GRANT THORNTON LLP
Grant Thornton Tower
171 N. Clark Street, Suite 200
Chicago, IL 60601-3370

D +1 312 856 0200
S linkd.in/grantthorntonus
twitter.com/grantthorntonus

November 1, 2023

Hillary H. Salo
Technical Director
Financial Accounting Standards Board
801 Main Avenue, PO Box 5116
Norwalk, CT 06856-5116

Via Email to director@fasb.org

Agenda Request – Warrants Paid to Customers, Interaction of ASC 718 and ASC 606

Dear Ms. Salo:

Grant Thornton LLP appreciates the opportunity to submit an agenda request to the Emerging Issues Task Force (EITF) to address whether warrants paid to customers in a revenue transaction that are not in exchange for a distinct good or service and that vest upon a customer's purchases (or a customer's customers' purchases) constitutes a *service condition* or a *performance condition*, as defined in ASC 718.

Background

In June 2018, the amendments in ASU 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, expanded the scope of ASC 718 to include share-based payment transactions for acquiring goods and services from nonemployees. In doing so, the amendments superseded the guidance in Subtopic 505-50, *Equity—Equity-Based Payments to Non-Employees,* and revised paragraphs ASC 606-10-32-25, ASC 718-10-15-5, and ASC 718-10-25-2C (formerly paragraph ASC 505-50-25-4) to require entities to account for share-based payment awards granted to a customer in conjunction with selling goods or services under ASC 606, *Revenue from Contracts with Customers*.

While ASC 606 provides presentation guidance for payments made to a customer that are not in exchange for a distinct good or service (that is, as a reduction of the transaction price and, therefore, of revenue), it previously did not provide guidance on measuring share-based payment awards granted to a customer. The FASB received

Grant Thornton

feedback indicating that this lack of guidance could lead to diversity in practice because entities could apply either the noncash consideration guidance under ASC 606 to measure the award at contract inception or under ASC 718 to measure the award at the grant date.

In November 2019, the amendments in ASU 2019-08, *Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements—Share-Based Consideration Payable to a Customer,* required an entity to measure and classify share-based payment awards granted to a customer using the guidance in ASC 718. Assuming the share-based payment award is not in exchange for distinct goods or services, the amount recorded as a reduction of the transaction price should be measured at the grant date in accordance with the fair value-based measurement approach in ASC 718.

The Codification's Master Glossary defines the "grant date" as the date at which a grantor (supplier) and a grantee (customer) reach a mutual understanding of the key terms and conditions of a share-based payment award. The classification and subsequent measurement of the award are subject to the guidance in ASC 718, unless both the share-based payment award is subsequently modified, and the grantee is no longer a customer.

Under ASC 718, an entity must make an accounting policy election to either estimate forfeitures or to account for forfeitures when they occur. A single policy can be elected for all employee awards and another policy for all nonemployee awards. The policy election only relates to the service condition aspects of awards, as entities still need to assess the likelihood of achieving performance conditions each reporting period.

Question

Based on this background, we pose the following question to the EITF:

Is a sales incentive granted to a customer in the form of an entity's warrants that is not in exchange for a distinct good or service and that vest or become exercisable upon a specified volume of customer purchases a service condition or a performance condition in accordance with ASC 718?

Implications

If the sales incentive described in our query is deemed to be a service condition, the entity must follow its existing accounting policy election for forfeitures of awards issued to nonemployees under ASC 718-10-35-1D. If that policy is to recognize the effects of forfeitures only when they occur, the transaction price should be reduced for the grant-date fair value of the total number of equity instruments that could theoretically be issued to the customer. Only when the customer fails to meet the purchase volume required in the contract upon actual forfeiture would the entity record an adjustment to the transaction price, resulting in a one-time pick-up of revenue.

On the other hand, if a sales incentive described in our query is deemed to be a performance condition, the entity must estimate the number of equity instruments that it will be obligated to issue to the customer each period under ASC 718. Any changes in the probability that the award will vest is recognized as a change in the transaction price based on either the grant-date fair value of the new outcome or the revised number of warrants, and the estimate should continuously be updated throughout the contract period until the award vests or fails to vest.

Under either view, if the warrants are classified as liabilities in accordance with the classification guidance in ASC 718, changes in the fair value of the warrants are due to the form of the consideration and, therefore, are recognized outside of revenue.

Example to illustrate

On January 1, 20X1, Entity enters into a two-year contract with Customer to provide access to its mobile betting platform, which is effectively a software as a service (SaaS) platform that end-consumers access to virtually place bets or wagers. Entity will earn a fixed percentage of gaming revenue processed through its platform from bets placed by end-consumers over the two-year period.

