested share options assumed to be repurchased is computed immediately before the modification. The resulting fair value at January 1, 20X9, of the original share options is $3.67 per share option, based on their remaining contractual term of 6 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 3.4 percent, expected volatility of 35 percent to 50 percent and a 1.0 percent expected dividend yield. The additional compensation cost stemming from the modification is $3.47 per share option, determined as follows.

| | | |
|---|---|---|
| Fair value of modified share option at January 1, 20X9 | $ | 7.14 |
| Less: Fair value of original share option at January 1, 20X9 | | 3.67 |
| Additional compensation cost to be recognized | $ | 3.47 |

**ASC 718-20-55-96**

Compensation cost already recognized during the vesting period of the original award is $10,981,157 for 747,526 vested share options (see paragraphs 718-20-55-14 through 55-17). For simplicity, it is assumed that no share options were exercised before the modification. Previously recognized compensation cost is not adjusted. Additional compensation cost of $2,593,915 (747,526 vested share options × $3.47) is recognized on January 1, 20X9, because the modified share options are fully vested; any income tax effects from the additional compensation cost are recognized accordingly.

Example 12, Case C demonstrates the accounting for a modification of an unvested share option.

**Example 12: Modifications and Settlements (excerpt)**

**ASC 718-20-55-93**

The following Cases illustrate the accounting for modifications of the terms of an award (see paragraphs 718-20-35-3 through 35-4) and are based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5:

**Case C: Modification of Nonvested Share Options**

**ASC 718-20-55-98**

On January 1, 20X6, 1 year into the 3-year vesting period, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the share options to $20. The three-year cliff-vesting requirement is not changed. In effect, in exchange for the original nonvested share options, Entity T grants new share options with an exercise price of $20 and a contractual term equal to the 9-year remaining contractual term of the original share options granted on January 1, 20X5. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange determined in the manner described in paragraphs 718-20-55-95 through 55-96. Entity T adds that additional compensation cost to the remaining unrecognized compensation cost for the original share options at the date of modification and recognizes the total amount ratably over the remaining two years of the three-year vesting period. Because the original vesting provision is not changed, the modification has an explicit service period of two years, which represents the requisite service period as well. Thus, incremental compensation cost resulting from the modification would be recognized ratably over the remaining two years rather than in some other pattern.

**ASC 718-20-55-99**

The January 1, 20X6, fair value of the modified award is $8.59 per share option, based on its contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $20 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. The fair value of the original award immediately before the modification is $5.36 per share option, based on its remaining contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. Thus, the additional compensation cost stemming from the modification is $3.23 per share option, determined as follows.

| | |
|---|---|
| Fair value of modified share option at January 1, 20X6 | $ 8.59 |
| Less: Fair value of original share option at January 1, 20X6 | 5.36 |
| Incremental value of modified share option at January 1, 20X6 | $ 3.23 |

**ASC 718-20-55-100**

On January 1, 20X6, the remaining balance of unrecognized compensation cost for the original share options is $9.79 per share option. Using a value of $14.69 for the original option as noted in paragraph 718-20-55-9 results in recognition of $4.90 ($14.69 ÷ 3) per year. The unrecognized balance at January 1, 20X6, is $9.79 ($14.69 – $4.90) per option. The total compensation cost for each modified share option that is expected to vest is $13.02, determined as follows.

| | |
|---|---|
| Incremental value of modified share option | $ 3.23 |
| Unrecognized compensation cost for original share option | 9.79 |
| Total compensation cost to be recognized | $ 13.02 |

**ASC 718-20-55-101**

That amount is recognized during 20X6 and 20X7, the two remaining years of the requisite service period.

## 8.3 When compensation cost is less than the fair value of the award at its original grant date

In accounting for a modification, total compensation cost for the award should generally not be less than the award's original fair value. Therefore, if the fair value of the modified award is less than the fair value of the original award on the modification date, the grant date fair value is not reduced. Total compensation cost is the award's grant date fair value.

There is one exception to the general rule that total compensation cost cannot be less than the grant-date fair value of the award as discussed above in ASC 718-20-35-3(b): if the performance or service conditions of the original award are not expected to be satisfied as of the modification date. In that situation, total compensation expense at the modification date consists of the sum of the following:

- The portion of the grant-date fair value of the original award for which requisite service is expected to be rendered (or has been rendered) as of the modification date. (This amount would be zero if it was probable at the modification date that the performance condition in the original award would not be achieved as illustrated below).
- The incremental cost resulting from the modification

An example of this exception is as follows.

**When compensation cost is less than the fair value of the award at its original grant date**

An employee has a sales target to sell 100,000 units in three years to vest in an award. The grant-date fair value is $600,000, and at the grant date the entity determines the sales target is probable of achievement. At the end of year 1, the sales target is not expected to be achieved because of unanticipated competition, and the cumulative cost recognized to date is reduced to $0. At the end of year 2, the sales target required for vesting is reduced to 80,000 units. The entity determines the modified sales target is probable of achievement.

The fair value of the modified award is $400,000.

| Total cost after modification | | |
|---|---|---|
| Fair value of the original award expected to be recognized as of the modification date | | $ 0 |
| Additional cost resulting from modification: | | |
| Fair value of the modified award | $400,000 | |
| Less fair value of the original award expected to be recognized as of the modification date | 0 | |
| | | $400,000 |
| Total cost if service and performance conditions are met | | $400,000 |

## 8.4 Short-term and long-term inducements

The accounting differs for short-term and long-term inducements, and modification accounting applies to both. With short-term inducements, only those awards of employees who accept the offer are subject to modification accounting, while modification accounting applies to all awards involved with a long-term inducement offer.

Inducements include offers to settle awards and offers to reset exercise prices, among other changes to the terms of the awards. The underlying concept is that the grantor is giving the grantees a choice to accept or decline to participate. This more often exists when the number of awardees is relatively large, but could exist with small numbers of awardees.

One important issue is evaluating whether an inducement is short-term or long-term because of the differing treatment as described below.

### 8.4.1 Short-term inducements

A short-term inducement results in modification accounting being applied only to those awards of employees who accept the inducement.

A **short-term inducement** is an offer by the entity that would result in modification of an award to which an award holder may subscribe for a limited period of time.

**Short-term inducement**

To raise capital, an entity offers employees an inducement in the form of a 25 percent reduction of the exercise price of their vested options, but only for options exercised during the subsequent 30 days. The excess of the fair value of the options with the reduced exercise price over the fair value of the original options on the modification date is recognized as additional compensation cost for the number of options exercised during the 30-day period.

As discussed in ASC 718-20-35-5, a short-term inducement is accounted for as a modification as of the employee acceptance date, and only for the employees that accept the inducement offer. That said, an employer that establishes a history or pattern of cash-setting awards through recurring inducements should consider whether its awards are substantive liabilities as discussed in Section 3.2.5.

**ASC 718-20-35-5**

Except as described in paragraph 718-20-35-2A, a short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement, and other inducements shall be accounted for as modifications of the terms of all awards subject to them.

An entity accounts for long-term inducements by applying modification accounting to all outstanding awards on the offer date, regardless which employees accept the inducement offer.

**Grant Thornton insights: What is a ‘limited period of time’**

ASC 718 does not provide guidance as to how long a “limited period of time” may be. Judgment is required to evaluate whether an inducement results in modification for only those employees accepting the inducement or broadly for outstanding awards.

In practice, periods of a few weeks are viewed as limited. At most, a few months could be viewed as a limited period, however, this is not commonplace. We believe that the facts and circumstances of an entity and its awards is relevant to the evaluation, including securities laws. For example, an entity that made awards to only a few employees, such as senior executives, would have a relatively short “limited period of time”, because those individuals are able to act quickly to accept or decline the offer. On the other hand, an entity with a large amount of outstanding awards to employees in multiple countries might have a somewhat longer period in order to ensure completeness of communication and compliance with local laws and regulations.

## 8.5 Equity restructuring

The ASC Master Glossary defines an “equity restructuring” as “a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.” If an entity has a 2-for-1 stock split or a spinoff and the exercise price and / or number of shares underlying its options is not adjusted, the options’ value would be significantly diluted. For that reason, awards of options or similar instruments (such as stock appreciation rights) frequently include antidilution provisions designed to equalize the value of those instruments before and after an equity restructuring. Typically, the exercise price or number of shares, or both, are adjusted in accordance with the antidilution provisions in the award, and some equity restructurings also involve the payment of cash as part of achieving equalized value.

Entities often undertake equity restructurings in the context of entity growth and in anticipation of significant capital transactions, such as an IPO. Therefore, entities should keep in mind that whereas properly structured antidilution provisions may lead to no financial statement impact, improperly structured (or absent) antidilution provisions may lead to substantial income statement charges when awards are modified as part of an equity restructuring.

A **equity restructuring** is a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

The guidance in ASC 718-20-35-6 states that changes related to awards due to an equity restructuring are modifications.

**ASC 718-20-35-6 (excerpt)**

Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this Subtopic. An entity shall apply the guidance in paragraph 718-20-35-2A to those exchanges or changes to determine whether it shall account for the effects of those modifications. Example 13 (see paragraph 718-20-55-103) provides further guidance on applying the provisions of this paragraph. …

### 8.5.1 Antidilution provisions

The impact of antidilution provisions can be significant and issues arise frequently in practice, especially when entities add antidilution provisions to existing awards. After the implementation of the guidance in ASU 2017-09, entities that add antidilution provisions to their stock based compensation awards begin their analysis in the same manner used for other modifications. That is, apply ASC 718-20-35-2A and its three criteria (see Section 8.1) to determine whether modification accounting is required.

This is a change from previous guidance in that ASC 718-20-35-6 had provided an exception that modification accounting was not required if an award was modified to add an antidilution provision and that modification was not made in contemplation of an equity restructuring. In ASU 2017-09, the FASB removed this explicit exception and replaced it with a requirement to apply ASC 718-20-35-2A to determine whether modification accounting applies.

In applying the first criterion of ASC 718-20-35-2A, if an award is modified to add an antidilution provision when there is no contemplated equity restructuring, the award's fair value might not change before and after the provision is added because the market is not anticipating an increase. Thus, the first criterion in ASC 718-10-35-2A may be met and modification accounting would not apply.

On the other hand, when an equity restructuring is anticipated at the time an antidilution provision is added, the market would place more value on the modified award than on the award before modification. This would more likely result in a fair value change and lead to the application of overall modification accounting. In this case, the entity is required to recognize any incremental fair value resulting from the modification over the award's remaining vesting period or immediately if the award is fully vested.

**Grant Thornton insights: When to consider antidilution provisions**

We believe that the time to address the issue of antidilution is when an award plan document or individual award agreement is drafted. This way, entities can consider what potential future events might occur and appropriately plan for them by including a variety of terms and conditions, including the potential for an equity restructuring. While, in practice, most awards have antidilution provisions, enough of them do not such that issues surface when an equity restructuring arises.

### 8.5.2 Applying modification accounting due to an equity restructuring

The specific wording of an equity restructuring provision is important. Again, the analysis begins with the application of ASC 718-20-35-2A to determine whether modification accounting applies.

The written terms of an award often provide one or two types of discretion with regard to an equity restructuring. The first type presents certain issues. An award might state, for example, that the entity, its board of directors, or its compensation committee has discretion in determining *whether* to adjust the award. In this case, marketplace participants would not know whether the award would be adjusted for the equity restructuring. As a result, discretion whether to apply an antidilution provision would lead to a change in fair value and failure to meet the first criterion of ASC 718-20-35-2A. A legal opinion may be necessary in some situations to determine if the wording of a particular discretionary antidilution provision requires that the terms of the awards be equitably adjusted.

The second type of discretion relates to *how* a required modification to award terms in an equity restructuring may be structured. The distinction from the first type is that in this case, the entity is required to adjust the awards, but simply has discretion as to how to achieve the equitable adjustment. For example, the entity may use this type of discretion to equalize the fair value of the awards solely by reducing option exercise prices, or through a mix of an option exercise price reduction and the award of additional options. As long as the award requires adjustment and the "how" discretion is properly applied, this form of discretion generally does not require modification accounting.

The below examples evaluate how to account for antidilution provisions, specifically when

- The original award contains an antidilution provision (Case A)
- The original award does not contain an antidilution provision (Case B)
- The original award does not contain an antidilution provision but is modified on the date of equity restructuring (Case C).

As discussed above, when an award contains an antidilution provision that is designed to maintain the value of an award and there is an announcement of a future equity structuring, the first criterion of ASC 718-20-35-2A normally is met. That is, the fair value of the award pre-and postmodification will usually be the same because the market participant would have anticipated the change.

### Example 13: Modifications Due to an Equity Restructuring (excerpts)

**Case A: Original Award Contains Antidilution Provisions**

**ASC 718-20-55-104**

In this Case, assume an award contains antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On October 12 the equity restructuring occurs and the terms of the award are modified in accordance with the antidilution provisions. In this Case, the modification occurs on October 12 when the terms of the award are changed. The fair value of the award is compared pre- and postmodification on October 12. The calculation of fair value is necessary to determine whether there is any incremental value transferred as a result of the modification, and if so, that incremental value would be recognized as additional compensation cost. If there is no change in fair value, vesting conditions, or the classification of the award, the entity would not account for the effect of the modification (see paragraph 718-20-35-2A).

In Case B below, the original award does not contain an antidilution provision. The entity announces a future equity restructuring, and approximately three months later, the terms of the award are modified to add the antidilution provision. This example has two modifications: when the terms are modified and again when the awards are changed in accordance with those terms.

When the award is modified to add the antidilution provision, the entity must compare the fair value of the award pre- and postmodification in accordance with ASC 718-20-35-2A to determine whether the entity should account for the effects of the modifications. The premodification fair value is based on the award without antidilution provisions taking into account the effect of the contemplated restructuring on its value. The postmodification fair value is based on an award with antidilution provisions, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation cost.

Once the equity restructuring occurs, there is a second modification event when the terms of the award are changed in accordance with the antidilution provisions. A second comparison of pre- and postmodification fair values is then required to determine whether the fair value of the award has changed as a result of the modification.

### Example 13: Modifications Due to an Equity Restructuring (excerpts)

**Case B: Original Award Does Not Contain Antidilution Provisions**

**ASC 718-20-55-105**

In this Case, the original award does not contain antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On July 26 the terms of an award are modified to add antidilution provisions in contemplation of an equity restructuring. On September 30 the equity restructuring occurs. In this Case, there are two modifications to account for. The first modification occurs on July 26, when the terms of the award are changed to add antidilution provisions. There must be a comparison of the fair value of the award pre- and postmodification on July 26 in accordance with paragraph 718-20-35-2A to determine whether the entity should account for the effects of the modifications as described in paragraphs 718-20-35-3 through 35-9. The premodification fair value on

July 26 is based on the award without antidilution provisions taking into account the effect of the contemplated restructuring on its value. The postmodification fair value is based on an award with antidilution provisions, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation cost. Once the equity restructuring occurs, there is a second modification event on September 30 when the terms of the award are changed in accordance with the antidilution provisions. A second comparison of pre- and postmodification fair values is then required to determine whether the fair value of the award has changed as a result of the modification. If there is no change in fair value, vesting conditions, or the classification of the award, the entity would not account for the effect of the modification on September 30 (see paragraph 718-20-35-2A). Changes to the terms of an award in accordance with its antidilution provisions typically would not result in additional compensation cost if the antidilution provisions were properly structured. If there is a change in fair value, vesting conditions, or the classification of the award, the incremental value transferred, if any, would be recognized as additional compensation cost.

Unlike Case B, in Case C below, the antidilution provision is added the same day as the equity restructuring and therefore, there is only one modification to assess. In this case, the entity must compare the pre- and postmodification fair value to determine whether to account for the modification, that is, recognize any incremental compensation cost.

**Example 13: Modifications Due to an Equity Restructuring (excerpts)**

**Case C: Original Award Does Not Contain an Antidilution Provision but Is Modified on the Date of Equity Restructuring**

**ASC 718-20-55-106**

Assume the same facts as in Case B except the terms of the awards are modified on the date of the equity restructuring, September 30. In contrast to Case B in which there are two separate modifications, there is one modification that occurs on September 30 and the fair value is compared pre- and postmodification to determine whether any incremental value is transferred as a result of the modification. Any incremental value transferred would be recognized as additional compensation cost.

## 8.6 Repurchases and settlements

When an entity establishes a pattern of cash-settling equity awards, this calls into question the substantive terms of the award and may indicate that the award provides for cash settlement which would require liability classification. (see Section 3.2.4)

That said, settlement accounting applies when an entity repurchases a share-based award. A "settlement" is an action or event that irrevocably extinguishes the issuing entity's obligation under a share-based payment award. If an entity settles an award by repurchasing it for cash or other consideration or by incurring a liability, the following apply:

- The amount paid, up to the fair value of the repurchased instrument, should be charged to equity.
- Any excess of the repurchase price over the fair value of the repurchased instrument should be recognized as additional compensation cost, even if the award is no longer accounted for under ASC 718.

This accounting applies to repurchases of both vested awards and unvested awards that are expected to vest. However, if the award is not fully vested (requisite service has not been rendered) on the repurchase date, the repurchase has, in effect, curtailed the vesting period, and compensation cost measured at the grant date and not yet recognized should be recognized on the repurchase date.

### ASC 718-20-35-7 (excerpt)

The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. …

Example 12, Case B illustrates the accounting for the repurchase of vested share options.

### Example 12: Modifications and Settlements (excerpt)

#### ASC 718-20-55-93

The following Cases illustrate the accounting for modifications of the terms of an award (see paragraphs 718-20-35-3 through 35-4) and are based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5:

…

b. Share settlement of vested share options (Case B)

…

#### Case B: Share Settlement of Vested Share Options

#### ASC 718-20-55-97

Rather than modify the option terms, Entity T offers to settle the original January 1, 20X5, share options for fully vested equity shares at January 1, 20X9. The fair value of each share option is estimated the same way as shown in Case A, resulting in a fair value of $3.67 per share option. Entity T recognizes the settlement as the repurchase of an outstanding equity instrument, and no additional compensation cost is recognized at the date of settlement unless the payment in fully vested equity shares exceeds $3.67 per share option. Previously recognized compensation cost for the fair value of the original share options is not adjusted.

When an entity repurchases an unvested award, all previously unrecognized grant date compensation cost is recognized at the repurchase date. This presumes that the award is probable of vesting, such as when a service (time) based vesting award is repurchased prior to vesting, but the award is probable of vesting when repurchased.

When an entity repurchases or cancels an unvested award or an award that is not probable of vesting at the repurchase or settlement date, it should recognize as compensation cost the entire amount paid by the employer to repurchase the award since the entity recognized zero compensation cost prior to the repurchase or cancellation.

**ASC 718-20-35-7 (excerpt)**

… An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Example 12, Case D illustrates the accounting for the repurchase of nonvested share options.

**Example 12: Modifications and Settlements (excerpt)**

**ASC 718-20-55-93**

The following Cases illustrate the accounting for modifications of the terms of an award (see paragraphs 718-20-35-3 through 35-4) and are based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5:

…

d. Cash settlement of nonvested share options (Case D).

**Case D: Cash Settlement of Nonvested Share Options**

**ASC 718-20-55-102**

Rather than modify the share option terms, Entity T offers on January 1, 20X6, to settle the original January 1, 20X5, grant of share options for cash. Because the share price decreased from $30 at the grant date to $20 at the date of settlement, the fair value of each share option is $5.36, the same as in Case C. If Entity T pays $5.36 per share option, it would recognize that cash settlement as the repurchase of an outstanding equity instrument and no incremental compensation cost would be recognized. However, the cash settlement of the share options effectively vests them. Therefore, the remaining unrecognized compensation cost of $9.79 per share option would be recognized at the date of settlement.

### 8.6.1 Distinguishing between a settlement and a modification

The accounting for a modification and a settlement is different. A question arises when an entity repurchases an equity-classified restricted share that does not have a repurchase feature, an equity-classified option that does not have a cash settlement feature, or the option share immediately after an option is exercised. The question is whether to account for the transaction as a cash settlement (repurchase) of the award or as a modification of the award to a liability, followed by a repurchase.

The primary difference is that in a settlement, there is recognition of what might be described as its final accounting, after which the award no longer exists. This is what the examples above in Section 8.6 illustrate. In a modification, there is a change, or changes, to an award's terms, but the award continues to exist.

There are two determining factors that distinguish a settlement from a modification:

- Whether the settlement amount continues to be indexed to the entity's shares
- Whether future service is required

If either of those factors applies, modification accounting is required. If neither applies, settlement accounting is required.

Therefore, if an equity-classified award is immediately purchased for cash and no future service is required to retain the repurchase price, the transaction is a settlement and repurchase accounting applies as described above. If the equity-classified award is exchanged for a promise to pay cash in the future, the above factors should be applied to determine whether the transaction is a settlement or a modification that would change the award's classification to a liability.

However, if an entity has a pattern of settling awards in cash and asserts that settlement accounting remains appropriate for each settlement, its pattern or past practice may cause settlement accounting to be inappropriate. ASC 718-10-25-15 requires entities to account for the substantive terms of their awards if past practice differs from the written terms of the awards. In other words, recurring cash settlement of awards can demonstrate that the entity's awards are, in substance, liability awards subject to ASC 718-30 (see Section 3.2).

## 8.7 Cancellations

If an award is cancelled for no consideration and is not accompanied by a concurrent grant of (or offer to grant) a replacement award, it is accounted for as a repurchase for no consideration. Any unrecognized compensation cost is recognized on the cancellation date.

### ASC 718-20-35-9

A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

### Grant Thornton insights: Cancellation of awards

Entities, in advance, should carefully consider the implications of cancelling an award as the guidance in ASC 718 requires recognition of the entire cost of an award when it is cancelled.

Cancellations might arise more often in a period of economic downturn when awards lose value and their ability to be incentives for performance declines. Entities might have little or no experience with cancellations until such time and then are surprised by the harsh accounting impact, even if the fair value upon cancellation is less than the grant date fair value or, if prior to the cancellation, no compensation cost was recognized since the awards were deemed not probable of vesting.

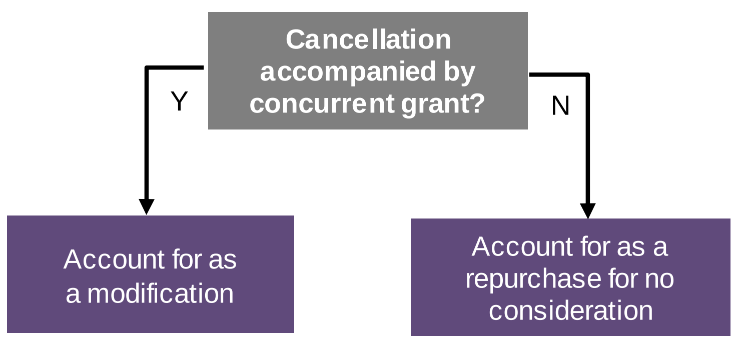
This accounting is quite punitive as cancellation reflects the same cost as if the awards instead vested in full.

## 8.8 Cancellations and concurrent replacements

A cancellation accompanied by a concurrent grant (or replacement) is accounted for as a modification. This contrasts with a cancellation that is not accompanied by a concurrent grant as discussed in Section 8.7.

Consider an entity that intends to replace cancelled awards, but not until sometime in the future and not concurrently with the cancellation. Cancellation without concurrent replacement leads to recognizing the remaining full fair value of the cancelled award. An exception would be an award with a performance condition that is not probable of achievement as of the cancellation date. In this case, the fair value of the cancelled award generally would not be recognized. If at a future date, new awards are granted, the accounting for these awards is not impacted by the previous cancellation. The sum of the recognized expense in this case might be greater than had the entity decided to cancel and concurrently issue the replacement awards.

If instead, the entity concurrently replaced the awards, modification accounting applies which generally requires that the incremental fair value of the replacement awards over the cancelled awards is recorded. This incremental value added to the unrecognized cost of the cancelled award might be lower than a cancellation followed by a new award at a later date.




A **replacement award** is an award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

On the date the entity modifies the award by cancelling it and either immediately grants or offers to grant a replacement award, the entity recognizes compensation cost as the sum of:

- The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered)
- Incremental cost resulting from the cancellation and replacement; that is, the excess, if any, of the fair value of the replacement award over the fair value of the cancelled award at the cancellation date.

### ASC 718-20-35-8

Except as described in paragraph 718-20-35-2A, cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. (The phrase offer to grant is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 718-20-35-3. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

### Grant Thornton insights: Offering to grant a replacement award

In practice, the replacement award may not be granted at the same time as the cancellation of the original award. This might occur, for example, when the steps necessary to issue the replacement award require a period of time—a relatively short period—in order to execute the necessary agreements. In this case, the question is whether the entity offered to grant the replacement concurrently with the cancellation.

We believe that whether cancellation and replacement accounting (ASC 718-20-35-8) or cancellation accounting (ASC 718-20-30-9) is appropriate depends on the specific facts and circumstances when there is a delay in issuing the replacement award. For example, one consideration is the reason for the delay: is it relatively short and solely due to the time needed to effect the issuance of the intended replacement awards, but not for reasons such as future events occurring or not occurring that might impact whether or to what extent the replacement awards are issued. Importantly, we believe that all employees involved with the cancellation and replacement should understand the arrangement before the cancellation occurs in order for the entity to assert that the offer was concurrent. In other words, the employees understand beforehand what is being given up and what will be issued in replacement.

### Evaluating replacements, repurchases, and cancellations

An entity granted its CEO 200,000 options in 20X1 that had a grant-date fair value of $1,600,000 and a four-year cliff vesting period. The following assumptions apply to the three following scenarios:

- The options have been outstanding one year.
- The entity has recognized compensation cost of $400,000.
- The options’ unrecognized grant-date fair value on the modification date was $1,200,000.

**Scenario 1**

In connection with obtaining new financing, an entity will have to cancel the 200,000 options held by its CEO. The current fair value of the options is $2,000,000. The entity is evaluating three possible actions in connection with the cancellation of the options:

- Replace the cancelled options with 110,000 shares that have a fair value of $20 each and would have a three-year vesting period
- Repurchase the options for $1,800,000
- Cancel the options with no replacement award

The following table summarizes the accounting effects of the three possible actions.

| | Replacement award | Repurchase | Cancellation |
|---|---|---|---|
| Fair value of new award | $2,200,000 | $1,800,000 | $ 0 |
| Fair value of original award on modification date | $2,000,000 | $2,000,000 | $2,000,000 |
| Incremental cost | $ 200,000 | $ 0 | $ 0 |
| Unrecognized grant-date fair value of original award on modification date | $1,200,000 | $1,200,000 | $1,200,000 |
| Cost to be recognized after modification | $1,400,000 | $1,200,000 | $1,200,000 |
| Recognition period | 3-year vesting period | Immediately | Immediately |

**Scenario 2**

Assume the entity asked the CEO to resign after the options had been outstanding one year. None have yet vested because of the four-year cliff vesting terms. As part of the CEO's severance package, the entity accelerates the vesting of the options. In effect, the CEO is exchanging the unvested original options that he will forfeit on resignation for modified options that are fully vested and have a remaining life of, say, 90 days.

The fair value of the original options is reduced to $0 because the CEO will not provide the requisite service. The $400,000 previously recognized compensation cost would be reversed.

The fair value of the modified options with a term of 90 days is $1,000,000.

The incremental fair value is $1,000,000 ($1,000,000 – $0) that would be recognized on the modification date.

**Scenario 3**

If the 200,000 options were instead being forfeited because the CEO terminated before they were fully vested and there is no acceleration of vesting, the accounting would differ. Because the requisite service was not provided, cumulative compensation cost should be reduced to $0. The $400,000 cost previously recognized for the unvested awards would be reversed in the period the CEO is terminated. This scenario describes a forfeiture of the original awards, not a modification.

## 8.9 Acceleration of vesting of deep-out-of-the-money options

Some entities have considered accelerating the vesting of options that no longer effectively promote employee motivation and retention because the options are deep-out-of-the-money. Normally, if awards are modified to accelerate vesting, the unrecognized compensation cost is recognized immediately on the modification date. However, if the options being modified are deep-out-of-the-money, they are still not exercisable. The modified options have an in-substance market condition: The entity's share price must increase to the options' exercise price before the employee can benefit from exercising the options.

