BLUEPRINT: A BDO SERIES

Share-based Payments Under ASC 718

February 2025

BDO

TABLE OF CONTENTS

Overview 4
- Accounting for Share-based Payments — In a Nutshell 4
- Scope 4
- Measurement 4
- Classification 5
- Recognition 5
- Modifications 5
- Presentation and Disclosure 6
- About this Blueprint 6
- Acknowledgements 7

Chapter 1 — Scope 8
- 1.1 Overview 8
- 1.2 Transactions in the Scope of ASC 718 9
- 1.3 Types of Grantees 17
- 1.4 Grantors Other Than the Direct Beneficiary of Goods or Services 23
- 1.5 Awards Based on or Settled in Shares of an Unrelated Entity 28

Chapter 2 — Measurement 29
- 2.1 Overview 29
- 2.2 Grant Date 29
- 2.3 Fair-Value-Based Measurement 40
- 2.4 Valuation of Nonpublic Entity Awards 67

Chapter 3 — Classification 77
- 3.1 Overview 77
- 3.2 Liability Versus Equity Classification 77
- 3.3 Temporary Equity (Mezzanine) Classification 107
- 3.4 Additional Classification Considerations for Nonpublic Entities 112

Chapter 4 — Recognition 114
- 4.1 Overview 114
- 4.2 Vesting Conditions 115
- 4.3 Expense Attribution 145
- 4.4 Accounting for Liability-Classified Awards 159
- 4.5 Clawback and Noncompete provisions 161
- 4.6 Recourse and Nonrecourse Notes 165
- 4.7 Dividend-Protected Awards 171
- 4.8 “Last Man Standing” Arrangements 172
- 4.9 Capitalization of Share-Based Compensation Cost 172

Chapter 5 — Modifications 174
5.1 Overview 174
5.2 Scope 177
5.3 Modifications of Vesting Conditions 179
5.4 Change in an Award's Classification 188
5.5 Equity Restructurings 193
5.6 Inducements 198
5.7 Cancellation and Replacement 199
5.8 Cash Settlements and Repurchases 201
5.9 Changes After a Grantee Is No Longer Providing Goods or Services or Is No Longer a Customer or Employee 205
5.10 Changes to an Award Previously Accounted for Under ASC 710 206
Chapter 6 — Nonemployee Awards 208
6.1 Overview 208
6.2 Scope 209
6.3 Measurement of Nonemployee Awards 210
6.4 Classification of Nonemployee Awards 211
6.5 Recognition of Nonemployee Awards 212
6.6 Share-Based Payments Awarded to Customers 216
6.7 Modifications of Nonemployee Awards 218
6.8 Awards to Nonemployees of Equity-Method Investees 218
6.9 Nonemployee Awards Exchanged in a Business Combination 218
6.10 Presentation for Nonemployee Awards 219
6.11 Disclosure for Nonemployee Awards 219
Chapter 7 — Presentation and Disclosure 220
7.1 Overview 220
7.2 Presentation 220
7.3 Disclosures 222
7.4 Interim Reporting 231
7.5 Earnings Per Share 232
Appendix A — Other BDO Blueprints 257
Contacts

Overview

This Blueprint discusses the guidance in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation*, regarding the accounting for share-based payment awards, such as stock options, restricted stock units (RSUs), restricted shares, and profits interests issued in exchange for goods or services from employees or nonemployees.

The core principle of ASC 718 requires an entity to recognize the cost of goods acquired or services received in a share-based payment transaction, generally at fair value.

The term "entity" used throughout this Blueprint refers to the grantor in a share-based payment transaction, which can be an employer issuing awards to its employees or an entity issuing awards to nonemployees.

ACCOUNTING FOR SHARE-BASED PAYMENTS — IN A NUTSHELL

ASC 718 requires an entity to reflect the cost of a share-based payment award in the financial statements using a fair-value-based measure. To achieve that, an entity must:

- Identify the award's key terms
- Determine the measurement date (which is the grant date for an equity-classified award and the settlement date for a liability-classified award) and valuation technique for estimating fair value
- Determine the award's classification
- Recognize the compensation cost when or as the award vests
- Account for award modifications
- Present and disclose awards appropriately

SCOPE

ASC 718 applies to all entities that enter share-based payment transactions. Regardless of its legal form, an award is in the scope of ASC 718 if it is either settled in the entity's stock or based at least partially on the entity's stock value. The guidance **excludes** the following transactions:

- Instruments issued to a lender or investor that provide financing to the entity (see BDO's Blueprint, **Issuer's Accounting for Complex Financial Instruments**, for more guidance)
- Share-based payment awards issued as part of the consideration transferred in a business combination (see BDO's Blueprint, **Business Combinations Under ASC 805**, for more guidance)
- Share-based payment awards settled in shares of an unrelated entity (see Section 1.5)
- Tax effects arising from share-based payment awards

See Chapter 1 for more guidance on the scope of ASC 718.

While ASC 718 substantially aligns the accounting for share-based payment awards issued to employees and nonemployees, some differences remain, primarily regarding expense attribution and some aspects of measurement. See Chapter 6 for more guidance on the accounting for awards granted to nonemployees.