In accordance with ASC 606, a revenue contract between Entity and Customer exists, and Entity recognizes revenue over the contract term. As an incentive to support the commercial success of the platform, Entity grants warrants to Customer in Entity's common stock at the contract's inception, with the following vesting schedule:

- If gaming revenue earned by Entity through Customer (and end-consumers) exceeds $10 million during the contract term, Customer vests in 15,000 warrants.
- If gaming revenue earned by Entity through Customer (and end-consumers) exceeds $30 million during the contract term, Customer vests in 50,000 warrants.

Entity determines that the grant-date fair value per warrant is $20 on January 1, 20X1, in accordance with the valuation principles in ASC 718. Entity's policy under ASC 718 is to recognize nonemployee forfeitures when they occur. Entity concludes, in accordance with ASC 606-10-32-25, that the noncash payment to Customer is not in exchange for a distinct good or service from Customer and, therefore, accounts for all warrants as a reduction to the transaction price.

At contract inception, Entity believes it is not probable that the customer will vest in any of the warrants.

Views

View A: A sales incentive granted to a customer in the form of an entity's warrants that is not in exchange for a distinct good or service and that vest or become exercisable upon a specified volume of customer purchases is deemed to be a service condition. The amendments in ASU 2018-07 updated the definition of a "service condition" to include "a nonemployee delivering goods or rendering services to the grantor," and the purchase of a certain quantity or dollar value of goods or services by a customer (and end-consumers) qualifies as a service rendered.

As a result, the probability of vesting does not impact the recognition of the awards and is considered only within the context of Entity's ASC 718 forfeiture policy for nonemployees. In other words, the probability of vesting impacts measurement only if forfeitures are estimated; in this example, forfeitures are not estimated since Entity's policy is to recognize forfeitures when they occur.

Therefore, Entity reduces the transaction price for the grant-date fair value of the full number of warrants that could be issued and recognizes the reduced transaction price as it transfers control of the service to Customer. Only when Customer fails to meet the criteria necessary to earn the award would Entity record an adjustment to the transaction price to reverse the reduction in revenue for the warrants granted to Customer (in other words, Entity will have a one-time pick-up in revenue).

View B: A sales incentive granted to a customer in the form of an entity's warrants that is not in exchange for a distinct good or service and that vest or become exercisable upon a specified volume of customer purchases is deemed to be a performance condition. As defined, a performance condition relates to both (a) rendering a service or delivering goods for a specified period of time, and (b) achieving a specified performance target that is defined solely by referring either to the grantor's own operations or activities or to the grantee's performance related to the grantor's operations or activities. Because a grantor's operations include financial metrics, such as revenue and earnings targets, a vesting condition tied to revenue realized by Entity from a customer's purchases meets the definition of a performance condition. As a result, the probability of vesting is considered for recognition purposes.

Therefore, Entity does not reduce the estimated transaction price for the grant-date fair value of any warrants granted to Customer because it deems that the awards are not probable of vesting.

Follow-on question The example illustrates a sales incentive to Customer in the form of Entity's warrants that is not in exchange for a distinct good or service and that vest or become exercisable upon a specified volume of Customer's customers' purchases. Does the answer regarding the determination of whether the sales incentive is a service condition or a performance condition differ if the specified volume target is based on the activity of Customer or on the activity of the Customer's customers?

Views

View A: Share-based payment incentives that vest based on purchases made by either Customer or Customer's customers are accounted for in the same manner in accordance with ASC 718. While ASC 718 is not prescriptive, this view is based upon the fact that ASC 606 generally pulls into its purview purchases made by both Customer and Customer's customers.

View B: Incentives that vest based on purchases made *directly* by Customer are within Customer's control and, therefore, represent a service condition. However, incentives that vest based on purchases made by Customer's customers represent a performance condition, because such purchases are outside of the direct control of Customer and, therefore, are not akin to a nonemployee providing goods and services to Entity. As a result, if the incentive is ultimately based on purchases made by Customer's customers, then the vesting condition is considered to be a performance condition.

Diversity in practice and pervasiveness

Based on our experience and outreach with other firms, there is currently diversity in practice in how stakeholders answer these questions.

We believe this is a pervasive issue as entities often grant share-based payment awards to customers to incentivize sales, which are not in exchange for distinct goods or services. This issue is further exacerbated because the majority of entities elect to recognize forfeitures as they occur for nonemployee awards in accordance with ASC 718.