If the employee has only a limited period of time to exercise vested options after terminating service, the entity in effect has exchanged options with an *explicit* service period for options with a *derived* service period (meaning derived using an option valuation model as discussed in Section 6.2.3) that is based on the market condition inherent in deep-out-of-the-money options. A question therefore arises about whether the unrecognized compensation cost of the modified options should be recognized on the modification date if the options continue to have a service period requirement that exists because they are deep-out-of-the-money.

ASC 718-10-55-67 provides the following guidance on this specific situation:

**ASC 718-10-55-67 (excerpt)**

[I]f an award with an explicit service condition that was at-the-money when granted is subsequently modified to accelerate vesting at a time when the award is deep out-of-the-money, that modification is not substantive because the explicit service condition is replaced by a derived service condition.

In informal discussion, the SEC staff indicated that it concurs with the guidance in ASC 718-10-55-67. Although it did not define "deep-out-of-the-money," the staff noted that not all out-of-the-money options are deep-out-of-the-money. As seen in ASC 718-10-55-67, however, the reason why accelerating the vesting of a deep-out-of-the-money option is not substantive is because the modification replaces one service period with another. The staff indicated that if, on the modification date, the derived service period for an out-of-the-money option is significant, that would be an indicator that the option is deep-out-of-the-money.

If the vesting of a deep-out-of-the-money option is accelerated and the employee has a limited period of time to exercise vested options after terminating service, the modification is not considered substantive, and the entity should continue recognizing the option's unrecognized compensation cost over the remaining service period of the original award. However, the SEC staff observed that, in the unusual circumstance in which the remaining explicit service period is longer than the derived service period on the modification date, the entity should consider whether the unrecognized compensation should be recognized over the shorter derived service period.

The issue of a derived service period does not arise if an entity accelerates the vesting of unvested shares or restricted stock units. Therefore, the unrecognized compensation cost in these situations is recognized immediately on the modification date.

### 8.10 Modifications of awards with performance and service vesting conditions

Entities may modify their performance and service condition awards by amending the vesting conditions. This is a frequently encountered form of modification and ASC 718 provides a number of detailed examples of the accounting for several different fact patterns, labeled as "Types" of modifications.

Note that ASC 718-20-55-107 states that these examples do not address modifications of awards with market conditions. See Section 8.11 for further discussion.

The key to determining the appropriate accounting is to determine at the modification date:

- If the original award (with the original vesting conditions) is expected to vest
- If the modified award is expected to vest

When an entity expects an award to vest under the original vesting conditions at the date of the modification, the entity recognizes compensation cost if the award vests either under the modified vesting conditions or under the original vesting conditions.

On the other hand, if at the modification date, the entity does not expect the award to vest under the original vesting conditions, the entity will recognize compensation cost in an amount equal to the modified award's fair value at the modification date.

ASC 718-20-55-107 introduces the background for the several Cases included in Example 14:

**ASC 718-20-55-107**

Paragraphs 718-10-55-60 through 55-63 note that awards may vest based on service conditions, performance conditions, or a combination of the two. Modifications of market conditions that affect exercisability or the ability to retain the award are not addressed by this Example. A modification of vesting conditions is accounted for based on the principles in paragraph 718-20-35-3; that is, total recognized compensation cost for an equity award that is modified shall at least equal the fair value of the award at the grant date unless, at the date of the modification, the performance or service conditions of the original award are not expected to be satisfied. If awards are expected to vest under the original vesting conditions at the date of the modification, an entity shall recognize compensation cost if either of the following criteria is met:

- The awards ultimately vest under the modified vesting conditions
- The awards ultimately would have vested under the original vesting conditions.

**ASC 718-20-55-108 (excerpt)**

In contrast, if at the date of modification awards are not expected to vest under the original vesting conditions, an entity shall recognize compensation cost only if the awards vest under the modified vesting conditions. Said differently, if the entity believes that the original performance or service vesting condition is not probable of achievement at the date of the modification, the cumulative compensation cost related to the modified award, assuming vesting occurs under the modified performance or service vesting condition, is the modified award's fair value at the date of the modification.

Based on an entity's determination, the following four combinations are possible:

- Type I probable to probable modification
- Type II probable to improbable modification
- Type III improbable to probable modification
- Type IV improbable to improbable modification

Each type and the associated accounting are illustrated below.

### 8.10.1 Type I probable to probable modification (Case A)

When an entity concludes that it is probable that both the original award and the modified award will vest, the entity recognizes compensation cost if the award vests either under the modified vesting conditions or under the original vesting conditions.

Example 14, Case A, illustrates the accounting for a Type I modification.

#### Example 14: Modifications of Awards with Performance and Service Vesting (excerpt)

**ASC 718-20-55-109**

Cases A through D are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (see paragraph 718-20-55-9). For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved.

**ASC 718-20-55-110**

Cases A through D assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

**Case A: Type I Probable to Probable Modification**

**ASC 718-20-55-111**

Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that it is probable that the sales target will be achieved. On January 1, 20X7, 102,000 units of Product A have been sold. During December 20X6, one of Entity T's competitors declared bankruptcy after a fire destroyed a factory and warehouse containing the competitor's inventory. To push the salespeople to take advantage of that situation, the award is modified on January 1, 20X7, to raise the sales target to 154,000 units of Product A (the modified sales target). Notwithstanding the nature of the modification's probability of occurrence, the objective of this Case is to demonstrate the accounting for a Type I modification. Additionally, as of January 1, 20X7, the options are out-of-the-money because of a general stock market decline. No other terms or conditions of the original award are modified, and management of Entity T continues to believe that it is probable that the modified sales target will be achieved. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed to be $8 in this Case at the date of the modification). Moreover, because the modification does not affect the number of share options expected to vest, no incremental compensation cost is associated with the modification.

**ASC 718-20-55-112**

This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 154,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $146,900.

b. Outcome 2—achievement of the original sales target. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of Product A but less than 154,000 units (the modified sales target is not achieved). In that outcome, Entity T would recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award.

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T would recognize cumulative compensation cost of $0.

In Example 14, Case A, the modification does not affect the number of share options expected to vest pre- and post- modification and therefore, no incremental compensation cost is associated with the modification.

In other cases, the entity might conclude that the modification does impact the number of instruments expected to vest and in that case, the impact should be taken into consideration. At its May 26, 2005 meeting, the Statement 123R Resource Group addressed a commonly encountered modification that results in fewer awards expected to vest under the modified vesting conditions than under the original vesting conditions.

**Fewer awards expected to vest under modified vesting conditions**

Entities sometimes reprice option awards that are significantly out-of-the-money and, at the same time, extend the vesting period. For example, option awards originally had a fair value of $8 and a four-year vesting period. At the end of two years, the options are out-of-the-money and the entity decides to lower the exercise price of the options and extend the vesting period to five years. On the modification date, the fair value of the modified award is $5 and the fair value of the original award immediately before the modification is $3. Compensation cost for the modified award consists of $4 remaining from the original award and an incremental $2 resulting from the modification, for a total remaining cost to recognize over the remaining three-year vesting period of $6.

The issue the Resource Group addressed is how the cost should be recognized after the modification date, because some employees will satisfy the original four-year vesting period, but not the new five-year vesting period. The Resource Group concluded that either of the following methods is acceptable, but the method chosen should be applied consistently and disclosed in the financial statements:

- *Method 1*: The $4 remaining of the original fair value is amortized over the two years remaining in the original vesting period and the incremental $2 is amortized over the modified remaining vesting period of three years. Employees who terminate after the end of the original vesting period but before the end of the modified vesting period do not vest in the award. However, the entity would reverse only the amortized amount of the incremental $2 on termination.
- *Method 2*: The total $6 of remaining compensation cost is amortized over the remaining three-year vesting period. For employees who terminate after the end of the original vesting period and before the end of the modified vesting period, compensation cost related to their forfeited awards is adjusted in the period of the termination so that cumulative recognized compensation cost is equal to the grant-date fair value of the awards.

The entity will ultimately recognize the same amount of compensation cost under Method 1 and Method 2, albeit the timing may differ between the two methods.

### 8.10.2 Type II probable to improbable modification (Case B)

When the original award is probable of vesting, but the modified award is not, the entity accounts for the modification as a Type II probable to improbable modification. In the case facts, the FASB stated that Type II modifications are rare.

Example 14, Case B, illustrates the accounting for a Type II modification.

**Example 14: Modifications of Awards with Performance and Service Vesting (excerpt)**

**ASC 718-20-55-109**

Cases A through D are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (see paragraph 718-20-55-9). For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved.

**ASC 718-20-55-110**

Cases A through D assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

**Case B: Type II Probable to Improbable Modification**

**ASC 718-20-55-113**

It is generally believed that Type II modifications will be rare; therefore, this illustration has been provided for the sake of completeness. Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date, it is probable that the sales target (150,000 units of product A) will be achieved. At January 1, 20X7, 102,000 units of product A have been sold and the options are out-of-the-money because of a general stock market decline. Entity T's management implements a cash bonus program based on achieving an annual sales target for 20X7. The options are neither cancelled nor settled as a result of the cash bonus program. The cash bonus program would be accounted for using the same accounting as for other cash bonus arrangements. Concurrently, the sales target for the option awards is revised to 170,000 units of Product A. No other terms or conditions of the original award are modified. Management believes that the modified sales target is not probable of achievement; however, they continue to believe that the original sales target is probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Moreover, because the modification does not affect the number of share options expected to vest under the original vesting provisions, Entity T would determine incremental compensation cost in the following manner.

| | |
|---|---|
| Fair value of modified share option | $ 8 |
| Share options expected to vest under original sales target | 10,000 |
| Fair value of modified award | $ 80,000 |
| Fair value of original share option | $ 8 |
| Share options expected to vest under original sales target | 10,000 |
| Fair value of original award | $ 80,000 |
| Incremental compensation cost of modification | $ - |

**ASC 718-20-55-114**

In determining the fair value of the modified award for this type of modification, an entity shall use the greater of the options expected to vest under the modified vesting condition or the options that previously had been expected to vest under the original vesting condition.

**ASC 718-20-55-115**

This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 170,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $146,900.

b. Outcome 2—achievement of the original sales target. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of Product A but less than 170,000 units (the modified sales target is not achieved). In that outcome, Entity T would recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award.

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T would recognize cumulative compensation cost of $0.

### 8.10.3 Type III improbable to probable modification (Case C)

When the original award is improbable of vesting, but the modified award is probable, the entity accounts for the modification as a Type III improbable to probable modification.

Type III modifications occur relatively frequently, most often in the context of awards with performance conditions that are modified to increase the likelihood of achievement. Another circumstance is modifying awards in connection with employee termination as discussed later in this section.

As discussed in Section 8.2, ASC 718-20-35-3b includes an exception to the general rule that total compensation cost cannot be less than the grant-date fair value of the award. This exception occurs if, as of the modification date, the performance or service conditions of the original award are not expected to be satisfied. In this fact pattern, the entity disregards the original grant-date fair value of the award because the original service or performance condition was not deemed probable. Therefore, the entity determines the fair value of the modified award and, if the employee achieves the modified vesting condition, the entity recognizes as compensation cost the modification date fair value of the modified award.

Example 14, Case C, illustrates the accounting for a Type III modification.

**Example 14: Modifications of Awards with Performance and Service Vesting (excerpt)**

**ASC 718-20-55-109**

Cases A through D are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (see paragraph 718-20-55-9). For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved.

**ASC 718-20-55-110**

Cases A through D assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

**Case C: Type III Improbable to Probable Modification**

**ASC 718-20-55-116**

Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that none of the options will vest because it is not probable that the sales target will be achieved. On January 1, 20X7, 80,000 units of Product A have been sold. To further motivate the salespeople, the sales target (150,000 units of Product A) is lowered to 120,000 units of

Product A (the modified sales target). No other terms or conditions of the original award are modified. Management believes that the modified sales target is probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Since the modification affects the number of share options expected to vest under the original vesting provisions, Entity T will determine incremental compensation cost in the following manner.

| | |
|---|---|
| Fair value of modified share option | $ 8 |
| Share options expected to vest under original sales target | 10,000 |
| Fair value of modified award | $ 80,000 |
| Fair value of original share option | $ 8 |
| Share options expected to vest under original sales target | - |
| Fair value of original award | $ - |
| Incremental compensation cost of modification | $ 80,000 |

**ASC 718-20-55-117**

This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 120,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $80,000.

b. Outcome 2—achievement of the original sales target and the modified sales target. In Outcome 2, Entity T would recognize cumulative compensation cost of $80,000 because in a Type III modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance).

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T would recognize cumulative compensation cost of $0.

### *Modification to accelerate vesting as a result of termination (a Type III modification)*

Sometimes an employer will modify the terms of an award to accelerate vesting in connection with terminating the employee. This might occur as part of negotiating an employee's severance agreement, or for other reasons. Essentially, the termination would have caused the employee to forfeit the award, but the modification provides the employee with either a fully vested award upon termination or an award the employee may not exercise (if an option) or receive (if a form of share equity) for a certain period after termination.

The accounting for such a modification is as if the employee forfeits the original award (because the vesting conditions are not met), but the employer grants the employee a fully vested new award. Note that Example 15 presents a fact pattern in which the fair value of the award on the modification date is less than on the grant date. The guidance, however, equally applies to fact patterns in which the fair value of the modified award is greater than the fair value on the grant date. Therefore, entities should keep in mind that these modifications can lead to significantly higher recognized cost if fair value has increased.

**Example 15: Illustration of a Type III Improbable to Probable Modification**

**ASC 718-20-55-120**

This Example illustrates the guidance in paragraph 718-20-35-3.

**ASC 718-20-55-121**

On January 1, 20X7, Entity Z issues 1,000 at-the-money options with a 4-year explicit service condition to each of 50 employees that work in Plant J. On December 12, 20X7, Entity Z decides to close Plant J and notifies the 50 Plant J employees that their employment relationship will be terminated effective June 30, 20X8. On June 30, 20X8, Entity Z accelerates vesting of all options. The grant-date fair value of each option is $20 on January 1, 20X7, and $10 on June 30, 20X8, the modification date. At the date Entity Z decides to close Plant J and terminate the employees, the service condition of the original award is not expected to be satisfied because the employees cannot render the requisite service. Because Entity Z's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3, any compensation cost recognized before December 12, 20X7, for the original award would be reversed. At the date of the modification, the fair value of the original award, which is $0 ($10 × 0 options expected to vest under the original terms of the award), is subtracted from the fair value of the modified award $500,000 ($10 × 50,000 options expected to vest under the modified award). The total recognized compensation cost of $500,000 will be less than the fair value of the award at the grant date ($1 million) because at the date of the modification, the original vesting conditions were not expected to be satisfied. If Entity Z's accounting policy was to account for forfeitures when they occur in accordance with paragraph 718-10-35-3, then compensation cost recognized before December 12, 20X7, would not be reversed until the award is forfeited. However, Entity Z would be required to assess at the date of the modification whether the performance or service conditions of the original award are expected to be satisfied.

### 8.10.4 Type IV improbable to improbable modification (Case D)

When the original award is improbable of vesting, and the modified award is also improbable, the entity accounts for the modification as a Type IV improbable to improbable modification.

Type IV modifications occur frequently, especially in the context of performance condition awards. A simple example is an award that vests if the entity is sold within five years for a multiple of at least X times the amount of the seller's original investment. This award is improbable of vesting until the sale occurs. If the award is modified in year three to change the multiple (either up or down), the award is still improbable of vesting until a sale occurs. Because of the modification, the original fair value is disregarded and a new fair value is determined at the modification date. This is the amount of cost recognized upon the sale of the entity.

Example 14, Case D, illustrates the accounting for a Type IV modification.

### Example 14: Modifications of Awards with Performance and Service Vesting (excerpt)

**ASC 718-20-55-109**

Cases A through D are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (see paragraph 718-20-55-9). For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved.

**ASC 718-20-55-110**

Cases A through D assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

**Case D: Type IV Improbable to Improbable Modification**

**ASC 718-20-55-118**

Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date it is not probable that the sales target will be achieved. On January 1, 20X7, 80,000 units of Product A have been sold. To further motivate the salespeople, the sales target is lowered to 130,000 units of Product A (the modified sales target). No other terms or conditions of the original award are modified. Entity T lost a major customer for Product A in December 20X6; hence, management continues to believe that the modified sales target is not probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Furthermore, the modification does not affect the number of share options expected to vest; hence, there is no incremental compensation cost associated with the modification.

**ASC 718-20-55-119**

This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 130,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $80,000 (10,000× $8).

b. Outcome 2—achievement of the original sales target and the modified sales target. In Outcome 2, Entity T would recognize cumulative compensation cost of $80,000 because in a Type IV modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance).

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T would recognize cumulative compensation cost of $0.

## 8.11 Modifications of awards with market conditions

The types of modifications discussed in Section 8.10 are relevant only for awards with service or performance vesting conditions, and ASC 718-20-55-107 specifically excludes their application to awards with market conditions. This is because market conditions are not considered to be vesting conditions. (See Section 5.3 for further discussion of market conditions.)

Because the probability of achievement does not impact cost recognition for an award with a market condition, a modification is evaluated solely based on whether it results in incremental compensation cost. This means, presuming the requisite service is provided, that the ultimate cost recognized for a modified market condition award will be no less than the original grant date fair value, and will be a greater amount if there is incremental cost arising in the modification. Section 8.2 discusses this general principle of grant date fair value plus any incremental cost.

## 8.12 Change in classification

A modification might impact the classification of an award. For example, the modification may cause the entity to reclassify an equity award to a liability instrument. This section illustrates the accounting when a modification causes a change in classification from equity to liability and liability to equity.

### 8.12.1 Equity to liability

As discussed above, paragraph 718-20-35-3(b) specifies that total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the service or performance conditions of the original award are not expected to be satisfied. In accordance with that principle, an entity that originally issues an equity award that later is modified to a liability award would ultimately recognize cumulative compensation cost equal to the greater of the following:

a. The grant-date fair value of the original equity award

b. The fair value of the modified liability award when it is settled.

On the modification date, the entity recognizes a liability equal to the portion of the award attributed to past service multiplied by the modified award's fair value. To the extent that the liability equals or is less than the amount recognized in equity for the original award, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount recognized in equity for the original award, the excess is recognized as compensation cost.

Example 16, Case A, illustrates the accounting for an equity to liability modification share-settled options to cash-settled options.

### Example 16: Modifications That Change an Award's Classification (excerpt)

**Case A: Equity to Liability Modification (Share-Settled Share Options to Cash-Settled Share Options)**

**ASC 718-20-55-123**

Entity T grants the same share options described in Example 1, Case A (see paragraph 718-20-55-10). As in Example 1, Case A, Entity T has an accounting policy to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3. The number of options for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 (900,000 × $.97^3$). For simplicity, this Case assumes that estimated forfeitures equal actual forfeitures. Thus, as shown in the table in paragraph 718-20-55-130, the fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69), and the compensation cost to be recognized during each year of the 3-year vesting period is $4,022,151 ($12,066,454 ÷ 3). The journal entries for 20X5 are the same as those in paragraph 718-20-55-12.

**ASC 718-20-55-124**

On January 1, 20X6, Entity T modifies the share options granted to allow the employee the choice of share settlement or net cash settlement; the options no longer qualify as equity because the holder can require Entity T to settle the options by delivering cash. Because the modification affects no other terms or conditions of the options, the fair value (assumed to be $7 per share option) of the modified award equals the fair value of the original award immediately before its terms are modified on the date of modification; the modification also does not change the number of share options for which the requisite service is expected to be rendered. On the modification date, Entity T recognizes a liability equal to the portion of the award attributed to past service multiplied by the modified award's fair value. To the extent that the liability equals or is less than the amount recognized in equity for the original award, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount recognized in equity for the original award, the excess is recognized as compensation cost. In this Case, at the modification date, one-third of the award is attributed to past service (one year of service rendered/three-year requisite service period). The modified award's fair value is $5,749,842 (821,406 × $7), and the liability to be recognized at the modification date is $1,916,614 ($5,749,842 ÷ 3). The related journal entry follows.

| | | |
|---|---|---|
| Additional paid-in capital | $1,916,614 | |
| Share-based compensation liability | | $1,916,614 |

To recognize the share-based compensation liability.

**ASC 718-20-55-125**

No entry would be made to the deferred tax accounts at the modification date. The amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151– $1,916,614).

**ASC 718-20-55-126**

Paragraph 718-20-35-3(b) specifies that total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the service or performance conditions of the original award are not expected to be satisfied. In accordance with that principle, Entity T would ultimately recognize cumulative compensation cost equal to the greater of the following:

a. The grant-date fair value of the original equity award

b. The fair value of the modified liability award when it is settled.

**ASC 718-20-55-127**

To the extent that the recognized fair value of the modified liability award is less than the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in that liability award's fair value through its settlement do not affect the amount of compensation cost recognized. To the extent that the fair value of the modified liability award exceeds the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in the liability award's fair value are recognized as compensation cost.

**ASC 718-20-55-128**

At December 31, 20X6, the fair value of the modified award is assumed to be $25 per share option; hence, the modified award's fair value is $20,535,150 (821,406 × $25), and the corresponding liability at that date is $13,690,100 ($20,535,150 × 2/3) because two-thirds of the requisite service period has been rendered. The increase in the fair value of the liability award is $11,773,486 ($13,690,100 – $1,916,614). Before any adjustments for 20X6, the amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151 – $1,916,614). The cumulative compensation cost at December 31, 20X6, associated with the grant-date fair value of the original equity award is $8,044,302 ($4,022,151 × 2). Entity T would record the following journal entries for 20X6.

| | | |
|---|---|---|
| Compensation cost | $ 9,667,949 | |
| Additional paid-in capital | $ 2,105,537 | |
| Share-based compensation liability | | $ 11,773,486 |

To increase the share-based compensation liability to $13,690,100 and recognize compensation cost of $9,667,949 ($13,690,100 – $4,022,151).

| | | |
|---|---|---|
| Deferred tax asset | $3,383,782 | |
| Deferred tax benefit | | $3,383,782 |

To recognize the deferred tax asset for additional compensation cost ($9,667,949 ×.35 = $3,383,782).

**ASC 718-20-55-129**

At December 31, 20X7, the fair value is assumed to be $10 per share option; hence, the modified award's fair value is $8,214,060 (821,406 × $10), and the corresponding liability for the fully vested award at that date is $8,214,060. The decrease in the fair value of the liability award is $5,476,040 ($8,214,060 – $13,690,100). The cumulative compensation cost as of December 31, 20X7, associated with the grant-date fair value of the original equity award is $12,066,454 (see paragraph 718-20-55-123). Entity T would record the following journal entries for 20X7.

| | | |
|---|---|---|
| Share-based compensation liability | $ 5,476,040 | |
| Compensation cost | | $1,623,646 |
| Additional paid-in capital | | $3,852,394 |

To recognize a share-based compensation liability of $8,214,060, a reduction of compensation cost of $1,623,646 ($13,690,100 – $12,066,454), and additional paid-in capital of $3,852,394 ($12,066,454 – $8,214,060).

| | | |
|---|---|---|
| Deferred tax expense | $568,276 | |
| Deferred tax asset | | $568,276 |

To reduce the deferred tax asset for the reduction in compensation cost ($1,623,646 ×.35 = $568,276).

**ASC 718-20-55-130**

The modified liability award is as follows.

**Modified Liability Award – Cliff Vesting**

| Year | Total Value of Award | Pretax Cost for Year | Cumulative Pretax Cost |
|---|---|---|---|
| 20X5 | $12,066,454 (821,406 x $14.69) | $4,022,151 ($12,066,454 ÷ 3) | $ 4,022,151 |
| 20X6 | $20,535,150 (821,406 x $25.00) | $9,667,949 [($20,535,150 x 2/3) - $4,022,151] | $13,690,100 |
| 20X7 | $12,066,454 (821,406 x $14.69) | $(1,623,646) ($12,066,454 - $13,690,100) | $12,066,454 |

**ASC 718-20-55-131**

For simplicity, this Case assumes that all share option holders elected to be paid in cash on the same day, that the liability award's fair value is $10 per option, and that Entity T has already recognized its income tax expense for the year without regard to the effects of the settlement of the award. In other words, current tax expense and current taxes payable were recognized based on income and deductions before consideration of additional deductions from settlement of the award.

**718-20-55-132**

The $8,214,060 in cash paid to the employees on the date of settlement is deductible for tax purposes. In the period of settlement, tax return deductions that are less than compensation cost recognized result in a charge to income tax expense. The tax benefit is $2,874,921 ($8,214,060 × .35). Because tax return deductions are less than compensation cost recognized, the entity must write off the deferred tax assets recognized in excess of the tax benefit from the exercise of employee stock options to income tax expense in the income statement. The journal entries to reflect settlement of the share options are as follows.

| | | |
|---|---|---|
| Share-based compensation liability | $8,214,060 | |
| Cash ($10 x 821,406) | | $8,214,060 |

To recognize the cash paid to settle share options.

| | | |
|---|---|---|
| Deferred tax expense | $4,223,259 | |
| Deferred tax asset | | $4,223,259 |

To write off deferred tax asset related to compensation cost ($12,066,454 × .35 = $4,223,259).

| | | |
|---|---|---|
| Current taxes payable | $2,874,921 | |

Current tax expense $2,874,921

To adjust current tax expense and current taxes payable for the tax benefit from deductible compensation cost upon settlement of share options.

**ASC 718-20-55-133**

If instead of requesting cash, employees had held their share options and those options had expired worthless, the share-based compensation liability account would have been eliminated over time with a corresponding increase to additional paid-in capital. Previously recognized compensation cost would not be reversed. Similar to the adjustment for the actual tax deduction described in paragraph 718-20-55-132, all of the deferred tax asset of $4,223,259 would be charged to income tax expense when the share options expire.

Example 16, Case E, illustrates the accounting for a modification that changes the award's classification from equity to liability because the entity ultimately decides to settle the awards with a fixed cash payment.

### Example 16: Modifications That Change an Award's Classification (excerpt)

**Case E: Equity to Liability Modification (Share Options to Fixed Cash Payment)**

**ASC 718-20-55-144**

Entity T grants the same share options described in Example 1, Case A (see paragraph 718-20-55-10) and records similar journal entries for 20X5 (see paragraphs 718-20-55-12 through 55-16). By January 1, 20X6, Entity T's share price has fallen, and the fair value per share option is assumed to be $2 at that date. Entity T provides its employees with an election to convert each share option into an award of a fixed amount of cash equal to the fair value of each share option on the election date ($2) accrued over the remaining requisite service period, payable upon vesting. The election does not affect vesting; that is, employees must satisfy the original service condition to vest in the award for a fixed amount of cash. Entity T considers the guidance in paragraph 718-20-35-2A. Because the change in the terms or conditions of the award changes the classification of the award from equity to liability, Entity T applies modification accounting. This transaction is considered a modification instead of a settlement because Entity T continues to have an obligation to its employees that is conditional upon the receipt of future employee services. There is no incremental compensation cost because the fair value of the modified award is the same as that of the original award. At the date of the modification, a liability of $547,604 [(821,406 × $2) × (1 year of requisite service rendered ÷ 3-year requisite service period)], which is equal to the portion of the award attributed to past service multiplied by the modified award's fair value, is recognized by reclassifying that amount from additional paid-in capital. The total liability of $1,642,812 (821,406 × $2) should be fully accrued by the end of the requisite service period. Because the possible tax deduction of the modified award is capped at $1,642,812, Entity T also must adjust its deferred tax asset at the date of the modification to the amount that corresponds to the recognized liability of $547,604. That amount is $191,661 ($547,604 × .35), and the write-off of the deferred tax asset is $1,216,092 ($1,407,753 – $191,661). That write-off would be recognized as income tax expense in the income statement. Compensation cost of $4,022,151 would be recognized in each of 20X6 and 20X7 for a cumulative total of $12,066,454 (as calculated in Case A); of this, $547,604 would be recognized as an increase to the liability balance, with the remaining $3,474,547 recognized as an increase in additional paid-in capital. A deferred tax benefit would be recognized in the income statement, and a corresponding increase to the deferred tax asset would be recognized for the tax effect of the increased liability of $191,661 ($547,604 × .35). The compensation cost recognized in additional paid-in capital in this situation has no associated income tax effect (additional deferred tax assets are recognized based only on subsequent increases in the amount of the liability).