MEASUREMENT

An entity that grants share-based payment awards generally must recognize the cost of the awards using a fair-value-based measure at the measurement date, which depends on the award's classification. For equity-classified awards, the measurement date is the grant date. For liability-classified awards, an entity initially measures the award at the grant-date fair value and subsequently remeasures it at fair value at the end of each reporting period until the award is settled.

While the fair-value-based measure required by ASC 718 is closely aligned with fair value measured in accordance with ASC 820, *Fair Value Measurement*, there are some differences, primarily related to typical provisions of share-based payment awards. For example, a fair-value-based measure in accordance with ASC 718 excludes the effects of service and performance conditions that affect only vesting or exercisability, reload features, and some contingent features, which would be reflected in the fair value in accordance with ASC 820. Unless noted otherwise, this Blueprint refers to the fair-value-based measurement required by ASC 718 as "fair value."

Although ASC 718 does not prescribe a specific valuation technique, it specifies criteria a valuation technique must meet to be used in estimating fair value when observable market prices of identical or similar equity or liability instruments are not available for an award. The standard also provides several alternatives and expedients to nonpublic entities in measuring fair value by using alternative measures such as intrinsic value and calculated value. Accordingly, the term "fair value" used throughout this Blueprint also encompasses intrinsic value and calculated value if a nonpublic entity elects to use them.

See Chapter 2 for more guidance on measuring share-based payment awards.

CLASSIFICATION

The accounting for a share-based payment award differs depending on whether it is classified as equity or as a liability. An award is typically equity-classified if its terms result in settlement of the award in the entity's stock and is typically liability-classified if its terms result in settlement of the award in cash or other assets. Determining the appropriate classification requires judgment and includes evaluating classification criteria under ASC 718, as well as under ASC 480, *Distinguishing Liabilities From Equity*.

See Chapter 3 for more guidance on classifying share-based payment awards.

RECOGNITION

An entity generally recognizes the fair value of a share-based payment award as compensation cost in the period in which it consumes the benefits of a grantee's performance. In other words, compensation cost is recognized for goods when they are obtained and for services as they are received, with a corresponding increase to equity or liability, depending on the award's classification. Although compensation cost is typically expensed, it may be capitalized in accordance with other applicable U.S. generally accepted accounting principles (GAAP).

Share-based payment awards typically include service conditions or performance conditions (vesting conditions) that affect the timing and pattern of compensation cost recognition. Compensation cost is recognized only for awards that vest, and any compensation cost previously recognized for awards that are no longer expected to vest is reversed. ASC 718 provides entities with an accounting policy election for awards with service conditions to either estimate forfeitures or account for forfeitures as they occur. ASC 718 requires an entity to estimate the probability of achieving a performance condition in an award and recognize compensation cost if the performance condition is probable.

Unlike service and performance conditions, a market condition is not considered a vesting condition for purposes of recognizing compensation cost. In other words, compensation cost for an award with a market condition is recognized regardless of whether a market condition is satisfied. However, a market condition affects the fair value determination of a share-based payment award, so it affects an award's measurement.

Aside from vesting conditions, entities must identify and consider the effect on compensation cost of other terms of a share-based payment award, such as repurchase features and conditions that affect factors other than vesting or exercisability.

See Chapter 4 for more guidance on recognizing compensation cost for share-based payment awards.

MODIFICATIONS

An entity may change the terms or conditions of an existing share-based payment award. An entity must account for a modification if it affects the award's classification, vesting, or fair value.

A modification to an equity-classified award is treated as an exchange of the original award for a new award with equal or greater value. If a grantee receives incremental value as a result of the modification, additional compensation cost is recognized on the modification date (for vested awards) or over the remaining vesting period (for unvested awards).

A modification to a liability-classified award is remeasured based on the fair value of the award using the modified terms at the modification date and each reporting period thereafter, irrespective of whether the modification resulted in incremental value to the grantee.

Modifications that change an award's vesting conditions affect the amount of compensation cost to be recognized based on whether the award is probable of vesting under its new terms. The accounting for a modification that results in reclassifying an award depends on the award's classification before and after the modification.

See Chapter 5 for more guidance on accounting for modification of share-based payment awards.

PRESENTATION AND DISCLOSURE

ASC 718 requires compensation cost to be expensed unless other applicable U.S. GAAP requires it to be capitalized. Balance sheet presentation of a share-based payment award depends on the award's accounting classification as a liability or equity. Because a share-based payment award represents a noncash transaction, an entity that presents the cash flow statement using the indirect method adjusts net income for compensation cost recognized in the period in reconciling net income to net cash flow from operating activities.

Further, an entity must apply ASC 260, *Earnings Per Share,* to determine the potential effect of a share-based payment award on its earnings per share (EPS).

The disclosure requirements in ASC 718 apply to awards granted to both employees and nonemployees. However, separate disclosures may be required when the characteristics of nonemployee awards significantly differ from those of employee awards.

See Chapter 7 for more guidance on the presentation and disclosure requirements in ASC 718.