Proposed solution

We do not believe it was the Board's intent when issuing ASU 2019-08 to require an entity to reduce the transaction price for the grant-date fair value of all equity instruments granted, without regard to probability, when that award is issued to a customer and vesting of the incentive is tied to customer purchases. As a result, we recommend the following options for a narrow-scope amendment to address this current issue:

- Allow entities to make a separate forfeiture policy election for share-based payment awards issued to nonemployee customers, allowing them to estimate forfeitures, and for all other nonemployees that are not customers.
- Clarify that a sales incentive to a customer in the form of warrants that is not in exchange for a distinct good or service and that vest upon customer purchases is a performance condition. The EITF may wish to clarify how the probability assessment in ASC 718 interacts (or does not) with the constraint guidance in ASC 606.

Because this is a narrow issue that we believe can be resolved in a short period of time, we believe this issue is appropriate for the EITF to address.

****

We would be pleased to discuss additional perspectives or our suggestions with you. If you have any questions concerning this request, please contact Andrea Willette (andrea.willette@us.gt.com) or Susan Mercier (susan.mercier@us.gt.com).

Sincerely,

/s/ Grant Thornton LLP

Appendix A: Codification guidance

Service condition (Master Glossary): 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 or a nonemployee delivering goods or rendering services to the grantor over a vesting period. A condition that results in the acceleration of vesting in the event of a grantee's death, disability, or termination without cause is a service condition.

Performance condition (Master Glossary): 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. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time

b. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's performance related to the grantor'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 to the performance of the entity as a whole or to some part of the entity, such as a division, or to the performance of the grantee if such performance is in accordance with the terms of the award and solely relates to the grantor's own operations (or activities).

ASC 606 – Revenue from Contracts with Customers

>Consideration Payable to a Customer

ASC 606-10-32-25A Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payment awards). Changes in the measurement of the equity instrument (through the application of Topic 718) after the grant date that are due to the form of the consideration shall not be included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement. See paragraphs 606-10-55-88A through 55-88B for implementation guidance on equity instruments granted as consideration payable to a customer.

Grant Thornton

>Equity Instruments Granted as Consideration Payable to a Customer

ASC 606-10-55-88A Paragraph 606-10-32-25A requires that equity instruments granted in conjunction with an entity selling goods or services be measured and classified under Topic 718 on stock compensation. If the number of equity instruments promised in a contract is variable due to a service condition or a performance condition that affects the vesting of an award, an entity should estimate the number of equity instruments that it will be obligated to issue to its customer and update the estimate of the number of equity instruments until the award ultimately vests in accordance with Topic 718. When measuring each instrument, the entity should include, in accordance with Topic 718, the effect of any market conditions and service or performance conditions that affect factors other than vesting. Examples of factors other than vesting are included in paragraph 718-10-30-15. Changes in the grant-date fair value of an award due to revisions in the expected outcome of a service condition or a performance condition (both those that affect vesting and those that affect factors other than vesting) are not deemed to be changes due to the form of the consideration (as described in paragraph 606-10-32-23) and, therefore, should be reflected in the transaction price.

ASC 606-10-55-88B Paragraph 606-10-32-25A requires that equity instruments granted by an entity in conjunction with selling goods or services be measured and classified under Topic 718 at the grant date of the instrument. When an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration in paragraph 606-10-32-7, the estimate should be based on the fair value of the award at the reporting dates that occur before the grant date. An entity should change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity should change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value previously used at any prior reporting date.

ASC 718 Compensation – Stock Compensation

ASC 718-10-15-5A Share-based payment awards granted to a customer shall be measured and classified in accordance with the guidance in this Topic (see paragraph 606-10-32-25A) and reflected as a reduction of the transaction price and, therefore, of revenue in accordance with paragraph 606-10-32-25 unless the consideration is in exchange for a distinct good or service. If share-based payment awards are granted to a customer as payment for a distinct good or service from the customer, then an entity shall apply the guidance in paragraph 606-10-32-26.

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. A share-based payment award granted to a customer shall be reflected as a reduction of the transaction price and, therefore, of revenue as described in paragraph 606-10-32-25 unless the payment to the customer is in exchange for a distinct good or service, in which case the guidance in paragraph 606-10-32-26 shall apply.

ASC 718-10-35-1D The total amount of compensation cost recognized for share-based payment awards to nonemployees shall be based on the number of instruments for which a good has been delivered or a service has been rendered. To determine the amount of compensation cost to be recognized in each period, an entity shall make an entity-wide accounting policy election for all nonemployee share-based payment awards, including share-based payment awards granted to customers, to do either of the following:

a. Estimate the number of forfeitures expected to occur. The entity shall base initial accruals of compensation cost on the estimated number of nonemployee share-based payment awards for which a good is expected to be delivered or a service is expected to be rendered. The entity shall revise that estimate if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimates shall be recognized in compensation cost in the period of the change.

b. Recognize the effect of forfeitures in compensation cost when they occur. Previously recognized compensation cost for a nonemployee share-based payment award shall be reversed in the period that the award is forfeited.