### 8.12.2 Liability to equity

When an entity modifies a liability award which causes a change in classification to an equity award, the entity must compare the fair value of the instrument immediately before the modification to the fair value of the modified award and recognize any incremental compensation cost. The modified award would then be accounted for as an equity instrument from the date of modification. At the modification date, the entity reclassifies the liability recognized to additional paid-in capital. Because the award is now equity-classified, the modification-date fair value is the new fair value of the award, and is not revalued at each reporting date thereafter.

**Example 16: Modifications That Change an Award's Classification (excerpt)**

**Case C: Liability to Equity Modification (Cash-Settled to Share-Settled Stock Appreciation Rights)**

**ASC 718-20-55-135**

This Case is based on the facts given in Example 1 (see paragraph 718-30-55-1). Entity T grants cash-settled stock appreciation rights to its employees. The fair value of the award on January 1, 20X5, is $12,066,454 (821,406 × $14.69) (see paragraph 718-30-55-2).

**ASC 718-20-55-136**

On December 31, 20X5, the assumed fair value is $10 per stock appreciation right; hence, the fair value of the award at that date is $8,214,060 (821,406 × $10). The share-based compensation liability at December 31, 20X5, is $2,738,020 ($8,214,060 ÷ 3), which reflects the portion of the award related to the requisite service provided in 20X5 (1 year of the 3-year requisite service period). For convenience, this Case assumes that journal entries to account for the award are performed at year-end. The journal entries for 20X5 are as follows.

| | | |
|---|---|---|
| Compensation cost | $2,738,020 | |
| Share-based compensation liability | | $2,738,020 |
| To recognize compensation cost. | | |

| | | |
|---|---|---|
| Deferred tax asset | $ 958,307 | |
| Deferred tax benefit | | $ 958,307 |

To recognize the deferred tax asset for the temporary difference related to compensation cost ($2,738,020 × .35 = $958,307).

**ASC 718-20-55-137**

On January 1, 20X6, Entity T modifies the stock appreciation rights by replacing the cash-settlement feature with a net share settlement feature, which converts the award from a liability award to an equity award because Entity T no longer has an obligation to transfer cash to settle the arrangement. Entity T would compare the fair value of the instrument immediately before the modification to the fair value of the modified award and recognize any incremental compensation cost. Because the modification affects no other terms or conditions, the fair value, assumed to be $10 per stock appreciation right, is unchanged by the modification and, therefore, no incremental compensation cost is recognized. The modified award's total fair value is $8,214,060. The modified award would be accounted for as an equity award from the date of modification with a fair value of $10 per share. Therefore, at the modification date, the entity would reclassify the liability of $2,738,020 recognized on December 31, 20X5, as additional paid-in capital. The related journal entry is as follows.

| | | |
|---|---|---|
| Share-based compensation liability | $2,738,020 | |
| Additional paid-in capital | | $2,738,020 |
| To reclassify the award as equity. | | |

**ASC 718-20-55-138**

Entity T will account for the modified awards as equity going forward following the pattern given in Example 1, Case A (see paragraph 718-20-55-1), recognizing $2,738,020 of compensation cost in each of 20X6 and 20X7, for a cumulative total of $8,214,060.

# 9. Income taxes

ASC 718-740, *Compensation – Stock Compensation: Income Taxes*, provides guidance on the accounting for income taxes related to share-based payments. This section discusses the accounting for income taxes related to share-based payments, which is often complex.

## 9.1 Introduction

Many share-based payment awards result in deductible temporary differences. When an entity recognizes the cost of an award, it also recognizes a related deferred tax asset, both of which are based on the grant-date fair value of the award. As a result, the amount of the deferred tax asset recorded typically differs from the amount deducted when an option is exercised or a restricted unit vests. The deduction is based on the market price of the underlying share at the exercise or vesting date, less the exercise price paid by the employee, without regard to the amount of compensation cost previously recognized. Further, the change in market price that occurs with the passage of time between the grant date and exercise / vesting date may lead to significant differences between the deduction and the previously recognized cost, resulting either in an excess tax benefit if the deduction exceeds the cumulative compensation expense for the award, or in a “shortfall” if the deduction is less than the cumulative expense.

Some types of awards, such as incentive stock options (ISO) that qualify under Internal Revenue Code regulations, do not ordinarily result in tax deductions and, therefore, do not result in a deductible temporary difference. In this case, entities would not recognize deferred income taxes as the financial statement cost is recognized. Section 9.6 discusses accounting for ISOs.

When evaluating the tax deductibility of stock compensation awards, entities should carefully consider income tax laws and regulations, such as those that limit deductions for compensation paid to certain executives. These limits, along with other statutory restrictions, may impact the ultimate amount that would be deductible and, over the vesting period, deferred taxes that can be recognized. Entities should seek the advice of appropriate tax advisers when determining the deduction for stock compensation awards.

In ASU 2016-09, the FASB simplified the accounting for income taxes related to share-based payments. The amendments in ASU 2016-09 were effective for all entities by January 2018. The most significant change was the elimination of the “APIC pool” previously utilized to track excess tax benefits and tax “shortfall” deficiencies, which was one of the most difficult areas of accounting for share-based payment awards. Under legacy guidance, excess tax benefits were recognized in additional paid-in capital (APIC) and tax deficiencies were either offset in APIC against previous accumulated excess tax benefits or charged to the income statement if there were no previous excess benefits to offset. Once the guidance in ASU 2016-09 is applied, entities recognize all excess tax benefits and tax deficiencies in the income statement tax provision.

The overarching objective of accounting for income taxes related to share-based payment arrangements is summarized in ASC 718-740, as follows.

**ASC 718-740-05-1**

Topic 740 addresses the majority of tax accounting issues and differences between the financial reporting (or book) basis and tax basis of assets and liabilities (basis differences).

**ASC 718-740-05-2**

This Subtopic addresses the accounting for current and deferred income taxes that results from share-based payment arrangements, including employee stock ownership plans.

**ASC 718-740-05-3**

This Subtopic specifically addresses the accounting requirements that apply to the following:

a. The determination of the basis differences which result from tax deductions arising in different amounts and in different periods from compensation cost recognized in financial statements

b. The recognition of tax benefits when tax deductions differ from recognized compensation cost

c. The presentation required for income tax benefits from share-based payment arrangements.

**ASC 718-740-05-4**

Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation cost recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

The rest of this section discusses considerations for income tax accounting for various share-based payment arrangements.

## 9.2 Determination of temporary differences

While book compensation cost is recognized over the share-based payment award's requisite service period, the associated tax deduction generally occurs later, when the award is exercised, resulting in a temporary difference with a related deferred tax asset. The deferred tax asset is calculated as the compensation cost recognized multiplied by the enacted tax rate expected to apply during the period in which an entity expects to realize the assets.

A **temporary difference** is a difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements

b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

### *Equity instruments*

An entity may receive a tax deduction for a share-based payment award in a later period than the period in which it recognizes compensation cost for financial reporting purposes. In that situation, when compensation cost is recognized, the entity should also recognize a deferred tax asset for the deductible temporary difference based on the amount of compensation cost recognized. If there ordinarily is no tax deduction for an award, such as an ISO, then no tax effects are recognized, unless and until certain future events occur.

**ASC 718-740-25-2**

The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

**ASC 718-740-25-3**

Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

### *Liability instruments*

An entity remeasures share-based payment awards that are classified as liabilities at each reporting period for financial statement accounting purposes. Therefore, the related deferred tax asset also is remeasured to reflect the effects of marking-to-market the liability-classified share-based payment award. In some cases, because the liability is remeasured and the deferred tax asset is adjusted each period through settlement of the award, the ultimate tax deduction will equal the recorded compensation cost, and the tax benefit will equal the deferred tax asset.

In other cases, the compensation cost and tax benefit will differ, for example, when an award is liability-classified for a period of time because it can be settled in a variable number of shares until a performance condition is met and then becomes equity-classified. Changes in the value of the underlying share after the award becomes equity-classified do not impact recorded compensation cost or the deferred tax asset, but they do impact the ultimate deduction. Therefore, when the deduction occurs in a future year for an award that becomes equity-classified, the tax benefit likely would not equal the deferred tax asset and that difference would be reflected in the income tax provision in the period the deduction occurs.

**ASC 718-740-25-4**

The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.

## 9.3 Initial measurement and valuation allowances

When the cost of awards that are expected to result in a future deduction are recorded, consideration is also given to whether a valuation allowance on the deferred tax asset recorded is necessary. The guidance in ASC 718-740 specifically addresses two aspects of measuring temporary differences and accounting for valuation allowances. First, increases and decreases in the deferred tax asset are recognized as the employee provides the requisite service and as forfeitures occur. Second, the entity does not consider changes in the market value of its shares when determining whether a valuation allowance is necessary. Said another way, an entity is not permitted to adjust the amount of its deferred tax asset or to establish a valuation allowance as a result of changes in its share price in periods before the entity reports the deduction in its tax return or, in the case of a vested option, before the option expires unexercised. For instance, assume that as of December 31, 20X6 an entity has a deferred tax asset related to options for which the exercise prices exceeds the market value, that are set to expire on January 31, 20X7. Although the options will likely expire unexercised, no adjustment to the deferred tax asset is made in the December 31, 20X6 financial statements—the write-off does not occur until the 20X7 expiration date.

**ASC 718-740-30-1**

The deferred tax benefit (or expense) that results from increases (or decreases) in the recognized share-based payment temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an award, shall be recognized in the income statement.

**ASC 718-740-30-2**

Subtopic 740-10 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 718-740-25-2 through 25-3 and the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

## 9.4 Subsequent measurement

If the deduction ultimately reported on the entity's tax return differs from compensation cost recognized for financial reporting purposes, an entity would recognize the related tax effect in the tax provision for the period in which the deduction occurs or, in the case of an award that expires, in the period when the award expires. The related tax effect may be a deduction that either exceeds or is less than the cumulative compensation cost, both of which should be recognized through the income tax provision.

An entity must recognize an excess tax benefit even if it cannot use the deduction to reduce taxes payable in the current period, such as when the entity has a net operating loss. In that case, an entity should evaluate whether to reduce the deferred tax asset associated with the recognized excess tax benefit by a valuation allowance.

### ASC 718-740-35-2

This Section addresses the accounting required in a period when actual tax deductions for compensation expense taken by an entity on its tax return for share-based payment arrangements differ in amounts and timing from those recorded in the financial statements. The tax effect of the difference, if any, between the cumulative compensation cost of an award recognized for financial reporting purposes and the deduction for an award for tax purposes shall be recognized as income tax expense or benefit in the income statement. The tax effect shall be recognized in the period in which the tax deduction arises or, in the case of an expiration of an award, in the period in which the expiration occurs. The appropriate period depends on the type of award and the incremental guidance under the requirements of Subtopic 740-270 on income taxes—interim reporting.

### Grant Thornton insights: Excess tax benefits in the statement of cash flows

Perhaps the most significant simplification made under ASU 2016-09 was to eliminate the accounting for APIC pools for share-based payment awards. The FASB decided that all excess tax benefits and deficiencies should be reflected as either income tax expense or benefit in the entity's results of operations.

Similarly, because the Board does not believe that a share-based payment award consists of two separate transactions (that is, a compensatory transaction at the grant date and an equity transaction for changes in fair value thereafter), ASU 2016-09 also amended the guidance in ASC 230 to clarify that excess tax benefits are not separate cash flows and should therefore be classified in the same manner as other cash flows related to income taxes (that is, as operating activities).

## 9.5 Tax effects of dividends paid on equity awards

Dividends and dividend equivalents paid to employees on equity-classified awards that are expected to vest should be charged to retained earnings. If dividends are paid on awards that are not expected to vest, the dividends should be recognized as compensation cost. To determine the amount of dividends not expected to vest, an entity should use the same forfeiture policy election (that is, its policy for estimating forfeitures or for recognizing forfeitures when they occur) that is used for other aspects of accounting for stock compensation.

ASC 718-740-45-8 addresses the accounting for the income tax benefits related to dividend or dividend-equivalent payments made to employees holding equity-classified nonvested shares, equity-classified nonvested share units, and equity-classified outstanding share options. The guidance requires an entity to recognize the income tax benefit from dividends or dividend equivalents that are charged to retained earnings and paid to employees as income tax expense or benefit in the income statement. In other words, an entity should recognize a tax benefit from dividends that are charged directly to retained earnings and do not create a deductible temporary difference, when compensation cost for the award is recognized in the income statement.

**ASC 718-740-45-8**

An income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for any of the following equity classified awards shall be recognized as income tax expense or benefit in the income statement:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

## 9.6 Tax effects of incentive stock options

If an award, such as an ISO, does not ordinarily result in a tax deduction, a deductible temporary difference is not recognized. However, if a future event results in a tax deduction, such as an employee's disqualifying disposition of an ISO, the tax effect is recognized when the future event occurs.

**ASC 718-740-25-3**

Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

When, for example, an employee disposes of shares obtained through an ISO before the statutory holding period expires, the award changes from a nondeductible award to a deductible award. The impact shall not be anticipated before it occurs; that is, an entity shall not estimate how many future disqualifying sales will occur and therefore, shall not recognize a deferred tax asset based on anticipated future tax deductions. Instead, the effect is recognized only when the disposition occurs.

## 9.7 Tax effects of nonqualified employee options issued in business combinations

ASC 805 addresses the accounting for the tax effects of equity-classified share-based payment awards issued as replacement awards in exchange for the acquiree's outstanding awards in a nontaxable business combination. If the replacement awards are nonqualified—meaning they will result in postcombination tax deductions under current tax law—the acquirer should recognize a deferred tax asset for the deductible temporary difference of the portion of the replacement awards' fair value that relates to the precombination service.

After the acquisition, the tax effects of nonqualified replacement awards are accounted for under ASC 718 and do not affect the consideration transferred for the acquired business. Similarly, the postacquisition tax effects of qualified replacement awards, such as disqualifying dispositions of shares, are accounted for under ASC 718.

# 10. Earnings per share, presentation of unvested shares in equity, and the statement of cash flows

Specific accounting guidance exists for evaluating the impact of share-based payments on earnings per share (EPS), and for presenting legally issued but unvested shares in the equity statement as well as share-based payment transactions in the statement of cash flows. Entities who have publically issued common stock or potential common stock (options, warrants, convertible securities, or contingent stock agreements) or have filed to have their common stock issued publically are required to present EPS in their financial statements. Nonpublic entities may choose to present EPS information.

## 10.1 Earnings per share

ASC 260, *Earnings per Share*, includes explicit guidance on computing the impact of share-based payment awards on EPS (basic EPS = income available to common shareholders ÷ number of weighted average common shares outstanding during the period). These awards impact the computation of EPS in a number of ways, including the calculation of "diluted" EPS. (defined in Section 10.1.1). Unexercised stock options and nonvested stock awards are excluded from the calculation of *basic* EPS, but considered in calculating *diluted* EPS. Diluted EPS is based primarily on the assumption that options have been exercised and awards have vested, and that the resulting "incremental" shares (difference between number of shares assumed issued and number of shares assumed purchased) increase the denominator in the equation used to calculate diluted EPS. The unit of account for calculating EPS is the individual share-based compensation award.

The vesting terms of share-based payment awards are an important consideration when calculating diluted EPS. The guidance on using the treasury stock method (Section 10.1.1) applies to awards that vest based on service conditions (time vesting), while the guidance on contingently issuable shares (Section 10.1.2) applies to awards with performance or market conditions.

In addition, for both basic and diluted EPS, the two-class method applies when share-based payment awards involve "participating" securities (that is, securities that may participate in any manner in undistributed earnings with common stock (see Section 10.1.4). The two-class method can be difficult for entities to understand and apply. Under the two-class method, entities reduce basic and diluted EPS by the amounts that participating security holders would receive if all earnings had been distributed. For example, if earnings are $100 and actual dividends declared in the period are $20, an entity might use the two-class method to determine how much would be payable to the holders of participating securities, and how much would remain for the common shareholders, if the remaining $80 were distributed. If participating securities would receive $30 of the $80, then the earnings for common shareholders is the remainder, or $50 (and some portion of the $20 based on the terms, see additional guidance in Section 10.1.4)

Under the amendments in ASU 2016-09, which were codified in ASC 718, entities can elect either to account for forfeitures of awards under share-based payments as they occur or to estimate forfeitures. Entities that choose to estimate forfeitures account for the cost of share-based payment awards, assuming that some of these awards will be forfeited. However, only actual forfeitures are considered in calculating the denominator for diluted EPS. In other words, entities may not reduce the potential number of dilutive shares based on how many of these awards might not vest.

ASU 2016-09 also amends how excess tax benefits and tax deficiencies arising from share-based payments impact diluted EPS. As a result, entities applying the treasury stock method to calculate diluted EPS no longer increase the assumed proceeds for certain excess tax benefits. This calculation often was difficult for entities to perform, so the amendments contained within ASU 2016-09 were designed to simplify the guidance.

**ASC 260-10-15-2**

The guidance in the Earnings per Share Topic requires presentation of earnings per share (EPS) by all entities that have issued common stock or potential common stock (that is, securities such as options, warrants, convertible securities, or contingent stock agreements) if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. This Topic also requires presentation of EPS by an entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of those securities in a public market.

### 10.1.1 Treasury stock method

Employee stock options are *call options*. Under ASC 260, entities reflect the dilutive effect of employee options in diluted EPS by applying the treasury stock method. This method determines how many additional shares would have been outstanding if, at the start of the period, all options had been exercised and all shares had been issued (referred to as "shares assumed issued"), and if the exercise proceeds plus the yet unrecognized compensation cost used to repurchase, as treasury stock, a number of outstanding shares (shares assumed repurchased). When the number of shares assumed issued exceeds the number of shares assumed repurchased, the options are considered "dilutive," and the excess number of shares is added to the denominator in the diluted EPS calculation, reducing EPS for common shareholders.

A **call option** is a contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period.

An **option**, unless otherwise stated, is a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. Options include, but are not limited to, options granted to employees and stock purchase agreements entered into with employees. Options are considered securities.

The **treasury stock method** is a method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.

**ASC 260-10-45-16**

The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In addition, in computing the dilutive effect of convertible securities, the numerator is adjusted to add back any convertible preferred dividends and the after-tax amount of interest recognized in the period associated with any convertible debt. The numerator also is adjusted for any other changes in income or loss that would result from the assumed conversion of those potential common shares, such as profit-sharing expenses. Similar adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods. See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

The guidance in ASC 260-10-45-22 through 45-27 outlines how to generally apply the treasury stock method. When applying the treasury stock method, the proceeds from the assumed option exercise (assumed proceeds) will be used to repurchase common stock at the average share price during the period.

Entities should also exclude options that are "out-of-the-money," meaning the exercise price is *higher* than the market price, when applying the treasury stock method. For example, if there are 100 vested options with an exercise price of $10 per share and the average market price for the period is $6 per share, the shares would be out-of-the-money. Applying the treasury stock method in this case would be antidilutive because if all options are exercised and would be dilutive in isolation, the assumed proceeds of $1,000 (from 100 assumed issued shares) would be used to repurchase approximately 167 shares of treasure stock (based on the average market price of $6), resulting in a net decrease of 67 outstanding shares. If the denominator of the diluted EPS calculation were decreased by 67 shares, the EPS for common stock would increase, and these options would therefore be ignored in calculating diluted EPS.

"In-the-money" options, meaning the exercise price is *lower* than the market price, might be antidilutive if the amount of average yet unrecognized compensation cost is so significant that the assumed proceeds can repurchase more shares than were issued upon exercise. For example, if there are 100 unvested options with an exercise price of $10 per share and the average market price for the period is $12 per share, the shares are in the money and, in isolation, would be dilutive. If, however, unrecognized compensation cost is $500, then the assumed proceeds would total $1,500 ($1,000 exercise price + $500 unrecognized cost). Applying the treasury stock method in this case would be antidilutive: Although 100 shares are assumed issued if all of the options are exercised, the $1,500 in assumed proceeds would repurchase 125 shares at $12 each, resulting in a net decrease of 25 outstanding shares. If the denominator of the diluted EPS calculation were decreased by 25 shares, the EPS for common stock would increase, and these options would be ignored in calculating diluted EPS.

In addition, an entity does not retroactively adjust previously reported EPS as a result of changes in the market price of its common stock. EPS is calculated separately for each period presented in the financial statements, so that each period stands on its own. Options might be dilutive in the first quarter and would therefore be included in calculating EPS, but might be antidilutive in the second quarter and ignored. Regardless of the differences among quarters, the first quarter should not be retroactively adjusted to reflect facts that occur in the second quarter. In other words, EPS for each quarterly, year-to-date, or annual period is calculated independently and without regard to market price changes that occur outside of that specific period.

During a reporting period, share-based awards may be granted, exercised, or cancelled, or they may expire. The dilutive impact is determined only for the portion of a period during which the award is outstanding. For example, if an option is exercised or an unvested share vests mid-period, the share received by the grantee is outstanding and would be included in the denominator of basic EPS from that date forward. Accordingly, any potential dilutive impact is determined only for the period before the share was issued. The same logic applies to awards granted in a period: Their dilutive effect is considered only for the portion of the period during which the awards are outstanding.

**ASC 260-10-45-22**

The dilutive effect of outstanding call options and warrants (and their equivalents) issued by the reporting entity shall be reflected in diluted EPS by application of the treasury stock method unless the provisions of paragraphs 260-10-45-35 through 45-36 and 260-10-55-8 through 55-11 require that another method be applied. Equivalents of options and warrants include nonvested stock granted under a share-based payment arrangement, stock purchase contracts, and partially paid stock subscriptions (see paragraph 260-10-55-23). Antidilutive contracts, such as purchased put options and purchased call options, shall be excluded from diluted EPS.

**ASC 260-10-45-23**

Under the treasury stock method:

- Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
- The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period.
- The incremental shares (the difference between the number of shares assumed issued and the number of shares assumed purchased) shall be included in the denominator of the diluted EPS computation.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance.

**ASC 260-10-45-24** [Paragraph not used]

**ASC 260-10-45-25**

Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). Previously reported EPS data shall not be retroactively adjusted as a result of changes in market prices of common stock.

**ASC 260-10-45-26**

Dilutive options or warrants that are issued during a period or that expire or are cancelled during a period shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive options or warrants exercised during the period shall be included in the denominator for the period prior to actual exercise. The common shares issued upon exercise of options or warrants shall be included in the denominator for the period after the exercise date. Consequently, incremental shares assumed issued shall be weighted for the period the options or warrants were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

**ASC 260-10-45-27**

Paragraphs 260-10-55-3 through 55-11 provide additional guidance on the application of the treasury stock method.

**ASC 260-10-45-92**

This Example illustrates the guidance in paragraphs 260-10-45-22 through 45-23.

**ASC 260-10-45-93**

Consider Entity A that has 10,000 warrants outstanding exercisable at $54 per share; the average market price of the common stock during the reporting period is $60. Exercise of the warrants and issuance of 10,000 shares of common stock would be assumed. The $540,000 that would be realized from exercise of the warrants ($54 x 10,000) would be an amount sufficient to acquire 9,000 shares ($540,000/$60). Thus, 1,000 incremental shares (10,000 – 9,000) would be added to the outstanding common shares in computing diluted ESP for the period.

Specific guidance for applying the treasury stock method to share-based payment arrangements is outlined in ASC 260-10-45-28 through 32.

**ASC 260-10-45-28**

The provisions in paragraphs 260-10-45-28A through 45-31 apply to share-based awards issued to grantees under a share-based compensation arrangement in exchange for goods and services.

**ASC 260-10-45-28A**

Awards of share options and nonvested shares (as defined in Topic 718) to be issued to an grantee under a share-based compensation arrangement are considered options for purposes of computing diluted EPS. Such share-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even through their exercise may be contingent upon vesting. Those share-based awards are included in the diluted EPS computation even if the grantee may not receive (or be able to sell) the stock until some future date. Accordingly, all shares to be issued shall be included in computing diluted EPS if the effect is dilutive. The dilutive effect of share-based compensation arrangements shall be computed using the treasury stock method. If the equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding. See Example 8 (paragraph 260-10-55-68).

**ASC 260-10-45-28B**

In applying the treasury stock method, all dilutive potential common shares, regardless of whether they are exercisable, are treated as if they had been exercised. The treasury stock method assumes that the proceeds upon exercise are used to repurchase the entity’s stock, reducing the number of shares to be added to outstanding common stock in computing EPS.

**ASC 260-10-45-29**

In applying the treasury stock method described in paragraph 260-10-45-23, the assumed proceeds shall be the sum of all of the following:

a. The amount, if any, the grantee must pay upon exercise

b. The amount of compensation cost attributed to future services and not yet recognized. (This provision applies only to those share-based awards for which compensation cost will be recognized in the financial statements in accordance with Topic 718).

c. Subparagraph superseded by Accounting Standards Update No. 2016-09.

**ASC 260-10-45-29A**

Under paragraph 718-10-35-3, the effect of forfeitures is taken into account by recognizing compensation cost only for those instruments for which the requisite service has been rendered, and no compensation cost shall be recognized for instruments that grantees forfeit because a service condition or a performance condition is not satisfied. See Example 8 (paragraph 260-10-55-68) for an illustration of this guidance.

**ASC 260-10-45-30**

If stock-based compensation arrangements are payable in common stock or in cash at the election of either the entity or the grantee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 260-10-45-45. If an entity has a tandem award (as defined in Topic 718) that allows the entity or the grantee to make an election involving two or more types of equity instruments, diluted EPS for the period shall be computed based on the terms used in the computation of compensation expense for that period.

**ASC 260-10-45-31**

Awards with a market condition, a performance condition, or any combination thereof (as defined in Topic 718) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-57.

**ASC 260-10-45-32 (excerpt)**

Fixed grantee stock options (fixed awards) and nonvested stock (including restricted stock) shall be included in the computation of diluted EPS based on the provisions for options and warrants in paragraphs 260-10-45-22 through 45-27. Even though their issuance may be contingent upon vesting, they shall not be considered to be contingently issuable shares (see Section 815-15-55 and paragraph 260-10-45-48).

An example of applying the treasury stock method to fully vested options follows.

**Fully vested options: application of the treasury stock method**

Entity A has $100,000 in net income available to common shareholders and 50,000 weighted-average shares outstanding for the period. Basic EPS is $2 per share ($100,000 ÷ 50,000). Vested options total 6,000, with an exercise price of $5 per share. The average market price of common stock during the reporting period is $6 per share, so the options are in-the-money. In computing diluted EPS, Entity A assumes all 6,000 options have been exercised.

The denominator of the diluted EPS calculation includes the number of incremental shares, representing the difference between the 6,000 shares assumed issued and the number of shares assumed purchased. In this case, $30,000 would be the assumed proceeds from exercising the options, which could be used to acquire 5,000 common shares ($30,000 ÷ $6 average market price). As a result, 1,000 incremental shares are assumed issued (6,000 – 5,000) in addition to the 50,000 average outstanding shares, totaling 51,000 shares, which would comprise the denominator for computing diluted EPS.

The diluted EPS calculation consists of $100,000 in income ÷ 51,000 shares, yielding diluted EPS of $1.96 per share.

Consider two variations of the facts.

An important assumption in the scenario above is that the options are in-the-money and are fully vested; that is, the assumed proceeds consist solely of the exercise price and there is no unrecorded compensation cost to include in the assumed proceeds. Changing the facts slightly can have a significant impact on the diluted EPS calculations.

For instance, if these fully vested options were out-of-the-money because the average market price of Entity A’s stock during the period was $4 instead of $6 per share, the options would be antidilutive and excluded from the diluted EPS calculation.

Then again, if the options were not fully vested and unrecognized compensation cost exists, Entity A would need to consider whether the unrecognized compensation cost added to the assumed proceeds would make them antidilutive, regardless of whether the options were out-of-the-money. In other words, Entity A should make the calculations to determine whether the options are dilutive and should not presume that all out-of-the-money options are dilutive.

When options are unvested and the grantor has yet to recognize some of the grant date fair value of the award, the calculation of diluted EPS includes additional assumed proceeds equal to the unrecognized compensation cost, as shown in the following example.