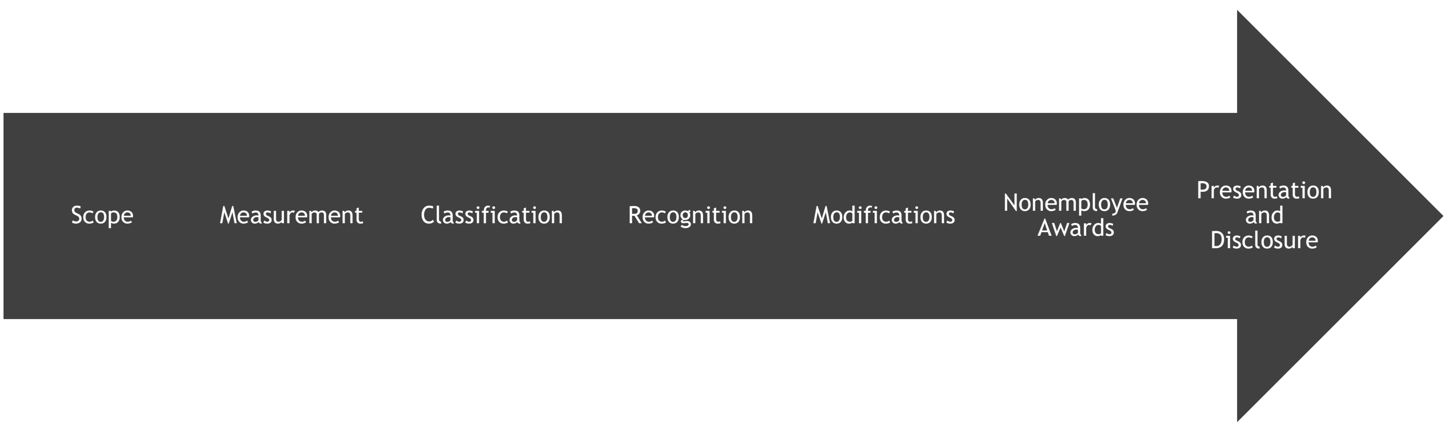
ABOUT THIS BLUEPRINT

This Blueprint reflects the guidance in ASC 718 after adopting Accounting Standards Update (ASU) 2024-01, *Compensation — Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*. It also incorporates SEC Staff Accounting Bulletin (SAB) Topics where applicable.

This Blueprint does not address the accounting by entities that offer employee share purchase plans and employee stock ownership plans. It also does not discuss the effect of income taxes.

The graphics and illustrations in this Blueprint are provided to help readers understand the accounting guidance. Accounting for your share-based payments awards may vary based on the facts and circumstances and therefore may differ from the illustrations herein.

This Blueprint is divided into chapters that are organized in the order an entity generally applies ASC 718. For example, Chapter 1 discusses whether a share-based payment is within the scope of ASC 718 and, if so, a reader moves to the next chapter, which addresses measurement. The arrow depicts the organization of this Blueprint.



Future Standard Setting

FASB PROJECT — SHARE-BASED CONSIDERATION PAYABLE TO A CUSTOMER

The FASB has a project on its agenda that would change some aspects of the accounting for share-based payment awards that are granted as consideration payable to a customer in accordance with ASC 718 and ASC 606, *Revenue From Contracts With Customers* (see Sections 1.3.5, 6.5.1.1, and 6.6).

FASB PROJECT — DISAGGREGATION OF INCOME STATEMENT EXPENSES

In November 2024, the FASB issued ASU 2024-03, *Disaggregation of Income Statement Expenses*, requiring public business entities to disclose more detailed information about the types of expenses (including employee compensation) included in commonly presented expense captions (such as cost of sales; selling, general, and administrative expenses; and research and development costs) (see Section 7.2.2)).

FASB PROJECT — INTERIM REPORTING

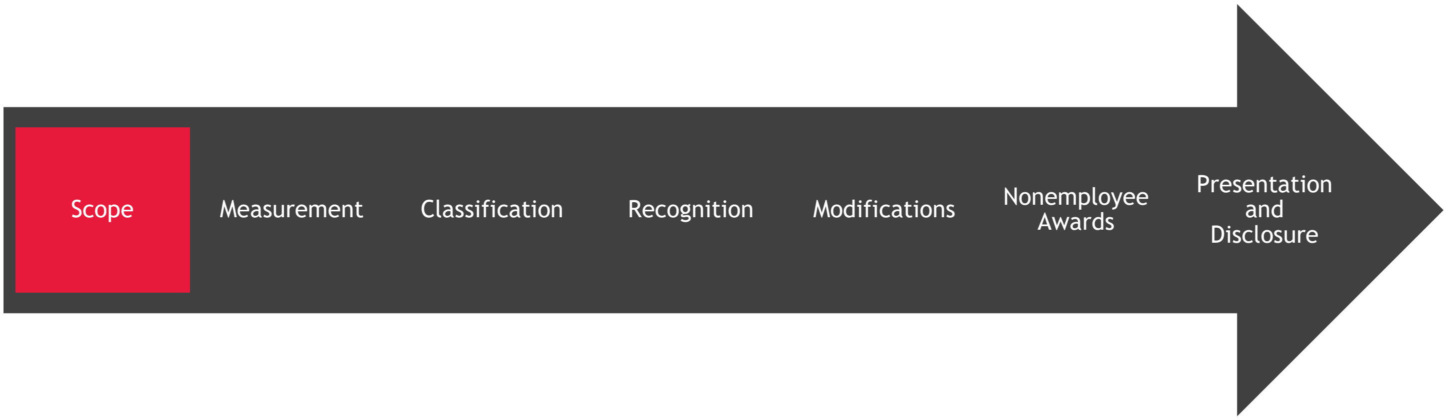
The FASB has a project on its agenda to improve the navigability of the required interim disclosures and clarify when that guidance applies (see Section 7.4).

ACKNOWLEDGEMENTS

This Blueprint, published by BDO's Professional Practice, is the culmination of efforts of many individuals, to whom we express our sincere appreciation.

- Adam Brown
- Angela Newell
- Jennifer Kimmel
- Jin Koo
- Jon Linville
- Meredith Taylor
- Oran Asher
- Stephanie Binford
- Smruthi M.N.
- Laura Breech

Chapter 1 — Scope



1.1 OVERVIEW

ASC 718 applies to all entities that enter share-based payment transactions. Entities issue share-based payment awards in exchange for goods or services from employees or nonemployees, including customers. Those awards can be in the form of outstanding shares (for example, restricted shares, RSUs or profits interests), equity instruments (for example, stock options, stock-settled stock appreciation rights, or warrants), or liabilities that are based on the price of the entity's shares (for example, cash-settled stock appreciation rights). Regardless of form, an award is subject to ASC 718 if it is either settled in stock or based at least partially on the value of the entity's stock as discussed in Section 1.2.

A grantee of a share-based payment award can be an employee or nonemployee (see Section 1.3). Further, share-based payment awards issued to a customer are subject to the guidance on consideration payable to a customer in ASC 606 but are measured and classified in accordance with ASC 718 (see Sections 1.3.5 and 6.6).

Share-based payment awards issued to a grantee by a parent or other related party of the reporting entity are also accounted for under ASC 718 as compensation in the financial statements of the reporting entity unless the award is clearly issued for purposes other than compensation (see Section 1.4).

An entity may also issue share-based payment awards that are based on (or settled in) shares of another entity. Those awards are not subject to ASC 718; instead, they are accounted for in accordance with ASC 815, *Derivatives and Hedging* (see Section 1.5).

Generally, an award that is initially recognized and measured in accordance with ASC 718 remains subject to ASC 718 throughout the award's life unless its terms are modified **after** the grantee:

- Vests in the award and is no longer providing goods or services
- Vests in the award and is no longer a customer
- Is no longer an employee.

See Section 5.9 for more guidance on such modifications.

1.2 TRANSACTIONS IN THE SCOPE OF ASC 718

FASB REFERENCES

ASC 718-10-20: Nonvested Shares and Restricted Share and ASC 718-10-15-3

ASC 718 applies to share-based payment awards issued to a grantee in exchange for goods or services that are either based at least in part on the price of the entity's shares or settled in the entity's shares. The table below lists common share-based payment awards.

COMMON AWARDS SUBJECT TO ASC 718	
Stock Option	▶ An instrument that gives the grantee the right to purchase a specified number of shares at a predetermined price for a specified period.
Restricted Share	▶ Defined in ASC 718 as "*a share for which sale is contractually or governmentally prohibited for a specified period.*" The term may also apply to other legal forms of ownership (for example, partnership interests or units).
Nonvested Share	▶ Defined in ASC 718 as a share "that an entity has not yet issued because the agreed-upon consideration, such as the delivery of specified goods or services and any other conditions necessary to earn the right to benefit from the instrument, has not yet been satisfied." ▶ Often referred to as a "restricted share."
Stock Appreciation Right (SAR)	▶ An instrument that gives the grantee the right to receive cash, shares, or a combination thereof in an amount equal to the appreciation in value of the entity's shares between the grant date and the vesting date. ▶ Generally does not require the grantee to pay an exercise price.
Phantom Share	▶ A hypothetical share that is either based on the full value of the entity's shares or on the appreciation in value of the entity's shares over a specified threshold. ▶ Generally settled in cash upon vesting.
Profits Interest	▶ An interest that gives the grantee the right to participate in the entity's future profits, distributions, and/or equity appreciation. ▶ Typically issued by limited partnerships (LPs) or limited liability companies (LLCs).
Long-Term Incentive Plan	▶ A compensation plan that is settled either in the entity's shares or in cash based on the value of the entity's shares. ▶ Typically requires meeting a specific target price or return over a specified period.
Employee Stock Purchase Plan (ESPP)[1]	▶ A program that allows employees to purchase shares of the entity's stock, typically at a discount to market price. ▶ No compensation cost is recognized if the criteria in ASC 718-50-25-1 are met.