**Unvested options: application of the treasury stock method**

On January 1, 2018, Entity A granted 6,000 options with an exercise price of $5, a grant-date fair value of $2 (or $12,000 of compensation cost in aggregate), and a four-year vesting period. The average market price of the stock for the year ended December 31, 2020 is $6, which means the options are in-the-money as of December 31, 2020. In computing diluted EPS for the year ended December 31, 2020, Entity A assumes all 6,000 options were exercised.

Entity A has $100,000 in net income available to common shareholders and 50,000 weighted-average shares outstanding for the period. Basic EPS is $2 per share ($100,000 ÷ 50,000).

Entity A calculates the assumed proceeds and dilutive impact for the year ended December 31, 2020 (the end of the year three of the four-year vesting period) as follows.

| Proceeds upon exercise | $30,000 |
|---|---|
| Average unrecognized compensation cost for 2020 ($12,000 ÷ 4 years = $3,000 compensation cost per year). Unrecognized compensation cost at 1/1/2020 is $6,000 (2 years × $3,000 per year) and at 12/31/2020 is $3,000 (1 year of compensation cost to recognize). The average for 2020 is $9,000 ($6,000 beginning of period + $3,000 end of period) ÷ 2 = $4,500) | $4,500 |
| Total assumed proceeds | $34,500 |
| Number of shares reacquired ($34,500 ÷ $6 average market price) | 5,750 |
| Number of assumed shares issued (6,000 upon exercise – 5,750 assumed repurchased) | 250 |

Entity A then calculates diluted EPS as $100,000 ÷ (50,000 + 250) = $1.99.

Example 8 in ASC 260-10-55-68 presents a thorough illustration of applying the treasury stock method when options are forfeited.

### Example 8: Application of the Treasury Stock Method to a Share-Based Payment Arrangement

**ASC 260-10-55-68**

This Example illustrates the guidance in paragraph 260-10-45-28A for the application of the treasury stock method when share options are forfeited.

**ASC 260-10-55-69**

Entity A adopted a share option plan on January 1, 20X7, and granted 900,000 at-the-money share options with an exercise price of $30. All share options vest at the end of three years (cliff vesting). Entity A's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3. At the grant date, Entity A assumes an annual forfeiture rate of 3 percent and therefore expects to receive the requisite service for 821,406 [900,000 × (.97 to the third power)] share options. On January 1, 20X7, the fair value of each share option granted is $14.69. Grantees forfeited 15,000 stock options ratably during 20X7.

**ASC 260-10-55-69A**

The average stock price during 20X7 is $44. Net income for the period is $97,385,602. For the year ended December 31, 20X7, there are 25,000,000 weighted-average common shares outstanding. This guidance also applies if the service inception date precedes the grant date.

**ASC 260-10-55-70**

The following table illustrates the computation of basic and diluted EPS for the year ended December 31, 20X7.

| | | | | |
|---|---|---|---|---|
| **Computation of Basic EPS for the Year Ended December 31, 20X7:** | | | | |
| Net income | | | $ | 97,385,602 |
| Weighted-average common shares outstanding | | | | 25,000,000 |
| Basic earnings per share | | | $ | 3.90 |
| **Computation of assumed proceeds for diluted earnings per share:** | | | | |
| Amount employees would pay if the weighted-average numbers of options outstanding were exercised using the average exercise price (892,500[b] x $30) | | | $ | 26,775,000 |
| Average unrecognized compensation cost in 20X7 (see computation) | | | | 10,944,050 |
| Assumed proceeds | | | $ | 37,719,050 |
| **Computation of average unrecognized compensation cost in 20X7:** | | | | |
| **Beginning of period** | | | | |
| Unrecognized compensation cost (900,000 x $14.69) | | | $ | 13,221,000 |
| **End of period** | | | | |
| Beginning of period | $ | 13,221,000 | | |
| Annual compensation cost recognized during 20X7, based on estimated forfeitures | | (4,022,151)[a] | | |
| Annual compensation cost not recognized during the period related to outstanding options at December 31, 20X7, for which the requisite service is not expected to be rendered | | (311,399)[c] | | |
| Total compensation cost of actual forfeited options | | (220,350)[d] | | |
| Total unrecognized compensation cost, end of period, based on actual forfeitures | | | | 8,667,100 |
| Subtotal | | | $ | 21,888,100 |
| Average total unrecognized compensation, based on actual forfeitures | | | $ | 10,944,050 |
| **Assumed repurchase of shares:** | | | | |
| Repurchase of shares at average market price during the year ($37,719,050 ÷ $44) | | | | 857,251 |
| Incremental shares (892,500 – 857,251) | | | | 35,249 |
| **Computation of Diluted EPS for the Year Ended December 31, 20X7:** | | | | |
| Net income | | | $ | 97,385,602 |

| | |
|---|---|
| Weighted-average common shares outstanding | 25,000,000 |
| Incremental shares | 35.249 |
| Total shares outstanding | 25,035,249 |
| Diluted earnings per share | $ 3.89 |

(a) Pre-tax annual share-based compensation cost is $4,022,151 [(821,406 x $14.69) / 3]

(b) Share options granted at the beginning of the year plus share options outstanding at the end of the year divided by two equals the weighted-average number of share options outstanding in 20X7: [(900,000 + 885,0000) ÷ 2] = 892,500. This example assumes that forfeitures occurred ratably throughout 20X7.

(c) 885,000 (options outstanding at December 31, 20X7) – 821,406 (options for which the requisite service is expected to be rendered) – 63,594 options x $14.69 (grant-date fair value per option) – $934,196 (total fair value). $934,196 ÷ 3 = $311,399 (annual share-based compensation cost).

(d) 15,000 (forfeited options) x $14.69 (grant-date fair value per option) = $220,350 (total fair value).

### 10.1.2 Contingently issuable shares: awards with market and performance conditions

This section discusses how market and performance condition awards impact diluted EPS under the contingently issuable share guidance in ASC 260. Diluted EPS is impacted only until the issuance of the actual shares is certain. When all contingencies and conditions have been met and there are no circumstances to preclude the shares from being issued, the shares are no longer included in calculating diluted EPS, but are instead included in computing basic EPS. For example, if a market condition is met in a period and the issuance of the shares is no longer contingent for any reason, the shares would be included in basic EPS, even if the shares have not yet been issued.

**ASC 260-10-45-12C**

Contractual agreements (usually associated with purchase business combinations) sometimes provide for the issuance of additional common shares contingent upon certain conditions being met. Consistent with the objective that basic EPS should represent a measure of the performance of an entity over a specific reporting period, contingently issuable shares should be included in basic EPS only when there is no circumstance under which those shares would not be issued and basic EPS should not be restated for changed circumstances.

ASC 260 specifies that the guidance on contingently issuable shares for determining diluted EPS should be applied to awards with market conditions, performance conditions, or a combination of the two because these market conditions and performance conditions are contingencies (see Sections 5.2 and 5.3 for further discussions of awards). A service or time-based vesting condition is not a contingency, however, and therefore does not require an entity to apply this guidance.

If an award includes a service requirement along with a market or a performance condition, the contingently issuable share guidance applies to the award, unless the award can vest based on time without regard to the market or performance condition. The distinguishing factor between an award evaluated under the treasury stock method discussed in Section 10.1.1 and an award evaluated under contingently issuable share guidance is the existence of contingencies that require specific achievement, and not solely the passage of time. The existence of the service-based vesting along with market or performance conditions does not impact whether an entity should apply the guidance on contingently issuable shares.

For example, the contingently issuable shares guidance applies to an award of options with a performance condition that, once met, leads to a two-year service-based vesting thereafter. Until the performance condition is met, the contingently issuable share guidance applies. If that guidance requires including the award in diluted EPS calculations, then an entity should apply the treasury stock method to determine the award's impact on diluted EPS.

This means there effectively are two steps in determining which contingently issuable shares impact the calculation of EPS:

- First, apply the contingently issuable share guidance to determine whether an award meets the criteria for inclusion in diluted EPS.
- Second, determine the impact on EPS, based primarily on the treasury stock method to determine incremental shares.

There is also an additional step in determining whether the contingently issuable share guidance causes an award with market or performance conditions to be considered when calculating diluted EPS before an entity can apply the diluted EPS guidance.

The underlying concept of the contingently issuable shares guidance is that provided that all necessary conditions for vesting have been met as of the reporting date (determined each period), then the denominator used to calculate diluted EPS includes the number of shares that would have been issuable if the period-end matched the end of the contingency period, as long as the effect is dilutive.

The guidance also specifies that year-to-date calculations should reflect contingent shares on a weighted-average basis, so that contingent shares are weighted for the interim periods when they have been included in diluted EPS.

**ASC 260-10-45-31**

Awards with a market condition, a performance condition, or any combination thereof (as defined in Topic 718) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-57.

**ASC 260-10-45-32**

Fixed grantee stock options (fixed awards) and nonvested stock (including restricted stock) shall be included in the computation of diluted EPS based on the provisions for options and warrants in paragraphs 260-10-45-22 through 45-27. Even though their issuance may be contingent upon vesting, they shall not be considered to be contingently issuable shares (see Section 815-15-55 and paragraph 260-10-45-48). However, because issuance of performance-based stock options (and performance-based nonvested stock) is contingent upon satisfying conditions in addition to the mere passage of time, those options and nonvested stock shall be considered to be contingently issuable shares in the computation of diluted EPS. A distinction shall be made only between time-related contingencies and contingencies requiring specific achievement.

The guidance in ASC 260-10-45-48 (see below) is applied broadly and is not specific to share-based payment awards. If shares included in awards are presumed to be contingently issuable, as noted in the first step in ASC 260-10-45-55a, an entity would then refer to the second step in ASC 260-10-45-55b to determine how to add the incremental shares to the diluted EPS denominator. Typically, those incremental shares are determined using the treasury stock method guidance discussed in Section 10.1.1. Said differently, an entity should follow the contingently issuable shares guidance to determine whether to include a market or performance condition award when calculating diluted EPS. An entity that concludes this type of award should be included in diluted EPS must follow the guidance on the treasury stock method to evaluate the quantitative impact, such as the assumed shares issued, the assumed proceeds, and the assumed shares repurchased.

**ASC 260-10-45-48**

Shares whose issuance is contingent upon the satisfaction of certain conditions shall be considered outstanding and included in the computation of diluted EPS as follows:

a. If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares shall be included as of the beginning of the period in which the conditions were satisfied (or as of the date of the contingent stock agreement, if later).

b. If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS shall be based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (for example, the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares shall be included in the denominator of diluted EPS as of the beginning of the period (or as of the date of the contingent stock agreement, if later).

**ASC 260-10-45-49**

For year-to-date computations, contingent shares shall be included on a weighted-average basis. That is, contingent shares shall be weighted for the interim periods in which they were included in the computation of diluted EPS.

**ASC 260-10-45-50**

Paragraphs 260-10-45-51 through 45-54 provide general guidelines that shall be applied in determining the EPS impact of different types of contingencies that may be included in contingent stock agreements.

**ASC 260-10-45-51**

If attainment or maintenance of a specified amount of earnings is the condition and if that amount has been attained, the additional shares shall be considered to be outstanding for the purpose of computing diluted EPS if the effect is dilutive. The diluted EPS computation shall include those shares that would be issued under the conditions of the contract based on the assumption that the current amount of earnings will remain unchanged until the end of the agreement, but only if the effect would be dilutive. Because the amount of earnings may change in a future period, basic EPS shall not include such contingently issuable shares because all necessary conditions have not been satisfied. Example 3 (see paragraph 260-10-55-53) illustrates that provision.

**ASC 260-10-45-52**

The number of shares contingently issuable may depend on the market price of the stock at a future date. In that case, computations of diluted EPS shall reflect the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive. If the condition is based on an average of market prices over some period of time, the average for that period shall be used. Because the market price may change in a future period, basic EPS shall not include such contingently issuable shares because all necessary conditions have not been satisfied.

**ASC 260-10-45-53**

In some cases, the number of shares contingently issuable may depend on both future earnings and future prices of the shares. In that case, the determination of the number of shares included in diluted EPS shall be based on both conditions, that is, earnings to date and current market price—as they exist at the end of each reporting period. If both conditions are not met at the end of the reporting period, no contingently issuable shares shall be included in diluted EPS.

**ASC 260-10-45-54**

If the contingency is based on a condition other than earnings or market price (for example, opening a certain number of retail stores), the contingent shares shall be included in the computation of diluted EPS based on the assumption that the current status of the condition will remain unchanged until the end of the contingency period. Example 3 (see paragraph 260-10-55-53) illustrates that provision.

**ASC 260-10-45-55**

Contingently issuable potential common shares (other than those covered by a contingent stock agreement, such as contingently issuable convertible securities) shall be included in diluted EPS as follows:

a. An entity shall determine whether the potential common shares may be assumed to be issuable based on the conditions specified for their issuance pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-54.

b. If those potential common shares should be reflected in diluted EPS, an entity shall determine their impact on the computation of diluted EPS by following the provisions for options and warrants in paragraphs 260-10-45-22 through 45-37, the provisions for convertible securities in paragraphs 260-10-45-40 through 45-42, and the provisions for contracts that may be settled in stock or cash in paragraph 260-10-45-45, as appropriate.

### *Performance conditions*

Recognizing the cost for awards with performance conditions is based on the probability that the conditions will be met. For example, assume that a grantor awards unvested shares. The award states that zero shares will vest if EBITDA does not increase 10 percent, 1,000 shares will vest if EBITDA increases 10 percent, and 2,000 shares will vest if EBITDA increases 20 percent by the end of a one-year period. In this case, the cost is recognized based on which outcome is considered probable when looking at the performance period. The grantor’s business is seasonal and mid-year results are historically low. If, at the end of each interim period, the grantor believes it will reach the 20 percent target at the end of the year, the cost for the entire 2,000 shares would be recognized throughout the year, even though some periods might yield lower results or even losses.

The guidance in ASC 260 looks at each reporting period separately when calculating EPS. Under the contingently issuable share guidance, the probability of ultimate achievement used to recognize cost is not relevant. Instead, ASC 260-10-45-48b requires the grantor to look at the facts at the end of the reporting period as if it were the end of the contingency period. The relevant metric in the preceding example—meeting an EBITDA threshold—will not change in the future. Also, even though the grantor recognizes cost based on the cost of 2,000 shares, no shares are considered for diluted EPS unless and until at least the 10 percent threshold is reached (the 20 percent threshold is not anticipated in advance of being achieved). In this scenario, there is no adjustment of cost in the numerator when calculating diluted EPS and the following guidance would apply:

- If the 10 percent EBITDA threshold is met in the first quarter, 1,000 shares are considered for diluted EPS and the grantor determines the dilutive impact based on the treasury stock method.
- If year-to-date EBITDA decreases below the 10 percent threshold in the second quarter, no shares are considered for the second quarter diluted EPS, calculation, but 1,000 shares from the first quarter would be included for the year-to-date diluted EPS calculation on a weighted-average basis for three out of six months.
- If EBITDA surpasses the 20 percent threshold in the third quarter, 2,000 shares are included in the diluted EPS calculation for the quarter and on a weighted-average basis for three out of nine months year-to-date. (The year-to-date calculation will include the 1,000 shares for the first quarter, zero shares for the second quarter, and 2,000 shares for the third quarter.)
- If the 20 percent threshold is ultimately met in the fourth quarter, 2,000 shares are included in the diluted EPS calculations for that quarter and on a weighted-average, year-to-date basis of six out of twelve months for the third and fourth quarters.

Note that achieving the 20 percent threshold when the one-year performance period ends does not change the EPS conclusions in the previous quarters. That is, each quarter stands on its own and is not retrospectively adjusted to reflect the ultimate outcome. Year-to-date EPS calculations reflect the weighted-average impact of the individual quarters.

### *Market conditions*

Under ASC 260, the approach to determining the impact of awards with market conditions on diluted EPS is mostly consistent with the approach for performance conditions and is based on whether the condition has been met in a particular period. An entity must apply the guidance on contingently issuable shares to gauge the impact of an award with market conditions on dilutive EPS, even though the cost of this award is recognized regardless of whether the condition is ever achieved. If the market condition is not achieved in a period, then the award is not considered for diluted EPS. If a target market price is achieved in a period but must be maintained for a specified amount of time, say 60 days, then the entity looks back from the end of that period to determine whether the condition has been achieved, without projecting that price into the future. For instance, if the target price is met as of the end of a quarter, the entity does not project the period's end price into the future and assert that the target has been met for 60 days for EPS purposes. Instead, the entity must look back 60 days from the period-end to determine whether the condition has been met at period-end.

### 10.1.3 Awards payable in stock or cash

Some awards permit the grantee or grantor to choose whether an award will be settled in shares or cash. Each period, the grantor considers the facts available when determining whether the award is expected to be settled in stock or cash.

According to ASC 260-10-45-45, a grantor presumes that the awards will be settled in stock if doing so would be more dilutive on EPS than settling the awards in cash. For liability-classified awards, the guidance in ASC 260-10-45-46 allows for a stated policy or past experience to overcome the presumption of stock settlement, unless, as stated in ASC 260-10-55-36, the counterparty (the grantee) controls the form of settlement. In that case, the grantor determines and then uses the more dilutive of stock or cash settlement.

**ASC 260-10-45-30**

If stock-based compensation arrangements are payable in common stock or in cash at the election of either the entity or the grantee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 260-10-45-45. If an entity has a tandem award (as defined in Topic 718) that allows the entity or the grantee to make an election involving two or more types of equity instruments, diluted EPS for the period shall be computed based on the terms used in the computation of compensation expense for that period.

**ASC 260-10-45-45**

If an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the computation of diluted EPS shall be made based on the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Topic) if the effect is more dilutive. Stock-based compensation arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and the following paragraph. An example of such a contract is a written put option that gives the holder a choice of settling in common stock or in cash.

**ASC 260-10-45-46**

A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b). The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

The following paragraphs under ASC 260-10-55 are relevant for accounting for share-based payments that can be settled in stock or in cash.

**ASC 260-10-55-33**

The references in paragraphs 260-10-45-30 and 260-10-45-45 for stock-based compensation arrangements that are payable in common stock or in cash at the election of either the entity or the grantee refer to using the guidance in paragraph 260-10-45-45 for purposes of determining whether shares issuable in accordance with such plans are included in the denominator for purposes of computing diluted EPS amounts. Accordingly, the numerator is not adjusted in those circumstances. Paragraph 260-10-55-36A illustrates these requirements.

### ASC 260-10-55-36

For contracts in which the counterparty controls the means of settlement, past experience or a stated policy is not determinative. Accordingly, in those situations, the more dilutive of cash or share settlement shall be used.

### ASC 260-10-55-36A

The following table illustrates the guidance in paragraphs 260-10-55-32 through 55-36 for the effects of contracts that may be settled in stock or cash on the computation of diluted EPS.

| Assumed Settlement for EPS Purposes[a] | Accounting for Book Purposes (per Topic 480 or 815) | Adjustment Required to Book Earnings (Numerator) for Purposes of Computing Diluted Earnings per Share[b] | Adjustment Required to Number of Shares Included in Denominator?[b] |
|---|---|---|---|
| Shares | Asset/Liability | Yes (per paragraph 260-10-45-45) | Yes |
| Shares | Equity | No | Yes |
| Cash | Asset/Liability | No | No |
| Cash | Equity | Yes (per Topic 260) | No |

(a) Note that for purposes of computing EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) should be considered share settlement.

(b) Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts.

## 10.1.4 Two-class method

The objective of the guidance in ASC 260 is to present EPS for common stockholders. Some entities also issue securities, including share-based payment awards that are participating securities. That is, they participate in undistributed earnings (e.g. dividends) along with common stock. The guidance in ASC 260 requires entities to use the two-class method for computing both *basic and diluted EPS*, but requires them to present basic and diluted EPS only for common stock, and not for other securities. A participating security is an instrument that gives the holder the right to receive undistributed earnings if common stockholders either receive undistributed earnings such as dividends or would receive dividends if undistributed earnings were distributed. The specific terms and conditions of the contractual rights of an award are the basis for determining whether it is a participating security and, if so, to what extent it participates in the undistributed earnings of an entity.

A **participating security** is a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

This section addresses only participating share-based payment awards; however, entities may have other types of participating securities.

Entities may encounter unique challenges when applying the two-class method to calculate EPS. Certain awards allow the holder to receive dividends prior to vesting, regardless of whether the dividends are paid when declared or are accrued and paid later upon vesting. If those dividends are nonforfeitable—that is, the holder is entitled to them regardless of whether the award ever vests—then the award is considered a participating security under the two-class method. Typically, these awards are in the form of restricted stock units or stock options, although other instruments could have nonforfeitable dividend rights.

In contrast, awards that provide forfeitable dividends prior to vesting are not considered participating securities because the holder forfeits accrued dividends, or repays dividends received during vesting, if the award itself does not vest. Awards that provide no dividends prior to vesting also are not considered participating securities. Accordingly, the two-class method would not apply to these awards.

Awards with either nonforfeitable or forfeitable dividend rights, however, may qualify as potential common stock in computing diluted EPS. For awards with nonforfeitable dividend rights, the more dilutive outcome of the two-class method or treasury stock method should be utilized in computing diluted EPS, whereas awards with forfeitable dividend rights should be evaluated utilizing the treasury stock method.

Computing basic EPS may be relatively straightforward under the two-class method if earnings are allocated to instruments in their current form. An entity may face challenges in determining the dilutive impact of participating securities, in part, because they can impact both the numerator and denominator of the diluted EPS equation. The two-class method does not supersede the treasury stock method for computing diluted EPS, but an entity is required to use the more dilutive of either method. For example, an entity is required to evaluate participating stock options under both the two-class method if, assuming the options have not been exercised during the current period, as well as under the treasury stock method, assuming the options have been exercised. Liability-classified options with an income statement charge or credit for the period may impact the EPS numerator when applying the treasury stock method. In each case, the more dilutive result for each participating security would be factored into the diluted EPS calculation, along with any other potential common shares from other instruments.

**ASC 260-10-45-60**

The two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders but does not require the presentation of basic and diluted EPS for securities other than common stock. The presentation of basic and diluted EPS for a participating security other than common stock is not precluded.

**ASC 260-10-45-60A**

All securities that meet the definition of a participating security, irrespective of whether the securities are convertible, nonconvertible, or potential common stock securities, shall be included in the computation of basic EPS using the two-class method.

**ASC 260-10-45-60B**

Under the two-class method:

a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends). Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the EPS for the security.

d. Basic and diluted EPS data shall be presented for each class of common stock.

For the diluted EPS computation, outstanding common shares shall include all potential common shares assumed issued. Example 6 (see paragraph 260-10-55-62) illustrates the two-class method.

### Example 6:Two-Class Method

#### ASC 260-10-55-62

This Example illustrates the two-class method of computing basic EPS (see paragraph 260-10-45-60B) for an entity that has more than one class of nonconvertible securities. This method is described in paragraph 260-10-45-59A through 45-70. Diluted EPS would be computed in a similar manner. This Example has the following assumptions for the year 20X0:

a. Net income was $65,000.

b. 10,000 shares of $50 par value common stock were outstanding.

c. 5,000 shares of $100 par value nonconvertible preferred stock were outstanding.

d. The preferred stock was entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.

e. After common stock has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 per-share ratio with common stock. (That is, after preferred and common stock have been paid dividends of $5 and $2 per share, respectively, preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)

f. Preferred stockholders have been paid $27,000 ($5.40 per share).

g. Common stockholders have been paid $26,000 ($2.60 per share).

#### ASC 260-10-55-63

Basic EPS for 20X0 would be computed as follows:

| | | |
|---|---|---|
| Net income | | $65,000 |
| Less dividends paid: | | |
| Preferred | $27,000 | |
| Common | $26,000 | $53,000 |
| Undistributed 20X0 earnings | | $12,000 |

Allocation of undistributed earnings:

*To preferred:*

0.4 (5,000) ÷ [0.4(5,000) + 0.6(10,000)] x $12,000 = $3,000
$3,000 ÷ 5,000 shares = $0.60 per share

*To common:*

0.6(10,000) ÷ [0.4 (5,000) + 0.6 (10,000)] x $12,000 = $9,000
$9,000 ÷10,000 shares = $0.90 per share

**Basic per-share amounts:**

| | **Preferred Stock** | **Common Stock** |
|---|---|---|
| Distributed earnings | $ 5.40 | $ 2.60 |
| Undistributed earnings | 0.60 | 0.90 |
| Totals | $ 6.00 | $ 3.50 |

Under the two-class method, an entity generally allocates dividends (or dividend equivalents) and undistributed earnings to each class of common stock and participating securities to determine basic and diluted EPS. This process reduces earnings available to common shareholders (that is, the EPS numerator), and therefore basic and diluted EPS of that class of common stock, by the amount of earnings allocable to holders of other classes of common stock and/or to holders of participating securities.

The following two types of awards are not participating securities and would therefore be included in an EPS calculation using the treasury stock, but not the two-class method:

- Awards with dividend rights that are forfeited if the award does not vest
- Awards with dividend rights that reduce the exercise price or purchase price of the award

### *Fully vested and unvested awards with nonforfeitable rights*

Participating securities are fully vested awards, such as fully vested options, shares, restricted stock units (RSUs), and other forms of awards, that give the holder the right to receive dividends declared on the common stock, as well as unvested awards with nonforfeitable rights to dividends or dividend equivalents, regardless of whether paid or unpaid.

**ASC 260-10-45-61**

Fully vested stock-based compensation subject to the provisions of Topic 718, including fully vested options and fully vested stock, that contain a right to receive dividends declared on the common stock of the issuer, are subject to the guidance in paragraph 260-10-45-60A.

**ASC 260-10-45-61A**

Unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method under the requirements of paragraph 260-10-45-60A.

**Vested participating RSUs**

Assume that an entity issues RSUs that now are fully vested, giving holders the right to receive the same per-share dividends as common stockholders. Also, assume that an equal number of RSUs and common shares are outstanding for the period, net income is $2,000, and no dividends were declared in the period. Because the RSUs are participating securities, income available to common shareholders (the EPS numerator) is reduced by 50 percent, or $1,000, in calculating basic EPS.

*Paid* (distributed) versus *undistributed* (unpaid) nonforfeitable dividends or dividend equivalents have a different impact on unvested awards that are not expected to vest, because the amounts paid on unvested awards are recognized as compensation cost rather than being charged to retained earnings. Since the EPS numerator is already reduced for amounts *paid,* these amounts are not included in allocating earnings under the two-class method to avoid double counting their impact. In contrast, *undistributed* (unpaid) earnings are allocated to all awards, including those that are not expected to vest, if an entity elects to estimate forfeitures.

ASC 260-10-45-68B provides further guidance on vested and unvested awards.

**ASC 260-10-45-68B**

Paragraph 718-10-55-45 requires that nonrefundable dividends or dividend equivalents paid on awards for which the requisite service is not (or is not expected to be) rendered be recognized as additional compensation cost and that dividends or dividend equivalents paid on awards for which the requisite service is (or is expected to be) rendered be charged to retained earnings. As a result, an entity shall not include dividends or dividend equivalents that are accounted for as compensation cost in the earnings allocation in computing EPS. To do so would include the dividend as a reduction of earnings available to common shareholders from both compensation cost and distributed earnings. *Undistributed* earnings shall be allocated to all share-based payment awards outstanding during the period, including those for which the requisite service is not expected to be rendered (or is not rendered because of forfeiture during the period, if an entity elects to account for forfeitures when they occur in accordance with paragraph 718-10-35-3). An entity's estimate of the number of awards for which the requisite service is not expected to be rendered (or no estimate, if the entity has elected to account for forfeitures when they occur in accordance with paragraph 718-10-35-3) for the purpose of determining EPS under this Topic shall be consistent with the estimate used for the purposes of recognizing compensation cost under Topic 718. Paragraph 718-10-35-3 requires that an entity apply a change in the estimate of the number of awards for which the requisite service is not expected to be rendered in the period that the change in estimate occurs. This change in estimate will affect net income in the current period; however, a current-period change in an entity's expected forfeiture rate would not affect prior-period EPS calculations. See Example 9 for an illustration of this guidance.