An entity may issue a share-based payment award that is not settled in its shares, stock options, or other equity instruments. Rather, an award may be settled in cash in an amount based on the price of the entity's shares or other

[1] Because most ESPPs are designed to comply with the criteria in ASC 718-50-25-1, resulting in no compensation cost, the accounting model for such plans is outside the scope of this publication.

equity instruments. For example, an entity may issue a specific number of phantom shares that provide the grantee the right to receive a cash amount determined by a formula that includes the fair value of the entity's other equity instruments. The phantom shares are subject to ASC 718 because they are indexed to the price of the entity's shares.

An entity may also incur a fixed liability that will be settled in a variable number of shares or other equity instruments. For example, an entity may promise to issue common shares that equal $100,000 (that is, a stated monetary amount at inception) based on the price of the common shares at the vesting date. That promise is subject to ASC 718 if issued in exchange for goods or services because it is based on the value of the entity's shares. See Section 3.2.1.3 for further guidance on classification of those awards.

Finally, a share-based payment award is in the scope of ASC 718 if it is based **at least in part** on the price of the entity's shares. In other words, the award does not have to be indexed **solely** to the price of the entity's shares to be in the scope of ASC 718. For example, an entity may issue a SAR to a grantee whereby the entity will pay the grantee a fixed cash amount of $50,000 if the entity's share price exceeds $20 per share. While the fixed cash amount is not based on the value of the entity's shares, it is still paid based on whether the entity's share price exceeds a specified target; therefore, the SAR is subject to ASC 718.

1.2.1 Profits Interests

FASB REFERENCES

ASC 718-10-20: Share-Based Payment Arrangements, Issued, Issuance, or Issuing of an Equity Instrument, Vest; ASC 718-10-15-3 through 15-3B; and ASC 718-10-55-138 through 55-148

An entity that issues a profits interest award must consider the scope of ASC 718 to determine how to account for the award. In March 2024, the FASB issued ASU 2024-01 to add an example demonstrating how to apply the ASC 718 scope guidance to determine whether to account for a profits interest award in accordance with ASC 718. See Examples 1-1 through 1-4 for adaptations of the ASU example. For public business entities, ASU 2024-01 is effective for annual periods beginning after December 15, 2024, and interim periods within those annual periods. For entities other than public business entities, ASU 2024-01 is effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods. The guidance may be early adopted.

A profits interest is a special class of equity or incentive unit issued by LPs, LLCs, and similar pass-through entities. The Internal Revenue Code — specifically, Internal Revenue Service (IRS) Rev. Proc. 93-27[2] — defines the term "profits interest" as a "*partnership interest other than a capital interest*." Unlike a capital interest, which provides rights to an entity's existing net assets, a profits interest provides rights only to an entity's future profits or equity appreciation. That distinction, along with other terms, conditions, and characteristics of profits interests, often complicates accounting decisions for profits interest awards, which has historically led to diversity in practice on whether to account for them under ASC 718 or other U.S. GAAP (for example, ASC 710, *Compensation — General*).

An entity's operating agreement typically defines all classes of legal equity the entity is authorized to issue, including any profits interest classes. The agreement also usually describes relevant features associated with each class of equity, including voting rights, preemptive and related rights, distribution and liquidation rights, repurchase features, and other relevant terms and provisions. Awards that qualify as profits interests are often described in legal agreements as "class X units," with "X" referring to the class of equity, or as "management units" or "incentive units."

[2] The IRS defines two types of interests in a partnership. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair value and the proceeds were distributed in a complete liquidation of the partnership. That determination generally is made upon receipt of the partnership interest. A profits interest is a partnership interest other than a capital interest. See Rev. Proc. 93-27, 1993-2 CB 343, and Internal Revenue Code (IRC) Section 721.

Common characteristics of profits interests include:

- Management's intent is to award the recipient compensation upon a sale, liquidity event (for example, an initial public offering (IPO) or a change in control), or final liquidation of the entity.
- Awards have a relatively high distribution hurdle, and recipients often will not receive distributions in the normal course of business because of that threshold and the level of subordination. Recipients are often more likely to receive residual value upon a sale or liquidity event.
- Awards frequently have a performance condition linked to a change in control, recapitalization, IPO, or other liquidity event.
- Awards may or may not have a service condition required for vesting.
- Forfeiture and repurchase provisions vary significantly. Some awards are forfeited upon separation from the entity for any reason, while other awards include a call option exercisable at fair value, calculated value, or some other amount.
- Awards typically contain various transfer restrictions, require no initial monetary investment by the grantee, and do not grant voting rights.
- Profits interest awards may qualify the recipient for beneficial tax treatment.

Some entities issue other types of awards that are economically similar to profits interest awards but do not meet the legal definition of a profits interest. Examples include unit appreciation rights or phantom units granted by a partnership that convey rights similar to those of a profits interest award without taking the form of legal equity. Such awards are more common in grants to international employees and nonemployees.[3]

Examples 1-1 through 1-4 demonstrate how an entity would apply the scope guidance in ASC 718 to profits interests and similar awards. They share the following assumptions:

- Entity X is a partnership. Before June 1, 20X1, it had Class A units outstanding. On June 1, 20X1, Entity X granted Class B incentive units to employees of its subsidiary in exchange for services.
- An exit event includes an IPO, change in control, or liquidation of Entity X's assets.