### *Allocating undistributed earnings*

Before allocating undistributed earnings to an award, an entity must carefully consider the award's contractual terms and conditions related to participation. ASC 260 states that the terms must be clear that the award provides nondiscretionary rights to participate and that absent those terms, no undistributed earnings should be allocated to that award. One consideration is whether the entity could avoid distributing earnings to a grantee based on the award's contractual terms. If the entity cannot avoid distributing earnings because the rights to participate are clearly stipulated in the contract, the entity must allocate undistributed earnings to the award.

**ASC 260-10-45-65**

Undistributed earnings for a period shall be allocated to a participating security based on the contractual participation rights of the security to share in those current earnings as if all of the earnings for the period had been distributed. If the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights, then undistributed earnings would not be allocated based on arbitrary assumptions. For example, if an entity could avoid distribution of earnings to a participating security, even if all of the earnings for the year were distributed, then no allocation of that period's earnings to the participating security would be made. Paragraphs 260-10-55-24 through 55-31 provide additional guidance on participating securities and undistributed earnings.

**ASC 260-10-45-66**

Under the two-class method the remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. This allocation is required despite its pro forma nature and that it may not reflect the economic probabilities of actual distributions to the participating security holders.

Some rights to undistributed earnings include contingent rights to participate in all or only some earnings, or other attributes that must be considered in allocating undistributed earnings. Again, evaluating an award's specific terms and conditions is critical to accurately allocating earnings. The following guidance provides several circumstances that might be relevant in evaluating an award's contractual terms.

**ASC 260-10-55-24**

In all of the following circumstances, the participation rights of the securities may be required to be disclosed in accordance with the provisions of 505-10, regardless of whether undistributed earnings are allocated to the participating security.

**ASC 260-10-55-25**

If a participating security provides the holder with the ability to participate in all dividends declared with the holders of common stock on a one-to-one per-share basis, then the undistributed earnings should be allocated between the common stock and the participating security on a one-to-one per-share basis.

**ASC 260-10-55-26**

If a participating security provides the holder with the ability to participate with the holders of common stock in dividends declared contingent upon the occurrence of a specified event, the occurrence of which is subject to management discretion or is not objectively determinable (for example, liquidation of the entity or management determination of an extraordinary dividend), then the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights; therefore, undistributed earnings would not be allocated to the participating security.

**ASC 260-10-55-27**

If a participating security provides the holder with the ability to participate with the holders of common stock in earnings for a period in which a specified event occurs, regardless of whether a dividend is paid during the period (for example, achievement of a target market price of a security or achievement of a certain earnings level), then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. Undistributed earnings would be allocated to the participating security if the contingent condition would have been satisfied at the reporting date, irrespective of whether an actual distribution was made for the period.

**ASC 260-10-55-28**

If a participating security provides the holder with the ability to participate in extraordinary dividends and the classification of dividends as extraordinary is predetermined by a formula, for example, any dividend per common share in excess of 5 percent of the current market price of the stock is defined as extraordinary, then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. If earnings for a given period exceed the specified threshold above which the participating security would participate (that is, earnings for the period are in excess of 5 percent of the current market price of the stock), undistributed earnings would be allocated to the participating security according to its terms.

**ASC 260-10-55-29**

If a participating security provides the holder with the ability to participate in extraordinary dividends and the classification of dividends as extraordinary is within the sole discretion of the board of directors, then undistributed earnings would be allocated only to common stock. Since the classification of dividends as extraordinary is within the sole discretion of the board of directors, undistributed earnings would not be allocated to the participating security as the participation in the undistributed earnings would not be objectively determinable.

**ASC 260-10-55-30**

If a participating security provides the holder with the ability to participate in all dividends up to a specified threshold (for example, the security participates in dividends per common share up to 5 percent of the current market price of the stock), then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. In this example, undistributed earnings would be allocated to common stock and to the participating security up to 5 percent of the current market price of the common stock, as the amount of the threshold for participation by the participating security is objectively determinable. The remaining undistributed earnings for the period would be allocated to common stock.

### *Allocating losses*

By their nature, most participating securities do not share in an entity's losses, but some do. We believe it would be rare that a share-based compensation award would share in an entity's losses. The following guidance outlines conditions when losses would affect the calculation of EPS.

**ASC 260-10-45-67**

An entity would allocate losses to a nonconvertible participating security in periods of net loss if, based on the contractual terms of the participating security, the security had not only the right to participate in the earnings of the issuer, but also a contractual obligation to share in the losses of the issuing entity on a basis that was objectively determinable. Determination of whether a participating security holder has an obligation to share in the losses of the issuing entity in a given period shall be made on a period-by-period basis, based on the contractual rights and obligations of the participating security. The holder of a participating security would have a contractual obligation to share in the losses of the issuing entity if either of the following conditions is present:

a. The holder is obligated to fund the losses of the issuing entity (that is, the holder is obligated to transfer assets to the issuer in excess of the holder's initial investment in the participating security without any corresponding increase in the holder's investment interest).

b. The contractual principal or mandatory redemption amount of the participating security is reduced as a result of losses incurred by the issuing entity.

### *Basic EPS for participating awards*

Example 9, Case D, in ASC 260-10-55-76 shows how to compute basic EPS using the two-class method when an entity has *unvested* share-based payment awards with nonforfeitable participation rights.

**Example 9, Case D: Participating Share-Based Payment Awards**

**ASC 260-10-55-76A**

Assume that Entity A had 25,000 shares of common stock and 5,000 unvested share-based payment awards outstanding during 20X8 and reported net income of $100,000. The share-based payment awards participate in any dividends on a 1:1 per-share ratio with common stock, and the dividends are nonforfeitable by the holder of the share-based payment awards. Entity A's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3.

**ASC 260-10-55-76B**

As of the beginning of 20X8, Entity A estimated that the requisite service will not be provided for 200 of the 5,000 share-based payment awards outstanding. At the end of 20X8, Entity A adjusts its estimate to reflect an increased expected forfeiture rate and now expects that the requisite service will not be provided for 300 awards. It recognizes the cumulative effect of this change in compensation cost in the current period.

**ASC 260-10-55-76C**

Entity A paid a $1.50 per-share dividend at the end of 20X8. Net income includes an expense of $450 related to dividends paid to the awards for which the requisite service is not expected to be rendered in accordance with paragraph 718-10-55-45. Basic EPS under the two-class method for 20X8 would be computed as follows:

| | | | | |
|---|---|---|---|---|
| Net income | | | $ | 100,000 |
| Less dividends paid: | | | | |
| Common stock | $ | 37,500 | | |
| Unvested share-based payment awards | $ | 7,050[(a)] | | |
| | | | $ | 44,550 |
| Undistributed earnings | | | $ | 55,450 |

(a) Reflects the dividends paid to unvested share-based payment awards ($7,500 = 5,000 unvested share-based payment awards x $1.50 dividend per share) less the dividends paid to awards for which the requisite service is not expected to be rendered ($450 = 300 share-based payment awards for which the requisite service is not expected to be rendered x $1.50 dividend per share). Dividends paid on awards for which the requisite service is not expected to be rendered are already recognized in net income as additional compensation cost.

Allocation of undistributed earnings:

*To unvested share-based payment awards:*

5,000 ÷ (5,000 + 25,000) x $55,450 = $9,242

$9,242 ÷ 5,000 total unvested share-based payment awards = $1.85 per share

*To common:*

25,000 ÷ (5,000 + 25,000) x $55,450 = $46,208

$46,208 ÷ 25,000 shares of common stock = $1.85 per share

Or, to simplify, because the common shareholders and the share-based payment award holders share in dividends on a 1:1 basis, undistributed earnings could also be calculated as follows:

$55,450 ÷ 30,000 shares[(b)] = $1.85 per common share and share-based payment award

(b) 25,000 shares of common stock ÷ 5,000 total unvested share-based payment awards

Basic earnings per share amounts:

| | Unvested Share-Based Payment Awards | | Common Stock |
|---|---|---|---|
| Distributed earnings | $1.41 | (c) | $1.50 |
| Undistributed earnings | 1.85 | | 1.85 |
| | $3.26 | | $3.35 |

(c) $7,050 of distributed earnings allocated to the unvested share-based payment awards divided by 5,000 total unvested share-based payment awards. Although all unvested share-based payment awards received a payment of $1.50 per share, totaling $7,500, only dividends to awards for which the requisite service is expected to be rendered are considered distributed earnings as that term is used in paragraph 260-10-55-19(a). Dividends paid on awards for which the requisite service is not expected to be rendered are recognized in net income as additional compensation cost.

**ASC 260-10-55-76D**

Note that in this illustrative example, application of the two-class method presents an EPS calculation for both the common stock and the participating security, that is, the unvested share-based payment awards. This presentation is for illustrative purposes only. The presentation of EPS is only required for each class of common stock. However, the presentation of basic and diluted EPS for a participating security other than common stock is not precluded. The disclosure in the notes to financial statements of actual distributions to unvested share-based payment awards, rather than the amount presented as distributed earnings, also is not precluded to reconcile earnings per common share and per unvested share-based payment awards. For example, Entity A in the example above may disclose that actual distributions to unvested share-based payment awards were $7,500 and that $450 of those distributions was included in net income as compensation cost related to awards for which the requisite service is not expected to be rendered. Disclosure on a per-share basis also is not precluded.

### *Diluted EPS and awards: interaction of the two-class method and other methods*

Calculating basic EPS can be relatively straightforward under the two-class method whereby earnings are allocated to instruments in their current form. On the other hand, participating securities and diluted EPS can present challenges in calculating EPS, in part, because these securities may impact both the EPS numerator and denominator. The two-class method does not supersede the treasury stock method for computing diluted EPS, but requires an entity to determine and use the more dilutive of the two-class or the treasury stock method. In other words, an entity is required to calculate diluted EPS under both methods and to compare the dilutive impact. Liability-classified awards with an income statement charge or credit for the period may impact the numerator when applying the treasury stock method.

### *Other practice issues and examples when implementing the two-class method*

At the 2006 AICPA National Conference on Sec and PCAOB Developments, the SEC staff[4] noted that when there is more than one class of common stock, one class may have higher dividend rates, while the other may have more voting rights. The SEC staff has also noted that one class of common stock can often be converted into another class with different characteristics. The SEC staff believes that regardless of conversion rights, an entity with more than one class of common stock should present both basic and diluted EPS for each class of common stock, in accordance with ASC 260-10-45-60B(d).

[4] 2006 AICPA National Conference on SEC and PCAOB Developments, Cathy Cole, Associate Chief Accountant, Office of the Chief Accountant.

The SEC staff further noted that some entities have more than one class of common stock lacking specified dividend rates. Determining how, and to what extent, participating securities share in earnings can be complex, depending on the terms of the award, such as whether dividends are shared equally or are subject to limitations, among other factors. What's more, participating securities classified as assets or liabilities might impact current-period net income. The SEC provided its view of the following fact pattern.

**More than one class of stock**

Assume the following factors regarding an entity that has more than one class of common stock:

- Dividends may be paid to Class A common stockholders without equal dividends paid to Class B common stockholders.
- Dividends may not be paid on Class B without an equal amount being paid on Class A.
- Class B shareholders control the entity (through voting rights) and may convert those shares into Class A common shares on a one-to-one basis.
- Upon liquidation, each class of common stock shares equally in the entity's net assets.
- Historically, each class of common stock received the same amount of dividends.

In this scenario, the SEC staff believes the entity should apply the two-class method. Since there are no contractually predetermined rights to dividends, a literal application of ASC 260-10-45-65 would result in no allocation of undistributed earnings to Class B common stock. However, the SEC believes that, because Class B common stockholders control the entity, it is unlikely that they would permit the board of directors to pay dividends on Class A shares without also making a distribution to Class B stockholders. Furthermore, the fact that Class B shares are convertible into Class A would allow Class B holders to capture any disproportionate dividend by exercising their conversion rights. The SEC staff therefore believes that a strict application of ASC 260-10-45-65 would not be appropriate based on these facts. Instead, the entity should apply the two-class method in this situation, by allocating undistributed earnings between the two classes on a one-to-one basis.

The SEC staff also believes that all of the rights and privileges of the classes should be considered in determining the allocation of undistributed earnings to each class of common stock.

## 10.2 Unvested shares in equity

Entities sometimes issue unvested shares, often called "restricted shares" to grantees. If these unvested shares have been legally issued, they are included as legally issued and outstanding in the equity section of the balance sheet.

Because unvested shares are not included in basic EPS, the notes to the financial statements should include a reconciliation between the number of issued shares shown on the balance sheet and the number of shares used to determine basic EPS, by identifying the number of shares that are not considered issued for accounting purposes.

The guidance in ASC 718 does not permit entities to present a contra-equity account for unearned compensation. Therefore, if shares are legally issued but are not yet vested, the statement of equity may not show the entire amount of additional paid-in capital equal to the fair value of the award less a contra-equity amount to equal the net vested amount. Instead, additional paid-in capital should be increased as compensation is recorded.

For example, one year ago, an entity granted 100 legally issued shares with no par value and a fair value of $1,000, which vest over five years. Recognized compensation cost is $200 per year. The award is now 20 percent vested. The statement of equity presents the 100 issued shares, but the amount recorded in additional paid-in capital is only $200, representing only the vested portion. The entity must disclose information as to the vesting status and unrecorded compensation in the notes to the financial statements. Prior to ASC 718, however, the entity would have presented the entire $1,000 as additional paid-in capital and a contra-equity amount of $(800), but ASC 718 precludes using a contra-equity account in this circumstance.

## 10.3 Statement of cash flows

The expense recognized for a share-based payment award is a noncash transaction. When presenting cash flows using the indirect method, an entity includes the noncash cost as a reconciling item between net income and the subtotal of cash from operations. The cash paid by a grantee to purchase an equity instrument or exercise an option is a cash inflow from financing activities.

The cash paid by a grantor to settle a liability-classified award generally is an operating cash outflow, consistent with the notion that this form of award does not represent a form of equity or financing that would call for classification as a financing activity.

Cash paid to a tax authority by a grantor when withholding shares from a grantee's award for tax-withholding purposes is a cash outflow from financing activities. This guidance was added to ASC 230-10-45-15 by the amendments in ASU 2016-09 because previously, there was no specific guidance. Often, the grantor withholds shares when an award vests or is exercised for the grantor to pay the required tax-withholding deposits to a tax authority (ies). In these arrangements typically the entire number of shares is issued, but immediately thereafter, some shares are repurchased to make the tax-withholding payment. In that context, the cash paid to the tax authority is considered a cash outflow from financing activities (to effect the repurchase) instead of an operating cash outflow.

**ASC 230-10-45-15 (excerpt)**

All of the following are cash outflows for financing activities:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments. Cash paid to a tax authority by a grantee when withholding shares from an grantee's award for tax-withholding purposes shall be considered an outlay to reacquire the entity's equity awards

Excess tax benefits (the difference between the tax deduction realized for a share-based payment transaction and the deferred tax asset recognized as compensation cost) are classified in operating activities where other income tax flows are presented. Prior to the amendments in ASU 2016-09, the additional cash retained from realized excess tax benefits from certain share-based payment awards was classified as a financing cash inflow, with a corresponding amount shown as an operating cash outflow. ASU 2016-09 simplified this previous presentation by eliminating the corresponding amounts and instead requiring any cash impact of excess tax benefits to be presented in operating activities along with other income tax cash flows.

# 11. Nonemployee awards (before adoption of ASU 2018-07)

Entities often grant share-based payment awards to nonemployees, such as suppliers, service providers, and independent contractors. Although the guidance in ASC 505-50 generally applies to nonemployee share-based payment awards, it does not address all aspects of accounting for these awards, so entities often need to refer to the guidance in ASC 718 by analogy. Because the accounting differs significantly depending upon whether the award is within the scope of ASC 505-50 or ASC 718, entities should ensure that they have properly identified the appropriate guidance to apply to nonemployee awards.

This section addresses the accounting for nonemployee awards *before* an entity adopts ASU 2018-07, which mostly aligns the accounting for share-based payments made to nonemployees with the guidance on accounting for share-based payment awards made to employees, with certain exceptions. Section 13 addresses the accounting for nonemployee awards after an entity adopts ASU 2018-07.

## 11.1 Scope

The guidance in ASC 505-50 does not apply to employee awards. The guidance applies to share-based payment transactions (and modifications of existing arrangements) with nonemployees, except for the following:

- Transactions with employee stock ownership plans
- Transactions that involve equity instruments that either are issued to a lender or an investor who provides financing to the issuer or are issued in a business combination

**ASC 505-50-15-3**

The guidance in this Subtopic does not apply to the following transactions:

a. Transactions with individuals meeting the definition of an employee

b. Transactions with employee stock ownership plans

c. Transactions involving equity instruments either issued to a lender or investor that provides financing to the issuer or issued in a business combination.

The guidance for distinguishing between *employees* and *nonemployees* for purposes of ASC 718 and ASC 505-50 is described in Section 2.1.

### 11.1.1 Applying ASC 718 by analogy

There is explicit guidance in ASC 505-50 addressing the recognition, measurement date, and measurement method for equity instruments issued to nonemployees. For accounting issues pertaining to equity instruments issued to nonemployees that are not specifically addressed in ASC 505-50, the SEC staff has indicated in SAB Topic 14.A, *Share-Based Payment Transactions with Nonemployees*, that the guidance in ASC 718 for employee transactions should be applied by analogy to transactions with nonemployees, unless other authoritative literature more clearly applies or the guidance in ASC 718 would be inconsistent with the terms of the nonemployee transaction.

### SAB Topic 14.A

**Question:** Are share-based payment transactions with nonemployees included in the scope of FASB ASC Topic 718?

**Interpretive Response:** Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by FASB ASC Topic 718. This Topic explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments;[4] and
- Requires that an entity record the value of a transaction with a nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued.[5]

FASB ASC Topic 718 does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, FASB ASC Topic 718 does not specify the measurement date for share-based payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued.[6] For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to FASB ASC Subtopic 505-50, Equity — Equity Based Payments to Non-Employees.

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in FASB ASC Topic 718 would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in FASB ASC Topic 718 by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in FASB ASC Topic 718 would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement.[7] For example, the staff believes the guidance in FASB ASC Topic 718 on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

4 – FASB ASC paragraph 718-10-30-2.

5 – Ibid.

6 – [Original footnote removed by SAB 114.]

7 – For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service termination, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the option's expected term rather than the contractual term. If these features (i.e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option

arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.

Most nonemployee awards must be valued using the contractual term rather than the expected term because they lack the specific features that are common in employee options—nontransferability, the inability to hedge, and the shortening of the vested option's term upon termination of service—that make use of the expected term appropriate in the valuation model for employee options.

Other areas where entities might refer by analogy to the guidance in ASC 718 to account for nonemployee awards include:

- Classification
- Income taxes
- Modification accounting

**Grant Thornton insights: Applying ASC 718 by analogy for nonpublic entities**

Although SAB 14.A applies to public business entities, we believe the guidance can also be applied to nonpublic entities. In other words, nonpublic entities should refer to the guidance in ASC 718 by analogy if ASC 505-50 lacks specific guidance on an accounting for nonemployee awards.

## 11.2 Awards that become subject to other guidance

ASC 718-10-35-9 describes in detail when a share-based payment award no longer falls within the scope of ASC 718. According to ASC 718-10-35-9, an employee award generally remains within the scope of ASC 718 throughout its life, unless it is modified after an employee is terminated. Because ASC 718-10-35-9 excludes nonemployee awards from that particular guidance, once an award is no longer impacted by the counterparty providing goods or services, the ASC 718 classification guidance no longer applies, and the guidance in another ASC Topic instead becomes applicable. Said differently, even though an employee termination is somewhat analogous to a nonemployee ceasing to provide services, the nonemployee award would no longer be accounted for under the share-based payment guidance in ASC 718. Other guidance that typically is applicable is ASC 815 or ASC 480.

As a result, nonemployee awards are generally subject to guidance other than ASC 718 once a nonemployee completes its performance, which might result in a change in classification in the grantor's accounting. Repurchase features are more likely to result in the reclassification of a nonemployee award; for example, redemption terms subject to SEC temporary equity classification guidance or mandatory redemption terms subject to ASC 480 liability classification.

An issue arises when the terms of a nonemployee award state that the grantee has a limited period of time to exercise a vested stock option after ceasing to provide goods or services. As noted in Section 11.1.1, one of the historic differences between employee and nonemployee awards is that nonemployee awards typically do not have such features as nontransferability, nonhedgability, and the truncation of the contractual term. If a nonemployee award has truncation terms, the issue is how long the truncation period is. If the service ends and the contractual term truncates to a short period—that is, 90 days or less—grantors generally do not treat the truncation as a modification and should apply other accounting.

If the period is longer than 90 days, then other guidance, such as ASC 815-40 or ASC 480, should be applied.

**ASC 718-10-35-9**

Paragraphs 718-10-35-10 through 35-14 are intended to apply to those instruments issued in share-based payment transactions with employees accounted for under this Topic, and to instruments exchanged in a business combination for share-based payment awards of the acquired business that were originally granted to employees of the acquired business and are outstanding as of the date of the business combination. Instruments issued, in whole or in part, as consideration for goods or services other than employee service shall not be considered to have been issued in exchange for employee service when applying the guidance in those paragraphs, irrespective of the employment status of the recipient of the award on the grant date.

## 11.3 Period and manner of recognition

The guidance in ASC 505-50 does not address the period or manner (that is, whether to capitalize or expense) in which a grantor should recognize the fair value of the share-based payment awards. This guidance requires a grantor to recognize an asset, expense, or sales discount in the same period(s) and in the same manner as though the grantor had either paid cash for the goods or services or used cash rebates as a sales discount instead of issuing equity awards. This concept of recognizing cost as if cash were paid differs from the guidance for recognizing employee awards in ASC 718 that uses the term "requisite service period" (See guidance in Section 6.2). Although the pattern of recognition can ultimately be quite similar for employee and nonemployee awards, a grantor that issues a nonemployee award should apply the guidance in ASC 505-50-25-4.

**ASC 505-50-25-4**

This guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an entity granting the equity instrument (the purchaser or grantor) shall recognize the fair value of the equity instruments that will be issued, other than to require that an asset, expense, or sales discount be recognized (or previous recognition reversed) in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with or using the equity instruments.

ASC 505-50 address the recognition, measurement date, and the measurement method for equity instruments issued to nonemployees. The guidance is summarized in the sections that follow.

## 11.4 Measurement principle

ASC 505-50 provides detailed guidance on the recognition, measurement date, and the measurement method for equity instruments issued to nonemployees. Equity instruments issued to a nonemployee are measured based on the fair value of the goods or services received or on the fair value of the equity instruments issued, whichever is "more reliably measurable." Similarly, the fair value of equity instruments issued as sales incentives is based on the fair value of the sales incentive or on the fair value of the equity instruments issued, whichever is "more reliably measurable."

### ASC 505-50-30-6

If the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction. In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued.

### ASC 505-50-30-7

Sales incentives in the form of equity instruments shall be measured at the fair value of the sales incentive or the fair value of the equity instruments issued, whichever is more reliably measurable.

### Grant Thornton insights: 'More reliably measurable'

Despite the guidance in ASC 505-50-30-6 to determine the "more reliably measurable" fair value, in the vast majority of cases, the fair value of the equity instruments issued is typically more reliably measurable than the fair value of the goods or services received. In the years since ASC 505-50 was issued, entities have become much more experienced with fair value estimation techniques. In most cases today, the fair value of the equity instruments is more reliably measurable than the fair value of goods or services, so an entity would find it difficult to support an assertion that the fair value of the goods or services is more reliably measured than the fair value of the equity instruments.

If the fair value of the equity instruments issued is more reliably measurable, entities must account for those instruments based on their substantive features, with the exception of certain explicitly excluded features, such as reload features and certain contingent provisions, including clawbacks.

### ASC 505-50-30-4

Paragraph 505-50-25-3 requires that the accounting for all share-based payment transactions reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances. The minimum value method (a method that reflects the time value of an option but ignores the volatility value) is not an acceptable method for determining the fair value of nonemployee awards by nonpublic entities.

The guidance in ASC 718 allows entities to measure certain awards at either calculated value or intrinsic value. For example, nonpublic entities may elect to measure liability awards at intrinsic value and certain nonpublic award plans at book value. This guidance does not, however, apply to nonemployee awards. On September 13, 2015, the Statement 123R Resource Group concluded that entities must account for equity instruments issued to nonemployees only at fair value, and not at intrinsic or calculated value. This principle applies regardless of whether the issuer is a public or nonpublic entity.

### 11.4.1 Measurement date

If the fair value of the equity instruments issued in a transaction with nonemployees is more reliably measurable than the fair value of the goods or services, the measurement date for determining the fair value of the equity instruments is the earlier of the following dates:

- The date the nonemployee commits to perform activities to earn the equity instruments (the “performance commitment” date)
- The date the nonemployee completes its performance

**ASC 505-50-30-11**

An entity (the issuer, grantor, or purchaser) may enter into transactions with nonemployees in which equity instruments are issued in exchange for the receipt of goods or services or to provide a sales incentive. The issuer shall measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions as of the earlier of the following dates, referred to as the measurement date:

a. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a performance commitment)

b. The date at which the counterparty’s performance is complete.

**Grant Thornton insights: Determining the measurement date for nonemployee awards**

Most awards granted to nonemployees are measured as of the date when the counterparty completes its performance based on the guidance in ASC 505-50, while in contrast, under ASC 718, the measurement date is the grant date, which is often the date when the award is made.

As a result, most nonemployee awards are remeasured each period during the nonemployee’s performance. If equity values rise during that time, measuring at the performance completion date generally results in higher ultimate cost.

The measurement-date guidance in ASC 505-50 stems from EITF deliberations in the 1990s. The EITF believed that there is a fundamental difference between the employer’s relationship with grantor entities and their employee and its relationship with a nonemployee. Specifically, the EITF concluded that there is a presumption that employees are more economically dependent on the entity granting the share-based payment awards than nonemployees and that employees are therefore more likely to complete the required service than nonemployees are. In other words, nonemployees may have multiple outside opportunities to generate compensation and may choose not to complete the required service if the fair value of the share-based payment award declines after the grant date. As a result, the EITF concluded that using the grant date as the measurement date was not appropriate for nonemployee awards. The EITF further concluded that a nonemployee's level of effort was directly related to the value of the award, whereas an employee also receives cash wages and would likely be less apt to make decisions about his or her level of effort based on "supplemental" compensation in the form of share-based payments.

### *Performance commitment*

A "performance commitment" exists when it is probable that a nonemployee will perform its services because there is a sufficiently large disincentive for nonperformance, such as a significant economic penalty. A disincentive must result from the relationship between the grantor and the grantee for a performance commitment to exist. Neither the right to forfeit the equity instruments nor the right to sue for nonperformance represents a sufficiently large disincentive to indicate that performance is probable.

**ASC 505-50-30-12**

A performance commitment is a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the issuer and the counterparty. Forfeiture of the equity instruments as the sole remedy in the event of the counterparty's nonperformance is not considered a sufficiently large disincentive for purposes of applying this guidance. In addition, the ability to sue for nonperformance, in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable. (An entity may always be able to sue for nonperformance but it is not always clear whether any significant damages would result.)

Example 1 in ASC 505-50 includes scenarios where a performance commitment exists before performance is completed.

**Example 1: Identification of Situations in Which Performance Commitment Exists Before Performance is Complete**

**ASC 505-50-55-2**

Section 505-50-30 provides guidance on the relevance of determining whether a performance commitment exists relative to establishing a measurement date in a share-based payment transaction with nonemployees. This Example consists of three Cases that describe arrangements in which a performance commitment exists before the counterparty's performance is complete. These arrangements contain performance commitments before performance is complete despite the fact that in some Cases the quantity or some of the terms of the equity instruments are not known when the arrangement is entered into and for that matter may not be known until sometime after the counterparty has provided or, in the case of sales incentives, purchased the requisite goods or services. Each Case assumes that the fair value of the equity instruments to be issued is more reliably measurable than the fair value of the corresponding goods or services. … The three Cases depict the following arrangements:

- Construction services of a manufacturer subject to a significant penalty (Case A)
- Legal services subject to damages (Case B)
- Marketing services subject to damages (Case C).

**Case A: Construction Services of a Manufacturer Subject to a Significant Penalty**

**ASC 505-50-55-3**

A telecommunications entity agrees to issue shares of its stock in exchange for the construction services of a manufacturer to build a new version of a satellite, with a contract delivery date not to exceed four years. The manufacturer is subject to a significant penalty if it does not complete construction of the satellite. This penalty is considered to be of a magnitude that is a sufficiently large disincentive for nonperformance; thus, the arrangement contains a performance commitment.

**Case B: Legal Services Subject to Damages**

**ASC 505-50-55-4**

An entity agrees to issue stock options in exchange for the services of a lawyer to defend it in a product liability case. The quantity, exercise price, and exercise period of the stock options are dependent on whether the lawyer wins or loses the case. If the lawyer quits the case, the lawyer is subject to damages. The damages are considered to be a sufficiently large disincentive for nonperformance; thus, this arrangement contains a performance commitment. This arrangement contains a performance commitment regardless of the fact that both the quantity and some of the terms of the stock options are unknown when the arrangement is established.

**Case C: Marketing Services Subject to Damages**

**ASC 505-50-55-5**

A retailer agrees to issue stock options to an advertising freelancer in exchange for designing a marketing campaign for a particular chain of its stores. The exercise price of the stock options is based on a formula that ties the exercise price to the cumulative percentage increase in sales from the date the new marketing campaign is rolled out until a particular stock option's exercise date. If the freelancer quits, then the freelancer is subject to specified monetary damages that, in the circumstances, constitute a sufficiently large disincentive for nonperformance. This transaction thus contains a performance commitment regardless of the fact that the exercise price of a particular stock option is not known until the date it is exercised.

**Grant Thornton insights: What constitutes a performance commitment?**

Generally, entities infrequently encounter performance commitments that meet the criteria for a measurement date. This is because most arrangements do not include sufficiently large disincentives for nonperformance, but instead call for forfeiture of vested amounts or minor financial penalties. ASC 505-50 specifically excludes forfeiture as a sufficiently large disincentive and clearly states that penalties must be large. In other words, the existence of a "significant" financial penalty for nonperformance is somewhat rare. Determining if a penalty is "significant" requires judgment and can be made only at the inception of the arrangement. Among other things, the entity should consider the overall value of the arrangement, the consequences for the counterparty if it fails to perform (such as lost future revenues), and the counterparty's ability to recover costs through other work and to pay the penalty.

### *Unvested, forfeitable awards with a performance commitment*

The SEC staff stated that unvested, forfeitable equity instruments granted to nonemployees should be treated as unissued for accounting purposes until the future services are received (the vesting date). This view applies even in a situation in which a registrant issues the equity instruments subject to a sufficiently large penalty for grantee nonperformance that a performance commitment and measurement date exist at the date of issuance. Therefore, in the staff's view, entities should not account for unvested, forfeitable equity instruments at the measurement date if the related services must still be performed in the future.

**ASC 505-50-S99-1**

The following is the text of SEC Staff Announcement: Grantor Balance Sheet Presentation of Unvested, Forfeitable Equity Instruments Granted to a Nonemployee.

> The SEC staff has received inquiries on the appropriate balance sheet presentation of arrangements where unvested, forfeitable equity instruments are issued to an unrelated nonemployee (the counterparty) as consideration for future services. The arrangements addressed by the staff entitle the grantor to recover the specific consideration paid, plus a substantial mandatory penalty, as a minimum measure of damages for counterparty nonperformance. Consequently, pursuant to paragraph 505-50-30-12, sufficiently large disincentives for counterparty nonperformance exist such that a performance commitment and measurement date have been achieved as of the date of issuance. The fair value of these arrangements is measured in accordance with paragraph 505-50-30-6. Practice appears mixed as to whether such transactions are recorded at the measurement date. Some registrants make no entries until performance occurs, while others record the fair value of the equity instruments as equity at the measurement date and record the offset either as an asset or as a reduction of stockholders' equity (contra-equity). This announcement sets forth the SEC staff's position on the appropriate accounting at the measurement date.
>
> In evaluating the appropriate balance sheet classification for the above arrangements, the staff considered the following guidance:
>
> - Paragraph 505-50-25-4, which states that the guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an enterprise should recognize the fair value of equity instruments that were issued, other than to reach a consensus that an asset or expense should be recognized in the same period(s) and in the same manner (capitalize or expense) as if the enterprise had paid cash for the goods or services instead of issuing equity instruments.
>
> The SEC staff believes that if the issuer receives a right to receive future services in exchange for unvested, forfeitable equity instruments, those equity instruments should be treated as unissued for accounting purposes until the future services are received (that is, the instruments are not considered issued until they vest). Consequently, there would be no recognition at the measurement date and no entry should be recorded.

### *Performance is complete*

If a share-based payment award made to a nonemployee does not contain a performance commitment, the measurement date for determining the fair value of the equity instruments is the date the grantee completes its performance. Most nonemployee awards are accounted for under this guidance.

The grantee completes its performance obligation upon delivery or, for a sales incentive, upon purchase of the goods or services, regardless of whether the quantity or terms of the equity instruments depend on subsequent events. For example, performance would be considered complete even if the award calls for measuring the subsequent results of a sales campaign or for the grantor's share price to reach a specified target.

**ASC 505-50-30-13**

The counterparty's performance is complete when the counterparty has delivered or, in the case of sales incentives, purchased the goods or services, despite the fact that at that date the quantity or all the terms of the equity instruments may yet depend on other events (this would occur, for example, if a target stock price requirement has not been met when the counterparty has delivered the goods or services).

Example 2 in ASC 505-50 includes several scenarios where a performance commitment does not exist before performance is completed.

**Example 2: Identification of Situations in Which Performance Commitment Does Not Exist Before Performance Is Complete**

**ASC 505-50-55-6**

Section 505-50-30 provides guidance on the relevance of determining whether a performance commitment exists relative to establishing a measurement date in a share-based payment transaction with nonemployees. The following Cases describe arrangements that do not contain performance commitments before the counterparty's performance is complete , for the reasons specified:

a. Construction services of a manufacturer not subject to a significant penalty (Case A)

b. Acquisition of goods not assured until delivery (Case B)

c. Marketing services not subject to damages (Case C)

d. Sales incentive with provision to change terms based on purchases (Case D).

**Case A : Construction Services of a Manufacturer Not Subject to a Significant Penalty**

**ASC 505-50-55-7**

A telecommunications entity agrees to pay cash in exchange for a manufacturer to build a new kind of satellite, with a contract delivery date not to exceed four years. However, the terms of the arrangement provide that if the manufacturer completes the satellite within three years, the issuer agrees to also compensate the manufacturer with stock options. This transaction does not contain a performance commitment with respect to the stock options (although it may contain a performance commitment with respect to the cash) because there is no penalty if the satellite is not finished within three years. If the satellite is completed within three years, the stock options would be measured on the date the satellite is completed.

**Case B: Acquisition of Goods Not Assured Until Delivery**

**ASC 505-50-55-8**

A clothing manufacturer commits to issue 100 shares of stock in exchange for clothing of historical significance if its bid at an auction is accepted. The transfer of the stock for the auctioned goods occurs 30 days after the date of the auction. The auctioning party has the 30 days in which to either accept the bid received at the auction or, if it believes the winning bid is too low, decide not to accept it. Even after the auctioning party accepts a bid it may change its mind up until the time the auctioned goods are delivered without incurring a penalty that constitutes a significant disincentive for nonperformance. This transaction does not contain a performance commitment on the date the clothing manufacturer commits to issue 100 shares nor thereafter, because there is no disincentive for nonperformance on the part of the auctioning party other than loss of the shares of stock that were to be received for the auctioned clothing. Accordingly, if the auctioned goods are received, the shares of stock would be measured on the date they are received.

**Case C: Marketing Services Not Subject to Damages**

**ASC 505-50-55-9**

A retailer agrees to issue a combination of cash and stock options to a freelancer in exchange for the design of a new advertising campaign. If the freelancer decides not to complete the entire campaign, the freelancer earns only the cash and stock options attributable to the components of the campaign, if any, that were completed. This transaction does not contain a performance commitment because the freelancer has no disincentive for nonperformance other than loss of the cash and stock options attributable to the work not performed. Accordingly, the stock options related to a particular completed component of the campaign would be measured at their then-current fair value when the component of the campaign to which they relate is completed.

**Case D: Sales Incentive with Provision to Change Terms Based on Purchases**

**ASC 505-50-55-10**

A manufacturer invents a new kind of plastic piping that can withstand the cold at record temperatures. To stimulate sales, the manufacturer sends letters to all its existing plastic piping customers offering them stock options if they will purchase a minimum amount of the new plastic piping within a five-year period. If a customer purchases more than the minimum amount of plastic piping, the exercise period of the options increases based on a sliding scale relative to the quantity purchased. This transaction does not contain a performance commitment because a potential customer can, but is not required to, purchase the plastic piping. Accordingly, the stock options earned by buying the minimum amount would be measured as of the date purchases of the minimum amount of plastic piping have been made. This measured amount would be adjusted (using modification accounting) as the length of the exercise period is modified as a result of subsequent purchases. See paragraph 505-50-35-7 for guidance on the use of modification accounting in this situation.

### Determining the measurement date

Entity C issues restricted stock units (RSUs) to Entity D in exchange for asset management services. In order for all the awards to become unrestricted, Entity C's stock price must increase by at least 10 percent over the one-year period following the date when the stock units were issued. If Entity D ceases to provide asset management services to Entity C at any time during the one-year period following the issuance date, it will forfeit the RSUs.

The RSUs qualify as nonemployee share-based payment awards under ASC 505-50. Since Entity D is allowed to forfeit the RSUs, there is no significant disincentive for nonperformance, (Entity D merely forfeits the RSUs), and the measurement date would not occur until performance is completed. Performance is completed once Entity D has provided asset management services to Entity C for the one-year period following the stocks' issuance date.

## *Fully vested, nonforfeitable awards*

In some situations, the equity instruments issued at the inception of an agreement are sometimes fully vested and nonforfeitable, even though the grantee may be required to perform services over a period of time. The measurement date in these cases is the grant date of the award, even if the equity instruments can be exercised only after a specified period or perhaps earlier if the grantee achieves specified performance conditions. Again, the grantor recognizes the related cost of the award as if it were paying cash instead of issuing an equity instrument, according to the guidance in ASC 505-50-25-8.

### ASC 505-50-30-14

Situations may arise in which counterparty performance may be required over a period of time (for example, three years) but the equity award granted to the party performing the services is fully vested and nonforfeitable on the date the parties enter into the contract. While this type of arrangement may be rare, because, typically, vesting provisions do exist, the measurement date for an award that is nonforfeitable and that vests immediately could be the date the parties enter into the contract, even though services have not yet been performed.

### ASC 505-50-30-15

As addressed in paragraph 505-50-25-7, if fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached.

### ASC 505-50-30-16

If an entity grants fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions, the grantor shall measure the fair value of the equity instruments at the date of grant and, under the guidance in paragraph 505-50-25-8, shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash.

### 11.4.2 Estimating cost before the measurement date

As noted above, the measurement date generally will not occur until the nonemployee completes its performance. ASC 505-50 addresses several aspects of how an entity should estimate the cost of a share-based payment award made to a nonemployee each period until performance is completed.

#### *Known quantity and terms*

An entity should measure an equity instrument at its then-current fair value on each interim reporting date if both of the following conditions are met:

1. It is appropriate under GAAP for the grantor to recognize cost for a transaction in reporting periods ending before the instrument's measurement date (for example, if the nonemployee has commenced performance).
2. The quantity and terms of the equity instrument are known.

Under these conditions, an entity should determine the total cost-to-date using the then-current fair value and adjust that amount for cost recognized in prior periods. On the measurement date, the entity should adjust the total cost recognized for the equity instrument to its fair value on that date.

This accounting is similar to the accounting for liability awards under ASC 718, which calls for an entity to remeasure the award's fair value each period and to adjust its cumulative cost to reflect the extent to which the requisite service period has been met.

**ASC 505-50-30-20**

Under generally accepted accounting principles (GAAP), it may be appropriate for an issuer to recognize costs related to share-based payment transactions with nonemployees before a measurement date has occurred. The following guidance addresses measurement of the equity instruments in such cases before the measurement date, specifically:

a. If the quantity and terms of the equity instruments are known up front

b. If the quantity or any of the terms of the equity instruments are not known up front.

**ASC 505-50-30-21**

The quantity and terms of the equity instruments may be known up front. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction during financial reporting periods before the measurement date, for purposes of recognition of costs during those periods the equity instruments shall be measured at their then-current fair values at each of those interim financial reporting dates. Changes in those fair values between those interim reporting dates shall be attributed in accordance with the methods illustrated in Example 5 (see paragraph 505-50-55-28). Example 5, Case A (see paragraph 505-50-55-32) illustrates application of this guidance.

### Example 5: Accounting if There Is No Performance Commitment Until Completion of Performance (excerpt: Case A – All Terms Known up Front)

**ASC 505-50-55-28 (excerpt)**

a. This Example illustrates the guidance in paragraphs 505-50-30-21; 505-50-30-25; and 505-50-30-30. The Cases in this Example illustrate grantor accounting for transactions that do not have a performance commitment before counterparty performance is complete. In Case A, both the quantity and all the terms of the equity instruments are known up front. …

**ASC 505-50-55-31 (excerpt)**

Entity A enters into an arrangement with a freelancer to create a new advertising campaign. The freelancer will be compensated with a combination of cash and stock options. The freelancer earns the cash and stock options attributable to each component of the five-component campaign, if any, that the freelancer designs. The only ramification for the freelancer of quitting the assignment before completing all its components is the lost opportunity to earn the cash and stock options associated with any unfinished components. The freelancer commences work on the campaign on January 1, 20X2, delivers the first component on March 31, 20X2, and delivers the second component on November 30, 20X2, then quits the assignment. For every component of the advertising campaign completed, the freelancer will earn $50,000 in cash and 600 stock options. The stock options have an exercise price of $10 and are exercisable for 10 years from the date the related component of the campaign is completed. Case A contains the calculations associated with these assumptions. …

**Case A: Advertising Campaign Services—All Terms Known up Front**

**ASC 505-50-55-32**

There is no performance commitment date before the completion of performance; thus, the appropriate quantity of stock options is measured at its then-current fair value as of the financial reporting dates, if any, at which the cost of the freelancer's work on the component of the advertising campaign in question needs to be recognized. This continues until the freelancer completes the component of the advertising campaign in question, at which time the set of 600 stock options is adjusted for the last time to its then-current fair value. If the fair value of the first set of 600 stock options is $25,000 on March 31, 20X2, then $25,000 is the cost recognized for the first set of 600 stock options. If the fair value of the second set of 600 stock options is $27,000 on June 30, 20X2, $28,000 on September 30, 20X2, and $24,000 on November 30, 20X2, then $24,000 is the cost ultimately recognized for the second set of 600 stock options. Interim measurements that Entity A would make, if any, to recognize the appropriate portion of the cost of the freelancer's services during each period the work is performed would be based on the $27,000 and the $28,000 for the quarters ended June 30, 20X2, and September 30, 20X2, respectively.

### *Unknown quantity and terms*

In some arrangements the quantity and terms of the equity instruments are not known on an interim reporting date because the instruments include a market condition (for example, the entity's stock price will affect the award's quantity or terms) and/or a performance condition (the entity's operational results or activities will affect the award's quantity or terms).

## Equity instruments with only a market condition

When the quantity or terms of an equity instrument depend only on a market condition, the instrument is accounted for based on its then-current fair value. In this situation, fair value equals the fair value of the instruments calculated without regard to the market condition, plus the fair value of the grantor's commitment to change the instrument's quantity or terms if the market condition is achieved. Said differently, the grantor measures the awards by incorporating the market condition in the fair value. Note that the grantor's commitment to change the quantity or terms is accounted for separately under ASC 815-40.

**ASC 505-50-30-23**

The guidance described in paragraph 505-50-30-21 (that is, the then-current fair value) also applies to the situation in which the quantity and terms of the equity instruments are dependent on only market conditions.

**ASC 505-50-30-24**

Paragraph 505-50-30-28 describes how the fair value of such equity instruments shall be calculated.

**Transactions that Involve Only Market Conditions**

**ASC 505-50-30-28**

The quantity or terms of an equity instrument may be dependent only on market conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of market conditions, then the issuer shall use the fair value of the equity instruments for recognition purposes. That fair value shall be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the issuer's commitment to change the quantity or terms of the equity instruments based on whether the market condition is met. Example 3, Case A (see paragraph 505-50-55-14) illustrates application of this guidance.

**Example 3: Arrangement Contains a Market Condition (excerpt: Case A – Transaction with Only a Market Condition)**

**ASC 505-50-55-11**

Paragraphs 505-50-30-28 and 505-50-30-31 provide guidance on accounting for transactions with market conditions, including transactions that also contain performance conditions. The following Cases illustrate how to apply the guidance regarding the date the equity instruments are to be measured to a transaction that contains a market condition. …

**ASC 505-50-55-13**

An entity agrees to pay cash and issue 1,000 stock options in exchange for an architectural design firm to design for the entity a new research laboratory and to deliver the plans within a year. The design firm is subject to a significant penalty if it does not complete the design of the research laboratory within one year. This penalty is considered to be of a magnitude that is a sufficiently large disincentive for nonperformance; thus, the arrangement contains a performance commitment. The quantity and terms of the stock options are known at the performance commitment date, except that if 2 years after the design firm has received the 1,000 stock options the entity's stock price is below $35 per share, the entity will issue to the design firm, based on a sliding scale, up to 250 additional stock options.

**Case A: Transaction with Only a Market Condition**

**ASC 505-50-55-14**

The entity would measure the 1,000 stock options on the performance commitment date pursuant to the requirements of paragraph 505-50-30-28. Assume this fair value is $10,000. At the performance commitment date the entity would also measure the fair value of the issuer's commitment to potentially issue another 250 stock options, regardless of whether this commitment is in the money at that date. Assume this fair value is $2,000. The total cost of the transaction to be recognized is thus $12,000. After the performance commitment date, the entity would account for the commitment to potentially issue the 250 additional stock options in accordance with the relevant accounting guidance on financial instruments, including Subtopic 815-40.

## Equity instruments with only grantee performance conditions

If the quantity or the terms of the equity instruments might be a range of outcomes under performance conditions, the instruments are accounted for at interim reporting dates based on the instruments' then-current "lowest aggregate fair value." (the lowest fair value when comparing the result of multiplying the fair value of the instrument with each multiple term by the applicable number of equity instruments). That amount may be zero. The concept of "lowest aggregate fair value" for nonemployee awards is different from the probability assessment made for employee awards with performance commitments under ASC 718. For a nonemployee award, the grantor considers the range of potential performance outcomes and then the grantor determines the lowest aggregate fair value, which is the basis for recognizing cost for each period when performance is ongoing.

The guidance in ASC 505-50-30-25 uses the term "counterparty performance conditions" in discussing how to account for nonemployee awards with performance conditions. Through our discussions with the FASB staff, however, we understand that the accounting in ASC 505-50-30-25 applies regardless of whether the award's performance condition is based on the counterparty's performance or on the grantor's performance. For example, a counterparty that performs services that are designed to increase the grantor's revenue may receive a share-based payment award for these services. In this case, the quantity of instruments ultimately issued to the nonemployee would depend on how much the grantor's revenue increased, as specified in the award agreement. This award is accounted for based on the following guidance.

**ASC 505-50-30-25**

The quantity and terms of the equity instruments may be dependent upon counterparty performance conditions. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction in reporting periods before the measurement date, the equity instruments shall be measured at their then-current lowest aggregate fair value at each of those interim reporting dates. Changes in those lowest aggregate fair values between those interim reporting dates shall be attributed in accordance with the methods illustrated in Example 5 (see paragraph 505-50-55-28).

Example 5, Cases B and C (see paragraphs 505-50-55-33 through 55-40) illustrate application of this guidance.

**ASC 505-50-30-30**

The quantity or terms of an equity instrument may be dependent only on counterparty performance conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of counterparty performance conditions that, based on the different possible outcomes, result in a range of aggregate fair values for the equity instruments as of that date, then the issuer should utilize the lowest aggregate (that is, the variable terms times the applicable number of equity instruments) amount within that range for recognition purposes. This amount may be zero. Example 4, Case B (see paragraph 505-50-55-22) and Example 5, Cases B and C (see paragraphs 505-50-55-33 through 55-40) illustrate application of this guidance.

### Example 5: Accounting if There Is No Performance Commitment Until Completion of Performance (excerpt: Cases B and C)

**ASC 505-50-55-28 (excerpt)**

This Example illustrates the guidance in paragraphs 505-50-30-21; 505-50-30-25; and 505-50-30-30. The Cases in this Example illustrate grantor accounting for transactions that do not have a performance commitment before counterparty performance is complete. In Case A, both the quantity and all the terms of the equity instruments are known up front, whereas in Cases B and C they are not. …

**ASC 505-50-55-29**

Cases A, B, and C, in contrast to Example 4 (see paragraph 505-50-55-17), share the assumption that a performance commitment has not been achieved before the counterparty's performance is complete.

**ASC 505-50-55-30**

Cases A and B initially share the following further assumptions.

**ASC 505-50-55-31**

Entity A enters into an arrangement with a freelancer to create a new advertising campaign. The freelancer will be compensated with a combination of cash and stock options. The freelancer earns the cash and stock options attributable to each component of the five-component campaign, if any, that the freelancer designs. The only ramification for the freelancer of quitting the assignment before completing all its components is the lost opportunity to earn the cash and stock options associated with any unfinished components. The freelancer commences work on the campaign on January 1, 20X2, delivers the first component on March 31, 20X2, and delivers the second component on November 30, 20X2, then quits the assignment. For every component of the advertising campaign completed, the freelancer will earn $50,000 in cash and 600 stock options. The stock options have an exercise price of $10 and are exercisable for 10 years from the date the related component of the campaign is completed. Case A contains the calculations associated with these assumptions. Case B modifies the assumptions to introduce terms that vary based on performance and presents revised calculations. …

### Case B: Advertising Campaign Services—Terms Dependent on Performance

#### ASC 505-50-55-33

In this Case, the assumptions are modified such that the exercise price of a particular stock option is based on the percentage increase in store revenue from the time the freelancer earns the option until the time the stock option is exercised, but in no case will it exceed $15.

#### ASC 505-50-55-34

There is no performance commitment date before the completion of performance; thus, each set of 600 stock options is measured at its then-current fair value as of the financial reporting dates, if any, at which Entity A would make interim measurements of the cost of the freelancer's work on the component of the advertising campaign in question. This continues until the freelancer completes the component of the advertising campaign in question, at which time the set of 600 stock options is adjusted for the last time to its then-current fair value. The calculations are as follows.

#### ASC 505-50-55-35

At March 31, 20X2, the freelancer has earned the first set of 600 stock options. The fair value of those stock options is $15,000 at an exercise price of $15. Because $15,000 is the lowest possible fair value (because $15 is the highest possible exercise price), the stock options earned on March 31, 20X2, are measured at $15,000. The $15,000 is recognized in the same period(s) as would be a payment by Entity A to the freelancer of $15,000 in cash in addition to the first $50,000 in cash.

#### ASC 505-50-55-36

At November 30, 20X2, the freelancer has earned the second set of 600 stock options. The fair value of those stock options at November 30, 20X2, is $21,000 at an exercise price of $15. Because $21,000 is the lowest possible fair value (because $15 is the highest possible exercise price), the stock options earned on November 30, 20X2, are measured at $21,000. The $21,000 is recognized in the same period(s) as would be a payment by Entity A to the freelancer of $21,000 in cash in addition to the second $50,000 in cash. Interim measurements that Entity A would make, if any, to recognize the appropriate portion of the cost of the freelancer's services during each period the work is performed, such as during the quarters ended June 30, 20X2, and September 30, 20X2, would be based on the lowest possible fair value of the stock options as of those dates.

#### ASC 505-50-55-37

On July 10, 20X6, the freelancer exercises all of the stock options earned on March 31, 20X2, and on November 30, 20X2. Based on the exercise price sliding scale, on July 10, 20X6, the options earned on March 31, 20X2, have an exercise price of $9 and the options earned on November 30, 20X2, have an exercise price of $12. The aggregate fair value on July 10, 20X6, of the 600 stock options earned on March 31, 20X2, is $60,000 assuming an exercise price of $9 and $45,000 assuming an exercise price of $15. Similarly, the aggregate fair value of the 600 stock options earned on November 30, 20X2, is $33,000 assuming an exercise price of $12 and $21,000 assuming an exercise price of $15. On July 10, 20X6, Entity A will thus recognize an additional cost of $27,000 (that is, [$60,000 – $45,000] + [$33,000 – $21,000]) to reflect the fact that the growth in sales fostered revisions in the exercise price from the $15 used to calculate the cost that Entity A previously recognized.

### Case C: Outsourcing Services—Terms Dependent on Performance

### ASC 505-50-55-38

Entity B enters into an outsourcing contract with a large data processing firm. Entity B's employees currently working in the management information systems department are to be terminated by Entity B and hired by the data processing firm. As part of its arrangement with the data processing firm, management of Entity B elects to grant these individuals stock options that will also contain performance provisions. Based on the hiring status of these individuals and the terms of the arrangement, Entity B considers the accounting for the stock options granted to these individuals to be within the scope of this Subtopic.

### ASC 505-50-55-39

The terms of the options provide for an increase in the number of options to be granted if an entity-wide software package is installed by June 30, 20X7. On June 30, 20X5, Software Engineer A is granted options to purchase 5,000 common shares at an exercise price of $5 per share that vest over 2 years. In the event the software described is installed timely, the award increases to 7,500 shares. On June 30, 20X7, the fair value of the options to purchase 5,000 shares is $20,000; the fair value of the options to purchase 7,500 shares is $30,000.

### ASC 505-50-55-40

There is no performance commitment before completion of performance because the software engineer may quit before completion of the software implementation with no penalty other than the loss of the options that he would have earned. The 5,000 stock options are thus ultimately measured when performance is complete, or on June 30, 20X7, at the then-current fair value of $20,000. During the 2 years ended June 30, 20X7, Entity B would recognize (as appropriate relative to the periods and manner that Entity B would recognize cash payments under the same arrangement) the cost of the appropriate number of the 5,000 stock options at their then-current fair value as of each financial reporting date within that period. Upon the completion of installation of the software, assuming it is on June 30, 20X7, an additional $10,000 (that is, $30,000 – $20,000) would be recognized to reflect the fact that the timely completion fostered a revision in the quantity from the 5,000 stock options used to calculate the cost that Entity B previously recognized.

## Equity instruments with both a market condition and grantee performance condition

Equity instruments with both a market condition and a grantee performance condition are accounted for based on their then-current lowest aggregate fair value at the interim reporting date, similar to transactions that involve only counterparty performance conditions.

### ASC 505-50-30-26

The quantity and terms of the equity instruments may be dependent on both market conditions and counterparty performance conditions. The guidance in the preceding paragraph (that is, the then-current lowest aggregate fair value) also applies in this situation.

## 11.5 Subsequent measurement after the measurement date

This section addresses the subsequent measurement (that is, after the measurement date) of equity instruments with the following terms:

- Only a market condition
- Only a grantee performance condition
- Both market conditions and grantee performance conditions
- Acceleration of exercisability conditions

### *Equity instruments with only a market condition*

Until a market condition is resolved, a grantor should recognize and classify changes in the post-measurement date fair value of its commitment to change the quantity or terms of the equity instruments on achieving the market condition according to other applicable GAAP for financial instruments, such as ASC 815-40. Thus, instruments classified as equity in accordance with ASC 815-40 would not be subject to remeasurement, however those instruments classified as liabilities under ASC 815-40 would generally be subject to remeasurement at fair value with the changes in fair value recognized in earnings.

**ASC 505-50-35-6**

After the issuer measures the then-current fair value of the issuer's commitment related to the market condition as described in paragraph 505-50-30-28, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting guidance on financial instruments, such as that in Subtopic 815-40.

### *Terms dependent only on achievement of grantee performance condition*

After the measurement date, an entity should recalculate the lowest aggregate fair value, and use modification accounting to adjust the cost of the transaction, on the date it determines a change in the award's quantity or terms. Under modification accounting (see Section 8), the amount of the cost adjustment is the difference between (a) the then-current fair value of the revised instrument using the then-known quantity and terms, and (b) the then-current fair value of the equity instrument immediately before a change in the quantity and/or terms becomes known. An entity should calculate the then-current fair value using the assumptions that result in the lowest aggregate fair value if the award's quantity or terms remain unknown.