EXAMPLE 1-1 (ADAPTED FROM EXAMPLE 10, CASE A, ASC 718-10-55-138 THROUGH 55-141): AWARD IS A SHARE-BASED PAYMENT ARRANGEMENT

FACTS

- The operating agreement specifies that Class B units are profits interest units that upon vesting participate pro rata with Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units (distribution waterfall).
- The Class B units cliff vest at the end of three years of service or upon an exit event. Upon such an event, the grantee would retain the vested Class B units. If the Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders according to the distribution waterfall.
- If a grantee of the Class B units terminates employment with Entity X's subsidiary (whether voluntarily, upon death or disability, or on retirement or at the election of Entity X for reasons other than cause), the grantee would forfeit any unvested Class B units for no consideration. If a grantee of the Class B units terminates employment after vesting, Entity X has a call right to repurchase the units. If the call right is exercised, Entity X would pay the grantee an amount of cash equal to the vested units' fair value on the call date.

CONCLUSION

Entity X has offered to issue its equity instruments to the grantee. The Class B units are within the scope of ASC 718.

[3] BC5 and BC6 of ASU 2024-01.

ANALYSIS

The Class B units are in the scope of ASC 718 because the factors below indicate that Entity X is offering to issue equity instruments:

- Upon either three years of service or an exit event, Entity X will have received the agreed-upon consideration (that is, the service will have been provided and any applicable performance condition will have been met) and the award will vest.
- Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units in accordance with the distribution waterfall described in the operating agreement.

EXAMPLE 1-2 (ADAPTED FROM EXAMPLE 10, CASE B, ASC 718-10-55-142 THROUGH 55-144): AWARD IS A SHARE-BASED PAYMENT ARRANGEMENT

FACTS

- The operating agreement specifies that Class B units are profits interest units that upon vesting participate pro rata with Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units (distribution waterfall).
- The Class B units are fully vested on the grant date and the grantee is eligible to begin participating in nonforfeitable operating distributions at the grant date.
- Upon an exit event, the grantee would retain the vested Class B units. If the Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders according to the distribution waterfall. Class B units are forfeitable upon the grantee’s termination for any reason at any time before an exit event.

CONCLUSION

Entity X has offered to issue its equity instruments to the grantee. The Class B units are within the scope of ASC 718.

ANALYSIS

The Class B units are in the scope of ASC 718 because the factors below indicate that Entity X is offering to issue equity instruments:

- Upon an exit event, Entity X will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met) and the award will vest. Although the Class B units are nominally vested at grant date, the forfeiture before an exit event functions as a performance vesting condition tied to an exit event (see Section 4.2.3.1).
- Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units in accordance with the distribution waterfall in the operating agreement.
- Also, Entity X would account for the grantee’s right to participate in nonforfeitable operating distributions in accordance with the ASC 718 guidance on dividend protected awards (see Section 4.7).

EXAMPLE 1-3 (ADAPTED FROM EXAMPLE 10, CASE C, ASC 718-10-55-145 THROUGH 55-146): AWARD IS A SHARE-BASED PAYMENT ARRANGEMENT

FACTS

- The Class B units are phantom units that do not entitle the grantee to receive equity instruments of Entity X.
- The grantee of the Class B units is not eligible to participate in distributions in the ordinary course of business.
- The grantee of the Class B units is eligible to receive cash upon an exit event. Upon an exit event, the Class B units vest immediately and must be settled in cash based on their fair value. The fair value of the Class B units is calculated by reference to the price of Entity X's Class A units as determined at the date of the exit event.
- The grantee of the Class B units must be providing services when the exit event occurs to receive any proceeds, and the units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

CONCLUSION

Entity X has incurred a liability for which the amount is based at least in part on the price of its equity instruments. The Class B units are within the scope of ASC 718.

ANALYSIS

Entity X is not issuing, or offering to issue, shares, share options, or other equity instruments because the Class B units do not entitle the grantee to receive shares or other equity instruments of Entity X.

However, the cash proceeds received by the grantee upon settlement in an exit event are based at least in part on the price of Entity X's shares.

EXAMPLE 1-4 (ADAPTED FROM EXAMPLE 10, CASE D, ASC 718-10-55-147 THROUGH 55-148): AWARD IS NOT A SHARE-BASED PAYMENT ARRANGEMENT

FACTS

- The Class B units are phantom units that do not entitle the grantee to receive equity instruments of Entity X.
- The grantee of the Class B units is eligible to participate in operating distributions made by Entity X equal to 1% of the preceding fiscal year's net income. The grantee is eligible to begin participating in the operating distributions after three years of service.
- The grantee of the Class B units is not eligible to participate in any proceeds distributed upon an exit event.
- The Class B units are forfeitable upon the grantee's termination for any reason at any time, including after the grantee has rendered three years of service.