**ASC 505-50-35-7**

Paragraph 505-50-30-30 provides measurement date guidance on the measurement of transactions that involve only counterparty performance conditions. As each quantity and term become known and until all the quantities and terms that stem from the counterparty's performance become known, the lowest aggregate fair value measured pursuant to the guidance in that paragraph shall be adjusted, to reflect additional cost of the transaction, using the modification accounting methodology described in paragraphs 718-20-35-3 through 35-4. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instruments as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity or term and the then-current fair value of the old equity instruments immediately before the quantity or term becomes known. The then-current fair value is calculated using the assumptions that result in the lowest aggregate fair value if the quantity or any other terms remain unknown.

### Example 4: Accounting after the Performance Commitment Date through Completion of Performance (excerpt: Case B)

**ASC 505-50-55-17**

This Example illustrates the guidance in paragraph 505-50-30-30. The Cases in this Example illustrate grantor accounting for transactions that have a performance commitment before counterparty performance is complete. In Case A, both the quantity and all the terms of the equity instruments are known up front, whereas in Case B they are not. …

**ASC 505-50-55-18**

Cases A and B share the assumption that a performance commitment has been achieved before the counterparty's performance is complete.

**ASC 505-50-55-19**

Cases A and B initially share the following further assumptions.

**ASC 505-50-55-20**

On December 31, 20X1, Entity A enters into an arrangement with an attorney to defend it in a lawsuit. On December 31, 20X1, the attorney commits to perform the services in exchange for 1,000 stock options with an exercise price of $10 and an exercise period of 10 years. If the attorney quits, then the attorney is subject to specified monetary damages that, in the circumstances, constitute a sufficiently large disincentive for nonperformance. The attorney commences work on the case on January 1, 20X2, and finishes work on the case on December 31, 20X3. The judge decides the case in Entity A's favor on January 31, 20X4.

#### Case B: Grantor Accounting—Terms Dependent on Performance

**ASC 505-50-55-22**

In this Case, the assumptions are changed such that the attorney will receive 1,000 stock options with an exercise price of $10 that are exercisable for 10 years if the case is won, whereas the attorney will receive 500 stock options with an exercise price of $15 that are exercisable for 5 years if the case is lost. As in Case A, the judge also decides the case in Entity A's favor on January 31, 20X4.

**ASC 505-50-55-23**

December 31, 20X1, is the performance commitment date, and thus the date at which Entity A will measure the fair value of the 1,000 stock options with an exercise price of $10 and the 500 stock options with an exercise price of $15. Entity A will select whichever fair value is lower, in the aggregate, and recognize that cost during the course of 20X2 – 20X3 in the same period(s) and in the same manner as if it had agreed to pay cash for the services.

**ASC 505-50-55-24**

Assume the aggregate fair values at December 31, 20X1, are $22,000 and $16,000 for the $10 and $15 options, respectively. Entity A will select the lower fair value, $16,000, and recognize it during the course of 20X2 – 20X3 in the same period(s) and in the same manner as if it had agreed to pay cash for the lawyer's services. At January 31, 20X4, when the case is won, Entity A will measure, using current assumptions as of that date, both the $10 and the $15 stock options and recognize additional cost equal to the difference between those two fair values. Assume that on January 31, 20X4, the $10 stock options are worth, in the aggregate, $54,000 and the $15 stock options are worth, in the aggregate, $43,000. Entity A will recognize an additional $11,000 (that is, $54,000 – $43,000) of transaction cost on January 31, 20X4, to reflect the fact that the case was won and thus the terms of the options have been revised from those assumed to calculate the $16,000 cost that Entity A previously recognized.

### *Terms dependent on both market conditions and counterparty performance conditions*

Until the last performance-related condition is resolved, an entity should apply modification accounting on each date a performance or market condition is satisfied. The market condition should be accounted for using the guidance in ASC 505-50, not under other applicable GAAP. If any market conditions remain when the last performance condition is resolved, the entity must measure the then-current fair value of its commitment to issue additional equity instruments, or it must change the terms of the equity instruments based on whether the market condition is met. The measured amount should be accounted for as an additional cost of the transaction.

After performance conditions are resolved and until any market condition is resolved, the entity should recognize and classify any future changes in the fair value of its commitment to change the quantity or terms of the equity instruments using other applicable GAAP for financial instruments, such as the guidance on derivatives and hedging in ASC 815-40.

**ASC 505-50-35-9**

Through the date the last performance-related condition is resolved, the issuer shall apply modification accounting for the resolution of both counterparty performance conditions and market conditions. If, at the time the last counterparty performance-related condition is resolved, any market conditions remain, then the issuer shall measure the then-current fair value of the issuer's commitment to issue additional equity instruments or change the terms of the equity instruments based on whether the market condition is met. This measured amount is an additional cost of the transaction. Example 3, Case B (see paragraph 505-50-55-15) illustrates application of this guidance.

**ASC 505-50-35-10**

After the issuer measures the then-current fair value of the issuer's commitment related to the market condition, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting literature on financial instruments, such as that in Subtopic 815-40.

### Example 3: Arrangement Contains a Market Condition (excerpt: Case B)

**ASC 505-50-55-13**

An entity agrees to pay cash and issue 1,000 stock options in exchange for an architectural design firm to design for the entity a new research laboratory and to deliver the plans within a year. The design firm is subject to a significant penalty if it does not complete the design of the research laboratory within one year. This penalty is considered to be of a magnitude that is a sufficiently large disincentive for nonperformance; thus, the arrangement contains a performance commitment. The quantity and terms of the stock options are known at the performance commitment date, except that if 2 years after the design firm has received the 1,000 stock options the entity's stock price is below $35 per share, the entity will issue to the design firm, based on a sliding scale, up to 250 additional stock options.

**Case B: Transaction with Both a Market Condition and Counterparty Performance Condition**

**ASC 505-50-55-15**

In this Case, the assumptions are changed such that the exercise price of the 1,000 stock options was not known at the performance commitment date because it would ultimately be determined based on a matter stemming from the design firm's performance in designing the research laboratory. The entity would measure the 1,000 stock options on the performance commitment date pursuant to the requirements of paragraph 505-50-30-31. (Assume the lowest aggregate fair value of the stock options is $8,000.) Thereafter, the entity would account for the arrangement in accordance with paragraph 505-50-35-9 through the time that the exercise price became known. If the exercise price becomes known before the time that the 2-year, $35 stock price guarantee elapses, then, at the time the exercise price becomes known, the issuer would apply modification accounting (see paragraph 505-50-35-9) to the change in exercise price (assume this results in an additional cost of $1,500) and determine the then-current fair value of the stock price commitment and recognize that fair value as additional cost of the transaction (assume the then-current fair value was $1,000). Thereafter, that is, from the time the exercise price becomes known, the entity would account for the commitment to potentially issue 250 additional stock options in accordance with the relevant accounting literature on financial instruments, including Subtopic 815-40. The total cost of the exchange transaction with the counterparty would be $10,500.

**ASC 505-50-55-16**

If, however, the exercise price had become known after the 2-year, $35 stock price guarantee had lapsed, then the entity would account for the actual issuance of any of the 250 additional stock options in accordance with the modification accounting provisions referred to in paragraph 505-50-35-9.

### *Acceleration of exercisability conditions*

If fully vested and nonforfeitable equity instruments are issued at the inception of an arrangement, the instruments' measurement date is the same as the arrangement's inception date. These instruments sometimes have a deferred exercisability date that is accelerated if the grantee achieves a specified performance condition. If, after the measurement date, the grantee satisfies the performance conditions and exercisability of the equity instruments is accelerated, the grantor should recognize incremental cost, to the extent that the then-current fair value of the revised instrument exceeds the fair value of the old instruments immediately before their exercisability was accelerated. However, if the only change in the equity instruments is the exercisability date, the difference in fair value before and after the instrument's exercisability is accelerated would result in a significant incremental charge only if the expected dividend on the underlying instrument exceeds the sum of (1) the effect of discounting the exercise price, and (2) the loss of time value (excluding the effect of discounting the exercise price) due to the earlier exercise of the equity instrument.

**ASC 505-50-35-11**

Paragraph 505-50-30-16 addresses the situation in which an entity grants fully vested, nonforfeitable equity instruments with terms that provide for potential acceleration of exercisability and establishes that the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash. The following paragraph establishes post-grant-date measurement requirements if the exercisability is accelerated.

**ASC 505-50-35-12**

An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and for which the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions. If, after the arrangement date, the grantee performs as specified and exercisability is accelerated, the grantor shall record incremental cost measured at the date of the revision of the terms of the equity instruments (that is, the acceleration date) as the difference between the then-current fair value of the revised instruments utilizing the accelerated exercisability date and the then-current fair value of the old equity instruments immediately before exercisability is accelerated. If the only change in the terms of the equity instruments is the acceleration of exercisability, the application of this methodology will only result in a significant additional charge if the expected dividend on the underlying instrument exceeds the sum of the effect of discounting the exercise price and the loss of time value (exclusive of the effect of discounting the exercise price) resulting from the early exercise of the equity instrument.

## 11.6 Statement of cash flows considerations

The cash flow impact of nonemployee awards is consistent with the impact on employee awards. As discussed in Section 9.4 regarding excess tax benefits, ASU 2016-09 amended the guidance in ASC 230 to clarify that excess tax benefits are not separate cash flows and should therefore be classified in the same manner as other cash flows related to income taxes (that is, operating activities).

Some nonemployee awards require the grantee to make a cash payment, such as an exercise price for stock options. In this case, the cash received by the grantor is classified as proceeds from issuing equity instruments in the financing section of the statement of cash flows.

## 11.7 Presentation

In addition to presenting a nonemployee award based on its classification as an equity or a liability, additional considerations apply if the grantor is a public entity. In SAB Topic 14.E, "FASB ASC Topic 718, Compensation – Stock Compensation," the SEC staff indicates that redeemable equity-based payment arrangements with nonemployees that are not classified as liabilities should be subject to the requirements of both SEC Accounting Series Release (ASR) 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks*,*"* and ASC 480-10-S99-3A, *Distinguishing Liabilities from Equity* (EITF

Topic D-98, “Classification and Measurement of Redeemable Securities”). In questions 2 and 3 in SAB Topic 14.E, the SEC staff indicates that the amount recorded in temporary equity for an equity-based payment arrangement within the scope of ASR 268 should equal the redemption amount prorated to an amount equal to the vested percentage of the award at the balance-sheet date. In other words, if the redemption amount of the unvested shares with a put is $10,000 and the shares are 75 percent vested, the amount classified in temporary equity would be $7,500. A nonpublic entity that presents redeemable instruments in temporary equity based on analogy to the SEC’s guidance would also follow the guidance in SAB Topic 14.E.

## 11.8 Disclosure

Although ASC 505-50 does not include detailed disclosure requirements, it does require grantors of nonemployee awards to provide disclosures similar to the disclosures required in ASC 718-10-50-1 through 50-2. The disclosures for nonemployee and employee awards should be distinct, meaning that the footnotes should clearly indicate which information is for employee awards and which information is for nonemployee awards. The disclosure requirements are described in Section 13.

### ASC 505-50-50-1

An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraphs 718-10-50-1 through 50-2 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements.

# 12. Nonemployee share-based payments (after adoption of ASU 2018-07)

In an effort to simplify the accounting for share-based payment awards, the FASB in 2018 issued ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting*. The amendments in ASU 2018-07 expand the scope of ASC 718 to include share-based payment transactions for acquiring goods and services from nonemployees and supersede the guidance on accounting for nonemployee awards in ASC 505-50. Some amendments simplify the guidance on share-based payments only for nonpublic entities. The amendments also make conforming changes to the ASC Master Glossary and other ASC Topics, such as ASC 260, *Earnings per Share*, and ASC 805, *Business Combinations*, among other Codification Topics. The amendments are effective in 2019 for calendar-year public business entities and in 2020 for nonpublic entities.

After an entity adopts the amendments in ASU 2018-07, the guidance for nonemployee awards is substantially the same as the guidance for employee awards, with a few exceptions.

## 12.1 Summary of ASU 2018-07 amendments

The amendments in ASU 2018-07 impact all entities that issue awards to nonemployees in exchange for goods or services that will be used or consumed in the grantor's own operations, as well as to nonemployees of an equity method investee that provide goods or services that the investee uses or consumes in its operations.

The amendments clearly state that the guidance in ASC 718 should be applied when an entity grants an award to a customer as consideration for a distinct good or service that will be used or consumed in the grantor's own operations. For example, an entity might issue an award to a customer in exchange for supplies used in the entity's operations, which should be accounted for under ASC 718.

On the other hand, if an entity issues an award to a customer in conjunction with selling goods or services to the customer (as a rebate, for example), the entity would apply the guidance in ASC 606, when accounting for consideration payable to a customer in the form of shares.

The amendments in ASU 2018-07 supersede the guidance on accounting for nonemployee awards in ASC 505-50 in its entirety, and amend ASC 718 to include guidance on accounting for nonemployee awards. A significant change to ASC 718 is to remove the words "employer" and "employee" and to replace them with "grantee" and "grantor" where appropriate. In areas where the FASB has retained different accounting for employee and nonemployee awards, the wording is very specific to avoid confusion.

The amendments in ASU 2018-07 align the accounting for nonemployee awards with the accounting for employee awards in ASC 718 in many areas, meaning that accounting for nonemployee awards and employee awards is now the same in these aspects:

- Using the grant date as the measurement date for equity-classified awards
- Considering the probability that a performance condition will be satisfied when an award contains such a condition
- Aligning the post-vesting classification considerations with those of employee awards
- Providing certain relief for nonpublic entities

- Providing an award-by-award election to either estimate the expected term of an award or to use the award's contractual life when estimating fair value

Some differences remain in accounting for nonemployee awards compared with employee awards:

- Recognizing the cost of nonemployee awards in the same manner and in the same period as if the entity had paid cash for the goods and services, as opposed to recognizing the cost of employee awards based on the requisite service period (See Section 6.2).
- Recognizing each tranche of a nonemployee award as if the award were, in substance, multiple awards. In other words, entities that grant nonemployee awards with only service conditions and graded vesting cannot elect to recognize compensation cost for the entire award on a straight-line basis, an option that is available for employee awards.
- Continuing separate disclosure requirements for nonemployee awards to the extent that the characteristics of those awards differ from employee awards.

**Grant Thornton insights: Expanding the scope of ASC 718 to nonemployee awards**

The superseded accounting for nonemployee awards in ASC 505-50 is significantly different from the accounting for employee share-based payment awards in ASC 718. Historically, the FASB believed there was a fundamental difference in the relationship between an entity and its employees and the relationship between an entity and its nonemployees. In most cases, nonemployee awards were remeasured to current fair value (called "variable accounting") each period under ASC 505-50, because nonemployees were considered more likely to complete their work or to walk away based on the trend in fair value. In contrast, employees generally receive cash compensation and are more economically dependent on the entity than nonemployees. Therefore, employees were more likely to stay and complete the required service than nonemployees, and a grant-date fair value ("fixed accounting") was more appropriate for employee awards.

The landscape has changed in recent decades in that more entities now have nonemployees working alongside employees, for example, five employee engineers and five nonemployee engineers in the same department. With stock compensation awards being made to both groups, the FASB concluded that the behavior of employees and nonemployees generally is not as different now as in the past, prompting the amendments in ASU 2018-07.

The following table from ASU 2018-07 presents the areas of guidance that have been improved by the amendments in ASU 2018-07.

| Current GAAP | Summary of amendments from ASU 2018-07 |
|---|---|
| ***Overall measurement objective*** | |
| Nonemployee share-based payment awards are measured at the fair value of the consideration received or the fair value of the equity | Consistent with the accounting requirements for employee share-based payment awards, nonemployee share-based payment awards within the scope of ASC 718 are measured at the grant-date fair value of the equity instruments that an |

| Current GAAP | Summary of amendments from ASU 2018-07 |
|---|---|
| instruments issued, whichever can be more reliably measured. | entity is obligated to issue when (1) the good has been delivered or the service has been rendered, and (2) any other conditions necessary to earn the right to benefit from the instruments have been satisfied. |
| ***Measurement date*** | |
| The measurement date for equity-classified nonemployee share-based payment awards is the earlier of the date at which a commitment for performance by the counterparty is reached and the date at which the counterparty's completes its performance. | Equity-classified nonemployee share-based payment awards are measured at the grant date. The definition of the term *grant date* is amended to generally mean the date at which a "grantor" and a "grantee" reach a mutual understanding of the key terms and conditions of a share-based payment award. |
| ***Awards with performance conditions*** | |
| Nonemployee share-based payment awards with performance conditions are measured at the lowest aggregate fair value. | Consistent with the accounting for employee share-based payment awards, an entity considers the probability of satisfying performance conditions when nonemployee share-based payment awards contain performance conditions. |
| ***Classification reassessment of certain equity-classified awards*** | |
| Generally, the classification of equity-classified nonemployee share-based payment awards is subject to other GAAP (for example, ASC 815) once (1) the good has been delivered or the service has been rendered, and (2) any other conditions necessary to earn the right to benefit from the instruments have been satisfied. This often results in the need to reassess the classification of such awards. | Generally, the classification of equity-classified nonemployee share-based payment awards will still be subject to the requirements of ASC 718, unless the award is modified after (1) the good has been delivered and the service has been rendered, (2) any other conditions necessary to earn the right to benefit from the instruments have been satisfied, and (3) the nonemployee is no longer providing goods or services. This eliminates the requirement to reassess the classification of such awards upon vesting. |
| **Amendments specific to nonpublic entities** | |
| ***Calculated value*** | |
| Inputs to the valuation of equity share options and similar instruments issued to nonemployees | Historical volatility of an appropriate industry-sector index is used by nonpublic entities for expected volatilities as inputs to the valuation of share options and similar instruments issued to |

| Current GAAP | Summary of amendments from ASU 2018-07 |
|---|---|
| include an estimate of the award's expected volatility. | nonemployees when it is not practicable to estimate the expected volatility of its share price. |
| ***Intrinsic value*** | |
| Entities are required to measure liability-classified nonemployee share-based payment awards at fair value. | A nonpublic entity can make a one-time election to switch from measuring liability-classified nonemployee share-based payment awards at fair value to intrinsic value. Regardless of the election, liability-classified awards are subject to remeasurement until they are exercised. |

### 12.1.1 Effective date and transition considerations

The amendments in ASU 2018-07 are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Nonpublic entities must apply the amendments in fiscal years beginning after December 15, 2019 and in interim periods in fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity's adoption of ASC 606.

An entity is required to apply the amendments in ASU 2018-07 to outstanding awards on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption. Upon transition, an entity should only remeasure liability-classified awards that have not been settled by the date of adoption and equity-classified awards for which a measurement date has not yet occurred. The entity is also required to measure these nonemployee awards at fair value as of the adoption date. An entity should not remeasure any assets that are completed, such as finished goods inventory or equipment that has begun amortization; however, fixed assets used in construction in process or work-in-process inventory should be remeasured. To calculate the adjustment, entities are required to record the difference between the cumulative amounts that were recorded up to the transition date, to the cumulative amounts that should have been recognized at the date of adoption.

#### *Overall transition guidance*

The transition guidance for the amendments in ASU 2018-07 is located in several paragraphs that address the impact on different types of awards, but the overall transition guidance is located in ASC 718-10-65-11. Different transition guidance applies to certain amendments.

**ASC 718-10-65-11**

The following represents the transition and effective date information related to Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting:*

a. The pending content that links to this paragraph shall be effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

b. The pending content that links to this paragraph shall be effective for all other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

c. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted for:

   1. Public business entities for which financial statements have not yet been issued, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1
   2. All other entities for which financial statements have not yet been made available for issuance, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1.

   If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period.

d. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-12 through 65-14.

e. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. For purposes of determining the cumulative-effect adjustment, an entity shall:

   1. Assess only liability-classified awards that have not been settled by the date of adoption and equity-classified awards for which a measurement date has not been established
   2. Remeasure awards as defined in (e)(1) at fair value as of the adoption date rather than grant-date fair value
   3. Not remeasure assets that are completed. For example, finished goods inventory or equipment that has begun amortization would not be remeasured upon transition.

f. In the first interim period and fiscal year of adoption, an entity shall disclose both of the following:

   1. The nature of and reason for the change in accounting principle
   2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

### *Aligning post-vesting classification transition*

As discussed in Section 11.2, the guidance in ASC 505-50 required grantors to reassess the classification of an award once a grantee completes its performance obligations. For example, ASC 815 might be applied to an award after a grantee has completed its performance. In contrast, the guidance in ASC 718 does not require entities to reassess the classification of an award if the award is not modified after a grantee completes its performance. The FASB notes in ASU 2018-07 that it is likely that some nonemployee awards would not have been reclassified after the awards vested if the amendments under ASU 2018-07 had been in place when the awards did vest. Consequently, some nonemployee awards classified as liabilities might revert to equity classification upon adoption of the amendments in ASU 2018-07. Therefore, a grantor with an award that meets this fact pattern would follow the transition guidance in ASC 718-10-65-12 below.

**ASC 718-10-65-12 (excerpt)**

a. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-11 and 718-10-65-13 through 65-14.

b. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. Upon adoption, an entity shall reevaluate the classification of nonemployee awards initially classified as equity before completion of performance and subsequently reclassified to liabilities upon completion of performance because of other guidance (for example, Topic 815 on derivatives and hedging).

c. For purposes of determining the cumulative-effect adjustment, an entity shall assess unsettled liability-classified awards that were previously classified as equity awards as of the adoption date. If a liability-classified award would have remained equity classified because of the application of the pending content that links to this paragraph, the guidance on the modification of an award from liability classification to equity classification in paragraphs 718-20-55-135 through 55-138 shall be applied. …

### *Electing intrinsic value transition (nonpublic entities)*

Under the amendments in ASU 2018-07, a nonpublic entity may to elect as of the effective date to measure all liability-classified nonemployee awards at their intrinsic value rather than fair value, without evaluating whether intrinsic value is preferable under ASC 250. A nonpublic entity that makes this election is required to measure all employee and nonemployee liability-classified awards at intrinsic value. The transition guidance in ASC 718-10-65-13 would apply in this situation.

**ASC 718-10-65-13 (excerpt)**

b. If a nonpublic entity has already made an accounting policy election to measure employee liability-classified awards at intrinsic value according to paragraph 718-30-30-2, then the nonpublic entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted by adjusting the carrying amount of nonemployee liability-classified awards that have not been settled by the adoption date to intrinsic value.

### *Calculated value transition (nonpublic entities)*

The guidance in ASC 718 preceding the amendments calls for a nonpublic entity to account for its employee equity share options and similar instruments based on a value that is calculated using the historical volatility of an appropriate industry sector index, instead of using the expected volatility of the entity's share price, when it is not practicable to estimate the expected volatility of its share price.
The amendments in ASU 2018-07 now allow a nonpublic entity to apply this calculation method to nonemployee equity share options and similar instruments. Therefore, a nonpublic entity with an award

that meets this fact pattern should apply the transition guidance in ASU 2018-07 on a modified retrospective, as discussed earlier in this section, and on a prospective basis for all awards.

**ASC 718-10-65-14 (excerpt)**

b. A nonpublic entity shall apply the pending content that links to this paragraph prospectively to all awards that are measured at fair value after the adoption date.

## 12.2 Scope of ASC 718 after adoption of ASU 2018-07

The scope of ASC 718 preceding the amendments was limited to employee awards, but once an entity adopts the amendments in ASU 2018-07, that guidance now applies to both employee and nonemployee awards.

**ASC 718-10-05-1**

The Compensation – Stock Compensation Topic provides guidance on share-based payment transactions. This Topic includes the following Subtopics:

a. Overall

b. Awards Classified as Equity

c. Awards Classified as Liabilities

d. Employee Stock Ownership Plans

e. Employee Stock Purchase Plans

f. Income taxes

**ASC 718-10-05-2**

This Topic provides guidance for employee and nonemployee share-based payment transactions.

**ASC 718-10-05-3**

This Subtopic provides general guidance related to share-based payment arrangements. This Subtopic and Subtopics 718-20 and 718-30 are interrelated and the required guidance may be located in either this Subtopic or one of the other Subtopics. In general, material that relates to both equity and liability instruments is included in this Subtopic, while material more specifically related to either equity or liability instruments is included in their respective Subtopics. Guidance referencing grantees is intended to be applicable to recipients of both employee and nonemployee awards, and guidance referencing employees or nonemployees is only applicable to those specific types of awards.

## 12.3 Measurement date

Perhaps the biggest change under the amendments in ASU 2018-07 is the revised measurement-date guidance for nonemployee awards. The amendments expand the scope of ASC 718 so that the measurement-date guidance under the existing model for employee awards now also applies to nonemployee awards. Under that model, the measurement date for equity-classified nonemployee awards will generally be the grant date and for liability-classified nonemployee awards will generally be the settlement date. In contrast, under ASC 505-50, the measurement date for nonemployee awards is the earlier of either (a) the performance commitment (the date the nonemployee commits to perform activities to earn the equity instruments) (See Section 11.4.1) or (b) the date when the nonemployee completes its performance.

The amendments in ASU 2018-07 also defined "grant date" as the date when a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The previous definition of "grant date" in ASU 505-50 only alluded to the employer (renamed the "grantor" under the amendments) and an employee (renamed the "grantee").

Refer to Section 4 for more information on measurement-date guidance under ASC 718.

**Grant Thornton insights: Measurement date amendments for equity-classified awards**

Under ASC 505-50, the measurement date for most nonemployee awards is the date when the nonemployee's performance has been completed because it was unusual for an award to contain a performance commitment. In accordance with the amendments to ASC 718, the measurement date for most nonemployee equity-classified awards now is the grant date—that is, the date when a grantor and grantee reach a mutual understanding of the key terms and conditions of a share-based payment award (see Section 4.2 for further discussion of the grant date). In other words, the guidance that entities have been using for many years to determine the grant date for an employee award will now be used for nonemployee awards as well.

In a strong economy where a grantor's equity generally increases in value, the overall impact of the earlier measurement date for nonemployee awards (that is, grant date versus performance completion date) is typically lower compensation cost and less volatility in financial reporting.

**Determining the measurement date**

Entity A issues restricted stock units (RSUs) to Entity B in exchange for asset management services on January 1, 20X1. In order for the RSUs to vest, the fair value of the net assets managed by Entity B must increase by at least 10 percent over the one-year period following the issuance date. If Entity B stops providing asset management services to Entity A at any time during the one-year period following the issuance date, it will forfeit the RSUs. Entity A issues quarterly and annual financial statements. The requirement for the fair value of the net assets managed by Entity B to increase by at least 10 percent over the one-year period following the issuance date is a market condition that is reflected in the grant-date fair value of an award, In addition, the use of a complex value technique to value the awards is typically appropriate. (See Section 5.3 for additional guidance on market conditions and Section 7 for additional guidance on determining the fair value of shared-based payment awards.

**Pre-amendments: ASC 505-50**

The RSUs are nonemployee share-based payment awards under ASC 505-50. Since there is no significant disincentive for nonperformance (Entity B merely forfeits the RSUs), the measurement date would not occur until Entity B completes its performance obligation. Performance is completed once Entity B has provided asset management services to Entity A for the one-year period following the

RSUs’ issuance date of January 1, 201X1, which would be January 1, 20X2. The fair value of the RSUs is remeasured to fair value at the end of each quarter and at year-end.

**Post-amendments: ASC 718**

The RSUs are nonemployee share-based payment awards under ASC 718. Entity A determines that January 1, 20X1 is the grant date for accounting purposes and therefore is also the measurement date. Accordingly, Entity A determines the fair value of the equity-classified awards at January 1, 20X1 and does not remeasure the fair value at the end of each reporting period.

## 12.4 Awards with performance conditions

Under the pre-amended guidance in ASC 718, a performance condition in a share-based payment award does not affect the award’s fair value. In addition, the grantor must consider the probability that the performance condition will be satisfied in determining the amount of expense recorded during the requisite service, or vesting, period. After adopting the amendments in ASU 2018-07, grantors are now required to apply this guidance to nonemployee awards as well and to recognize the cost over the vesting period.