CONCLUSION

The Class B units do not meet any of the conditions to be accounted for in the scope of ASC 718. Entity X would apply other U.S. GAAP to account for the units.

ANALYSIS

Entity X is not issuing or offering to issue shares, share options, or other equity instruments because the Class B units do not entitle the grantee to receive shares or other equity instruments of Entity X.

Also, the proceeds the grantee may receive related to operating distributions are based on an operating metric (1% of the preceding fiscal year's net income) of Entity X and are not based at least in part on the price of Entity X's shares.

The SEC staff discussed accounting for profits interests at the 2006 AICPA National Conference on SEC and PCAOB Developments. The staff described a scenario below in which an entity issued a legal form equity instrument, but the instrument did not have substantive characteristics of equity.

SEC STAFF GUIDANCE

Remarks before the 2006 AICPA Conference on Current SEC and PCAOB Developments

Joseph Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant

December 11, 2006

Special Classes of Stock Granted to Employees

> *Several accounting issues arise when a special class of stock is granted to employees. First and foremost, one must look through the legal form of the instrument to determine whether the instrument is in fact a substantive class of equity for accounting purposes, or is instead similar to a performance bonus or profit sharing arrangement. When making this determination, all relevant features of the special class must be considered. There are no bright lines or litmus tests. When few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or profit-sharing arrangement. Instruments that provide the holder with substantive voting rights and pari passu dividend rights are at times indicative of an equity interest. Consideration should also be given to any investment required, and any put and call rights that may limit the employee's downside risk or provide for cash settlement. Many of these factors were contained in Issues 28 and 40 of EITF Issue 00-23, which provided guidance on the accounting under Opinion 25 for certain of these arrangements.*
>
> *When the substance of the instrument is that of a performance bonus or profit sharing arrangement, it should be accounted for as such. In those circumstances, any returns to the employee should be reflected as compensation expense, not as equity distributions or minority interest expense. Further, if the employee remitted consideration at the outset of the arrangement in exchange for the instrument, such consideration should generally be reflected in the balance sheet as a deposit liability.*

BDO INSIGHTS — ASC 718 GENERALLY APPLIES TO PROFITS INTERESTS

We believe an award of legal form equity (for example, a profits interest as defined by the IRC) generally meets the condition in ASC 718-10-15-3(a) (that is, the entity has issued or offered to issue its equity instruments) if the award's terms provide at least one vesting condition that allows the grantee to retain the award. For example, if the terms of a profits interest award state that time-vested award units will be forfeited for no consideration upon the grantee's voluntary termination but also will automatically vest upon a change in control (and would not be subject to forfeiture thereafter), the entity has offered to issue equity and the award is in the scope of ASC 718.

An award that does not take the legal form of a profits interest but is structured similarly (for example, a cash-settled SAR) is within the scope of ASC 718 if it meets **either** of the conditions in ASC 718-10-15-3(b) (that is, if it is a liability that is at least partially indexed to the price of the entity's shares or that will be settled in a variable number of shares).

Less commonly, a profits interest or similar award might not meet any of the conditions to be in the scope of ASC 718 because it does not convey rights associated with a substantive ownership interest in the entity. If so, the award may be akin to a performance bonus or a profit-sharing arrangement in the scope of other guidance (see Example 1-5).

An entity should assess the provisions of a profits interest award to determine the appropriate accounting. That generally includes reading partnership and operating agreements, incentive plan documents, individual award documents, and employment contracts, as well as any amendments thereto. An entity also should understand the organizational structure of the employer and its related parties. Determining the appropriate guidance to apply to a profits interest award requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 1-5: LEGAL EQUITY SETTLED IN CASH BASED ON A FORMULA

FACTS

- An entity issues incentive units to a member of senior management. The units constitute profits interests as defined by the IRC and therefore represent legal form equity.
- The units cliff vest at the end of three years (service condition) and upon the entity achieving specific revenue targets in each of those years (performance condition).
- If all vesting conditions are satisfied at the end of the three years, the entity will settle the units by issuing to the grantee a cash payment based on a specified percentage of the entity's revenue.
- If the grantee separates from service for any reason at any time before the third anniversary, the grantee forfeits all units for no consideration.
- The units do not entitle the grantee to participate in any other type of distributions, do not convey voting rights, and may not be transferred or sold.

CONCLUSION

The units are not within the scope of ASC 718; instead, the entity accounts for them by applying ASC 710.

ANALYSIS

Although the entity has issued a legal equity instrument to the grantee in exchange for service, the award does not meet any of the criteria to be in the scope of ASC 718 because:

- The grantee cannot retain the units upon vesting or participate in fair value fluctuations of the entity's equity. The grantee also is ineligible to receive distributions and does not have a right to any of the entity's residual net assets. Therefore, the award does not provide the grantee with the rights associated with a substantive ownership interest in the entity.
- When the units vest, the grantee is entitled to a cash payment based on a formula tied to operating metrics, so the entity has not incurred a liability based at least in part on the price of its shares.

Therefore, the units represent a profit-sharing arrangement and the entity accounts for them in accordance with ASC 710.