This accounting differs from and improves the guidance in ASC 505-50, which was often difficult to apply. Under ASC 505-50, if the quantity or the terms of the equity instruments resulted in a range of outcomes under the performance condition, the nonemployee instruments would be accounted for at interim reporting dates based on the instruments’ then-current lowest aggregate fair value, which might have been zero. After adopting the amendments, the grantor now recognizes expense based on the grant-date fair value of the number of instruments that the grantor believes will probably vest.

Additional guidance on performance conditions is discussed in Section 5.2.

### Instruments with a performance condition

Assume the same facts used in the measurement-date example above, except that there is a performance condition which requires that Entity A’s return on assets be greater than 10 percent for the period from January 1 to December 31, 20X1. For awards with a performance condition that affects vesting or the exercisability of options, compensation cost is recognized only if it is “probable” that the performance condition will be satisfied. (See Section 5.2 for additional guidance on performance conditions.)

**Pre-amendments: ASC 505-50**

Under ASC 505-50, the measurement date does not occur until Entity B completes its performance obligation. Performance is completed once Entity B has provided asset management services to Entity A for the one-year period following the award’s issuance date of January 1, 20X1 which would be January 1, 20X2.

If Entity A paid cash to Entity B in exchange for the asset management services, it would recognize the cost of those services as they are performed over the one-year period following the issuance date. However, the quantity and terms of the RSUs depend on a counterparty performance condition. Therefore, Entity A would recognize the then-current lowest aggregate fair value of the awards at each reporting date preceding the measurement date. The lowest aggregate fair value of the awards on March 31, 20X1 would be zero because it is possible that Entity A’s return on assets could be lower than 10 percent for the period from January 1 to December 31, 20X1. Therefore, as of March 31, 20X1, Entity A would not recognize any expense associated with the RSUs issued to Entity B.

**Post-amendments: ASC 718**

If Entity A believes it is probable that the performance condition will be satisfied, it would begin recognizing compensation expense starting from the grant date of January 1, 20X1, the same accounting that applies to employee awards.

## 12.5 Post-vesting classification considerations

The amendments in ASU 2018-07 align the post-vesting classification requirements for employee and nonemployee awards, meaning the grantor now applies the initial classification requirements in ASC 718 and does not reassess classification once the grantee vests in the award and finishes providing goods or services to the grantor. As with employee awards, the only exception to this guidance is for post-vesting modifications where the grantor applies the modification guidance in ASC 718 (see Section 8).

The changes to the accounting for post-vesting classification requirements are yet another change from the superseded guidance for nonemployee share-based awards. Because ASC 505-50 has relatively little detailed guidance and illustrations on this subject, many grantors of nonemployee awards analogized to the guidance in ASC 718 to ascertain the appropriate accounting. However, analogy was not appropriate for post-vesting accounting after the nonemployee provided the goods or services as required and the terms of the award are no longer subject to change as the awards generally became subject to other guidance, which might have resulted in a change in classification. For example, some awards became subject to other guidance, such as ASC 815.

**Grant Thornton insights: Applying ASC 718 to goods and services consumed by grantor**

The FASB clarified that ASC 718 applies only to instruments granted for goods and services used or consumed in a grantor’s own operations and does not apply to instruments issued to raise capital. This guidance ensures that entities cannot circumvent the classification guidance in other ASC Topics, such as ASC 815, when issuing instruments related to raising capital.

Also, ASC 718 does not apply to instruments issued to customers. Instead, these instruments are accounted for under the guidance in ASC 606.

## 12.6 Nonpublic entities: intrinsic value and calculated value

At the effective date of the new guidance, a nonpublic entity may elect a practical expedient for liability-classified nonemployee awards, as long as the election is consistent with its accounting for employee awards. This practical expedient allows a nonpublic entity upon adoption to measure all liability-classified nonemployee awards at “intrinsic value”—the amount by which the fair value of the underlying stock exceeds the option’s exercise price—rather than at fair value, without evaluating whether the change is preferable. The guidance in ASC 505-50 is silent about such an election.

After adopting the amendments, however, an entity making this election would be required to evaluate preferability and to apply the guidance in ASC 250.

Paragraph ASC 718-30-30-2, as revised by the amendments, states that nonpublic entities must have a policy for measuring all liability-classified awards at either fair value or intrinsic value. The practical expedient offered to nonpublic entities when adopting the amendments in ASU 2018-07 is solely intended to provide relief if an entity elects to measure these awards at intrinsic value at that date.

**ASC 718-30-30-2**

A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements (for employee and nonemployee awards) at fair value or to measure all such liabilities at intrinsic value.

Under the amendments, a nonpublic entity may use calculated value (see Section 7.2) for both liability-classified and equity-classified stock options granted to employees and nonemployees, as well as for similar awards, if the nonpublic entity is unable to estimate fair value because it is not practicable to estimate the award's expected volatility. If an entity is unable to estimate the fair value of an award for that reason, it must account for these awards by using an appropriate historical industry-sector volatility input.

Existing ASC 718 guidance included the calculated value method for employee awards, but ASC 505-50 did not include the calculated value model and instead required determination of the fair value for nonemployee awards. This determination of fair value for nonemployee awards was difficult for some nonpublic entities, so conforming this narrow guidance for both employee and nonemployee awards is an improvement.

Therefore, a nonpublic entity should estimate the fair value for all awards, if practicable, or it must apply the guidance on calculated value in ASC 718-10-30-19A that was added in the amendments.

**ASC 718-10-30-19A**

Similar to employee equity share options and similar instruments, a nonpublic entity may not be able to reasonably estimate the fair value of nonemployee awards because it is not practicable for the nonpublic entity to estimate the expected volatility of its share price. In that situation, the nonpublic entity shall account for nonemployee equity share options and similar instruments on the basis of a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the nonpublic entity's share price (the calculated value) in accordance with paragraph 718-10-30-20. A nonpublic entity's use of calculated value shall be consistent between employee share-based payment transactions and nonemployee share-based payment transactions.

## 12.7 Elections and expedients for nonemployee awards

The amended guidance allows entities to elect to use the contractual term or the expected term when valuing awards granted to a nonemployee, as well as relief specifically designed for nonpublic entities when accounting for nonemployee awards.

### 12.7.1 Election to use contractual term or expected term

Employee share options generally differ from transferrable share options in that employees can exercise, but cannot sell or hedge, their share options once vested – they can only exercise them. Based on outreach, the FASB concluded that nonemployee options typically do not have the same restrictions on transfer after vesting. Because of these differences, and to simplify the guidance, the amendments now allow an entity to either

- Elect, on an award-by-award basis, to use the contractual term as the expected term when estimating the fair value for each nonemployee award
- Estimate an expected term for each nonemployee award that reflects the effect of expected exercise and post-vesting termination behavior

**ASC 718-10-30-10A**

On an award-by-award basis, an entity may elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award to satisfy the measurement objective in paragraph 718-10-30-6. Otherwise, an entity shall apply the guidance in this Topic in estimating the expected term of a nonemployee award, which may result in a term less than the contractual term of the award.

The guidance in ASC 718-10-30-10A allowing entities to use either the contractual term or an expected term for nonemployee awards differs from the accounting for employee awards. An entity that grants employee awards is *required* to determine the expected term as an input for the option-pricing model (see Section 7.6) when valuing an employee award and does not have the option to use the contractual term.

Entities must consider a variety of items when determining whether to use the contractual or expected term for nonemployee awards, including the contractual provisions of the award, specifically its transferability. A grantee with transferable awards may be more inclined to sell the award, in which case, it is more likely that the expected term would be consistent with the contractual term. In contrast, nontransferable awards are typically expected to be exercised prior to the end of the contractual term. Entities should also consider post-vesting termination activity based on the historical practices of nonemployees when developing an award's estimated term.

### 12.7.2 Nonpublic entity expedient for nonemployee awards

The amendments offer nonpublic entities additional relief related to an award's expected term in the way of practical expedients that are outlined in ASC 718-10-30-10B and ASC 718-10-30-20A through 20B. Nonpublic entities may now elect a practical expedient to estimate the expected term for nonemployee awards, consistent with the process used for employee awards. This is an accounting policy election and must be applied to employee and nonemployee awards. In other words, the expedient may not be applied to employee awards, but not to nonemployee awards. The application must be consistent for both.

**ASC 718-10-30-10B**

When a nonpublic entity chooses to measure a nonemployee share-based payment award by estimating its expected term and applies the practical expedient in paragraph 718-10-30-20A, it must apply the practical expedient to all nonemployee awards that meet the conditions in paragraph 718-10-30-20B. However, a nonpublic entity may still elect, on an award-by-award basis, to use the contractual term as the expected term as described in paragraph 718-10-30-10A.

**ASC 718-10-30-20A**

For an award that meets the conditions in paragraph 718-10-30-20B, a nonpublic entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

a. If vesting is only dependent upon a service condition, a nonpublic entity shall estimate the expected term as the midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term of the award.

b. If vesting is dependent upon satisfying a performance condition, a nonpublic entity first would determine whether the performance condition is probable of being achieved.

   1. If the nonpublic entity concludes that the performance condition is probable of being achieved, the nonpublic entity shall estimate the expected term as the midpoint between the employee’s requisite service period (a nonpublic entity shall consider the guidance in paragraphs 718-10-55-69 through 55-79 when determining the requisite service period of the award) or the nonemployee’s vesting period and the contractual term.

   2. If the nonpublic entity concludes that the performance condition is not probable of being achieved, the nonpublic entity shall estimate the expected term as either:

      i. The contractual term if the service period is implied (that is, the requisite service period or the nonemployee’s vesting period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future)

      ii. The midpoint between the employee’s requisite service period or the nonemployee’s vesting period and the contractual term if the requisite service period is stated explicitly.

**ASC 718-10-30-20B**

A nonpublic entity that elects to apply the practical expedient in paragraph 718-10-30-20A shall apply the practical expedient to a share option or similar award that has all of the following characteristics:

a. The share option or similar award is granted at the money.

b. The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods or terminates service after vesting.

c. The grantee can only exercise the award. The grantee cannot sell or hedge the award.

d. The award does not include a market condition.

A nonpublic entity that elects to apply the practical expedient in paragraph 718-10-30-20A may always elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award as described in paragraph 718-10-30-10A. However, a nonpublic entity must apply the practical expedient in paragraph 718-10-30-20A for all nonemployee awards that have all the characteristics listed in this paragraph if that nonpublic entity does not elect to use the contractual term as the expected term and that nonpublic entity elects the accounting policy election to apply the practical expedient in paragraph 718-10-30-20A.

## 12.8 Accounting that did not change as a result of ASU 2018-07

Throughout the amendments to ASC 718, the wording is intentionally precise as to which type of awards a particular paragraph applies to, as follows:

- *For amendments that apply to both employee and nonemployee awards:* The word “grantee” generally is used, or there is no reference to the type of grantee.
- *For amendments that apply only to employee awards:* The word “employee(s)” is used.
- *For amendments that apply only to nonemployee awards:* The word “nonemployee(s)” is used.

In this way, the FASB clearly differentiates the continuing differences between the accounting for employee and nonemployee awards.

This section discusses the guidance on accounting for nonemployee awards in ASC 505-50 that did *not* change. In other words, key aspects of guidance in ASC 505-50 have been incorporated into the amended text of ASC 718 without being amended.

### 12.8.1 Nonemployee award cost attribution and vesting period

Under ASC 505-50, entities are required to recognize an asset, expense, or sales discount in the same period or periods and in the same manner (expensed or capitalized) as though the grantor had either paid cash for the goods or services or used cash rebates as a sales discount instead of issuing equity awards. The FASB did not change this guidance, which was integrated into ASC 718. Therefore, the cost of nonemployee awards is recognized based on the pattern in which the grantor would recognize the award if it had paid cash instead of issuing an award.

The practice of recognizing cost as if cash had been paid differs from the requisite service period principle (see Section 6.2) required to account for employee awards, although the period of time may be the same if employee and nonemployee award terms are the same. The amended guidance in ASC 718 therefore uses the term “vesting period” to express the period over which a nonemployee may earn an award. There is no change to the terminology related to “requisite service period” for employee award cost attribution. Paragraph 718-10-25-2C was moved from ASC 505-50 into ASC 718 to illustrate this difference in accounting for employee awards and nonemployee awards.

**ASC 718-10-25-2C**

This guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an entity granting the share-based payment award (the purchaser or grantor) to a nonemployee shall recognize the cost of the share-based payment award that will be issued, other than to require that an asset or expense be recognized (or previous recognition reversed) in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services instead of paying with or using the share-based payment award.

The amendments revised the definition of ‘vest” in the ASC Master Glossary to show the distinction between using the requisite service period to account for employee awards and using the vesting period to account for nonemployee awards. This distinction exists in many places throughout the guidance in ASC 718.

To **vest** means to earn the rights to. A share-based payment award becomes vested at the date that the grantee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

The stated vesting provisions of an award often establish the employee's requisite service period or the nonemployee's vesting period, and an award that has reached the end of the applicable period is vested. However, as indicated in the definition of requisite service period and equally applicable to a nonemployee's vesting period, the stated vesting period may differ from those periods in certain circumstances. Thus, the more precise terms would be options, shares, or awards for which the requisite good has been delivered or service has been rendered and the end of the employee's requisite service period or the nonemployee's vesting period.

**Grant Thornton insights: Cost attribution for nonemployee awards**

Under the pre-amendment guidance in ASC 505-50, entities must use judgment to determine the period and manner in which to recognize the cost of nonemployee share-based payment awards, and they will continue to use judgment under the amendments in ASU 2018-07. Many entities grant similar awards to both employees and nonemployees and, in our experience, the cost attribution ultimately is nearly the same. Put differently, the accounting for recognizing the cost of a nonemployee award as if cash had been paid is often the same as the accounting for recognizing the cost of an employee award over the requisite service period.

### 12.8.2 Graded vesting

ASC 718 allows a grantor to use a straight-line method to recognize the cost of employee awards with only service conditions and graded vesting. This election is not, however, available for nonemployee awards under the amendments in ASU 2018-07.

In other words, even if the terms of employee and nonemployee awards are the same, the grantor may elect straight-line recognition for employee awards, but not for nonemployee awards. As a result, each tranche of a nonemployee award is separately recognized as if the award were, in substance, multiple awards. In-substance multiple-award accounting is discussed in Section 6.3.

## 12.9 Disclosures

ASC 505-50 has no specific requirement to separately disclose share-based payments made to nonemployees, unless separate disclosures are needed to understand the effects of those transactions in the financial statements. Nevertheless, in practice, entities generally provide separate disclosures for nonemployee awards, which are similar to those required for employee awards.

The amendments do not change this overall principle, and the current disclosure practices for nonemployee awards will probably continue because the disclosure guidance in ASC 718-10-50 now applies to all awards. That guidance stipulates the use of a disclosure principle that if there are different types of awards, there should be separate disclosures. The amendments in ASU 2018-07 add the phrase "(including nonemployee versus employee)" in ASC 7187-10-50-2g to clarify that nonemployee awards are considered a different type of awards from employee awards. Therefore, grantors should make appropriate disclosures. This approach to disclosures is not new, for example, grantors separately disclose vesting status, performance conditions, and liability-classified versus equity-classified awards.

**ASC 718-10-50-2 (excerpt, emphasis added)**

…

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements **shall provide the information specified in paragraph (a) through (f) 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** [bolded emphasis added]**.** 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. …

# 13. Required presentation and disclosures

ASC 718 provides relatively little guidance on how to present compensation costs from share-based payments in the income statement. The guidance does, however, provide expansive guidance on the disclosures required for share-based payment arrangements. This section reflects the presentation and disclosure guidance after issuance of the amendments in ASU 2018-07 (see Section 12). Those amendments do not change the disclosures for employee awards and mostly conform nonemployee award disclosures with existing employee award disclosures.

## 13.1 Presentation

### 13.1.1 Balance sheet

The balance-sheet presentation of share-based payment obligations is dictated by whether the awards are classified as either equity or liability (see Section 3).

**ASC 718-10-25-2**

An entity shall recognize the goods acquired or services received in a share-based payment transaction when it obtains the goods or as services are received, as further described in paragraphs 718-10-25-2A through 25-2B. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 718-10-25-6 through 25-19A).

### 13.1.2 Income statement

Most share-based payments are granted in exchange for services. Accordingly, the related cost typically is recognized in earnings in the period the services are provided. Where those costs are presented in the income statement depends on the nature of either the service provided or the goods acquired in exchange for the awards. For example, awards granted to executive employees typically are included in administrative expenses, similarly to the executives' cash salaries. Or, awards granted to research engineers may be considered part of the research and development expense, depending on the particular facts and circumstances. Judgment is necessary to determine the proper presentation for services provided in exchange for share-based payment awards.

An entity may include the cost of certain awards granted to those involved with the production of inventory or in the construction of an asset for internal use, in the total costs for direct labor or overhead allocated to those assets. An entity would recognize these costs in the income statement as inventory is sold or as property and equipment are depreciated.

Again, the nature of the services (or goods) received is important in determining how to present the related costs, as illustrated in ASC 718-10-25.

### ASC 718-10-25-2A

Employee services themselves are not recognized before they are received. As the services are consumed, the entity shall recognize the related cost. For example, as services are consumed, the cost usually is recognized in determining net income of that period, for example, as expenses incurred for employee services. In some circumstances, the cost of services may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed. This Topic refers to recognizing compensation cost rather than compensation expense because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

### ASC 718-10-25-2B [nonemployee]

Transactions with nonemployees in which share-based payment awards are granted in exchange for the receipt of goods or services may involve a contemporaneous exchange of the share-based payment awards for goods or services or may involve an exchange that spans several financial reporting periods. Furthermore, by virtue of the terms of the exchange with the grantee, the quantity and terms of the share-based payment awards to be granted may be known or not known when the transaction arrangement is established because of specific conditions dictated by the agreement (for example, performance conditions). Judgment is required in determining the period over which to recognize cost, otherwise known as the nonemployee's vesting period.

### ASC 718-10-25-2C [nonemployee]

This guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an entity granting the share-based payment award (the purchaser or grantor) to a nonemployee shall recognize the cost of the share-based payment award that will be issued, other than to require that an asset or expense be recognized (or previous recognition reversed) in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services instead of paying with or using the share-based payment award.

In SEC Staff Accounting Bulletin 14, the SEC staff addressed how to present share-based payments within the context of an entity seeking to emphasize the noncash nature of the expense and the capitalization of share-based payment costs.

### ASC 718-10-S99-1 (excerpt)

**SAB Topic 14.F, Classification of Compensation Expense Associated with Share-based Payment Arrangements**

Facts: Company G utilizes both cash and share-based payment arrangements to compensate its employees and nonemployee service providers. Company G would like to emphasize in its income statement the amount of its compensation that did not involve a cash outlay.

Question: How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?

Interpretive Response: The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. [FN 87] The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements. Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

FN87 FASB ASC 718 does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

**SAB Topic 14.I, Capitalization of Compensation Cost Associated with Share-Based Arrangements**

Facts: Company K is a manufacturing company that grants share options to its production employees. Company K has determined that the cost of the production employees service is an inventoriable cost. As such, Company K is required to initially capitalize the cost of the share option grants to these production employees as inventory and later recognize the cost in the income statement when the inventory is consumed. [FN94]

FN94 FASB ASC paragraph 718-10-25-2.

Question: If Company K elects to adjust its period end inventory balance for the allocable amount of share-option cost through a period end adjustment to its financial statements, instead of incorporating the share-option cost through its inventory costing system, would this be considered a deficiency in internal controls?

Interpretive Response: No. FASB ASC Topic 718, Compensation—Stock Compensation, does not prescribe the mechanism a company should use to incorporate a portion of share-option costs in an inventory-costing system. The staff believes Company K may accomplish this through a period end adjustment to its financial statements. Company K should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment. The fact that the entry is recorded as a period end adjustment, by itself, should not impact managements ability to determine that the internal control over financial reporting, as defined by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002, [FN95] is effective.

FN95 Release No. 34-47986, June 5, 2003, Managements Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.

### 13.1.3 Statement of cash flows

By their nature, share-based compensation payments for equity classified awards are non-cash transactions and therefore are not presented in the statement of cash flows, apart from the reconciliation from net income to cash flows from operations under the indirect method. Cash received when the stock options are exercised, other cash paid by grantees, and realized excess tax benefits are also presented in the statement of cash flows. As further discussed in Section 10, the amendments in ASU 2016-09 simplify the presentation of excess tax benefits by requiring entities to classify the related cash flows in operating activities as part of cash payments for taxes.

### 13.2 Disclosure requirements

ASC 718-10-50-1 provides general disclosure requirements and ASC 718-10-50-51 provides detailed disclosure guidance. An overarching principle is that an entity's disclosures for its share-based payment arrangements should allow financial statement users to understand certain aspects of the arrangements, as well as the effects of such transactions on the financial statements.

Prior to adopting the amendments for nonemployee awards in ASU 2018-07 (see Section 11), an entity was directed in ASC 505-50-50-1 to follow the disclosure guidance for employee awards in ASC 718-10-50-1 and 50-2, to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements. Once an entity adopts the amendments in ASU 2018-07 (see Section 12), the guidance on disclosures required for nonemployee awards is included in ASC 718-10-50. This section reflects the guidance on disclosures required for employee and nonemployee awards after the amendments are adopted.

**ASC 718-10-50-1**

An entity with one or 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 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 interim reporting see Topic 270. See Example 9 (paragraph 718-10-55-134 through 55-137) for an illustration of this guidance.

ASC 718-10-50-2 expands on the general disclosure requirements outlined in ASC 718-10-50-1 by listing the minimum disclosure information that an entity should provide to satisfy the disclosure objectives. However, specific circumstances might cause an entity to disclose more than these minimum disclosure items. ASC 718-10-50-2 also provides the following exceptions from certain minimum disclosure requirements pertaining to intrinsic value:

- Nonpublic entities are not required to disclose the aggregate intrinsic value of options (or share units) currently exercisable (or convertible).
- Nonpublic entities are not required to disclose the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest.

Entities that have multiple share-based arrangements with employees should disclose information separately for different types of awards to the extent that separate disclosure is important to understanding the entity's use of share-based compensation. For example, it may be important to provide separate disclosures of arrangements with awards that feature any one of the following characteristics:

- Fixed exercise price or an indexed exercise price

- Service condition only or both performance and service conditions
- Classified in equity or classified as a liability

### ASC 718-10-50-2

The following list indicates the minimum information needed to achieve the objectives in paragraph 718-10-50-1 and illustrates how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:

   1. 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)
   2. The maximum contractual term of equity (or liability) share options or similar instruments
   3. The number of shares authorized for awards of equity share options or other equity instruments.

b. The method it uses for measuring compensation cost from share-based payment arrangements.

c. For the most recent year for which an income statement is provided, both of the following:

   1. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):
      i. Those outstanding at the beginning of the year
      ii. Those outstanding at the end of the year
      iii. Those exercisable or convertible at the end of the year
      iv. Those that during the year were:
         01. Granted
         02. Exercised or converted
         03. Forfeited
         04. Expired.
   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 paragraph 718-10-30-21) of equity instruments not specified in (c)(1), for all of the following groups of equity instruments:
      i. Those nonvested at the beginning of the year
      ii. Those nonvested at the end of the year
      iii. Those that during the year were:
         01. Granted

02. Vested

03. Forfeited.

d. For each year for which an income statement is provided, both of the following:

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 718-10-30-21 through 30-22) 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.

e. 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 in accordance with paragraph 718-10-35-1D or 718-10-35-3) at the date of the latest statement of financial position, both of the following:

1. 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
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).

f. For each year for which an income statement is presented, both of the following (an entity that uses the intrinsic value method pursuant to paragraphs 718-10-30-21 through 30-22 is not required to disclose the following information for awards accounted for under that method):

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):

   i. 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 postvesting termination behavior into the fair value (or calculated value) of the instrument.

   ii. 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.

   iii. 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.

   iv. 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.

   v. Discount for postvesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements shall provide the information specified in paragraph (a) through (f) 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.

h. For each year for which an income statement is presented, both of the following:

   1. Total compensation cost for share-based payment arrangements

      i. Recognized in income as well as the total recognized tax benefit related thereto

      ii. Capitalized as part of the cost of an asset.

   2. A description of significant modifications, including:

      i. The terms of the modifications

      ii. The number of grantees affected

      iii. The total (or lack of) incremental compensation cost resulting from the modifications.

i. 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

j. [Subparagraph superseded by Accounting Standards Update No. 2016-09]

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

l. 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.

m. If not separately disclosed elsewhere, the policy for estimating expected forfeitures or recognizing forfeitures as they occur.

**ASC 718-10-50-2A**

Another item of minimum information needed to achieve the objectives in paragraph 718-10-50-1 is the following:

a. 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.

**ASC 718-10-50-3**

Paragraph Not Used.

**ASC 718-10-50-4**

In addition to the information required by this Topic, 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 Topic. The alternative assumptions shall be described to enable users of the financial statements to understand the basis for the supplemental information.

## 13.3 Example disclosures

ASC 718 includes an example of disclosures for a public company for its employee share-based payment awards, but the example is equally applicable to nonemployee awards granted.

**Example 9: Disclosure**

**ASC 718-10-55-134**

This Example illustrates disclosures (see paragraphs 718-10-50-1 through 50-2) of a public entity's share-based compensation arrangements. The illustration assumes that compensation cost has been recognized in accordance with this Topic 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. Although this Example focuses on employee share-based payment plans, the disclosures are equally applicable to share-based payment awards issued to nonemployees. An entity should refer to the guidance in paragraph 718-10-50-2(g) when evaluating whether separate disclosure of nonemployee share-based payment awards is warranted.

**ASC 718-10-55-135**

On December 31, 20Y1, the Entity has two share-based compensation plans: 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.

## ASC 718-10-55-136

### Case A: Share Option Plan

The following illustrates disclosure for a share option plan.

The Entity's 20X4 employee share option 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. Entity A 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 Entity A'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 employee share option 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 Entity A's stock, historical volatility of Entity A's stock, and other factors. Entity A 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% |
| 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 employee share option 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 Entity A's nonvested shares as of December 31, 20Y1, and changes during the year ended December 31, 20Y1, is presented below.

| Novested 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 employee share option 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, Entity A 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.

### ASC 718-10-55-137

### Case B: Performance Share Option Plan

The following illustrates disclosure for a performance share option plan.

Under its 20X7 performance share option plan, which is shareholder-approved, each January 1 Entity A 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 share option 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 5 million.

The fair value of each option grant under the performance share option plan was estimated on the date of grant using the same option valuation model used for options granted under the employee share option 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 employee share option plan. The expected term for options granted under the performance share option 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 share option 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 | 9,958 | 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 share option plan; that cost is expected to be recognized over a period of 4 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 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.

Entity A has a policy of repurchasing shares on the open market to satisfy share option exercises and expects to repurchase approximately 1 million shares during 20Y2, based on estimates of option exercises for that period.

## 13.4 Disclosures in interim statements

ASC 718 does not require any disclosures of share-based payment information on a quarterly basis. However, entities should consider the general requirements in ASC 270-10-50, *Interim Reporting,* when assessing whether to provide these disclosures in quarterly financial reports. ASC 270 requires disclosures for changes in accounting principles or estimates and for significant changes in financial position.

In addition, as discussed in Paragraph 239 in the Basis for Conclusions of Statement 123R (not included in the Codification), entities with significant share-based compensation costs may consider providing additional quarterly information to help users in understanding the quarterly impact of share-based compensation arrangements, as follows.

BC239. Some respondents said that certain of the minimum disclosures, such as the total amount of compensation cost, also should be required on a quarterly basis. The Board notes that paragraph 30 of APB Opinion No. 28, Interim Financial Reporting [ASC 270-10-50-1], specifies information to be included in quarterly financial reports, including information about changes in accounting principles or estimates and significant changes in financial position. The Board concluded that this Statement should not specify information about share-based compensation arrangements to be provided quarterly. Rather, entities should look to the general requirements of Opinion 28 [ASC 270]. The Board also notes that entities for which share-based compensation cost is significant may wish to provide additional information, including the total amount of that cost, on a quarterly basis to help users better understand their quarterly financial reports.