1.2.2 Escrowed Share Arrangements

FASB REFERENCES

ASC 718-10-15-4 and ASC 718-10-S99-2

As part of a business combination, IPO, or other financing, some shareholders who are also key employees may be required to place their shares (or a portion thereof) into escrow. The shares are released if the entity meets performance targets, or the shareholders remain employed with (or continue to provide services to) the entity over a specified period. If the performance targets or service requirements are not achieved, the shareholders forfeit the shares.

The SEC staff has historically expressed the view that escrowed share arrangements involving the release of shares to specific shareholders based on performance-related criteria are presumed to be compensatory, equivalent to a reverse stock split followed by the grant of a restricted stock award under a performance-based plan. Those arrangements include transactions between shareholders and the registrant or directly between shareholders and new investors. When evaluating whether the presumption of compensation has been overcome, a registrant considers the substance of the arrangement, including whether the arrangement was entered for purposes unrelated to, and not contingent upon, continued employment. For example, if the escrowed shares will be released or canceled without regard to continued employment, the arrangement may in substance be an inducement made to facilitate the transaction on the registrant's behalf, rather than compensation. If not compensatory, the arrangement is recognized and measured according to its nature and reflected as a reduction of the proceeds allocated to the newly issued shares. Conversely, if the escrowed shares are automatically forfeited if employment is terminated, the arrangement is compensatory and accounted for in accordance with ASC 718.

EXAMPLE 1-6: AWARDS PLACED IN ESCROW UPON ACQUISITION

FACTS

An entrepreneur founds Entity X on May 1, 201X. In return for her initial contribution of $1,000, the entrepreneur receives 1,000 shares of common stock of Entity X. More than 10 years later, on December 1, 202X, Entity X enters into an agreement with PE Entity to issue to PE Entity 500 shares of common stock in return for $1 million to fund continued growth. PE Entity believes the entrepreneur's continued efforts are critical to the future success of Entity X. Therefore, as a condition of its investment, PE Entity requires the entrepreneur to place half (500) of her shares of common stock into an escrow account. The shares will be released from escrow to the entrepreneur in three years upon both her continuous employment over three years and an increase in Entity X's earnings before interest, taxes, depreciation, and amortization (EBITDA) of 25%. On December 1, 202X, Entity X believes it is probable that an increase in EBITDA of 25% will be achieved in two years.

CONCLUSION

The escrow arrangement is compensatory because the release of the shares is tied to the entrepreneur's continued employment with Entity X. Therefore, the arrangement is accounted for as a reverse stock split and the grant of a restricted stock award.

ANALYSIS

To receive her shares from escrow under the terms of the agreement, the entrepreneur must provide service for three years and Entity X's EBITDA must increase by 25%. Therefore, the arrangement is compensatory. As such, Entity X accounts for it as a reverse stock split and the grant of a restricted stock award. A reverse stock split does not result in an accounting impact to Entity X.

However, Entity X must measure the restricted stock award based on the current fair value of its common stock. It must recognize that value as compensation cost over three years, which is the longer of the explicit service period of three years and the implicit service period of two years related to the performance condition (increase in EBITDA of 25%) that is considered probable. See Section 4.2.5 for guidance on multiple vesting conditions and Section 4.2.1.1 for guidance on determining the implicit service period. Because the terms and conditions of the shares issued to PE Equity on December 1, 202X, are identical to those placed in escrow for the entrepreneur, Entity X determines that the grant-date fair value of the restricted stock award is $1 million. Therefore, the award's grant-date fair value of $1 million is recognized over the requisite service period of three years. See Section 4.3 for guidance on expense attribution.

BDO INSIGHTS — ESCROWED SHARES GUIDANCE APPLIES TO NONPUBLIC ENTITIES

We believe nonpublic entities should also apply the SEC guidance on escrowed share arrangements because they involve related parties and economic interest holders under ASC 718-10-15-4 (see Section 1.4.3). Determining whether an arrangement is compensatory or noncompensatory requires the application of professional judgment based on the facts and circumstances.

1.3 TYPES OF GRANTEES

An entity can issue a share-based payment award to an employee, a nonemployee, or a customer. While the accounting for share-based payment awards issued to employees and nonemployees are largely aligned, there are some differences (see Chapter 6). See Sections 1.3.5 and 6.6 for guidance on awards issued to customers.

1.3.1 Definition of Employee

FASB REFERENCES

ASC 718-10-20: Employee

While ASC 718 substantially aligns the accounting for share-based payment awards issued to employees and nonemployees, differences remain, primarily regarding expense attribution and some aspects of measurement. Therefore, an entity must determine whether the grantee is an employee or nonemployee.

ASC 718 defines an 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." One indication that the grantee is a common law employee is that they are subject to payroll taxes. However, being subject to payroll taxes does not itself provide conclusive evidence that a grantee is a common law employee.

Rev. Ruling 87-41 lists 20 factors in determining whether a grantee is a common law employee, listed below.

Instructions	If the entity for which the services are performed has the right to require compliance with instructions, this is an indication of employee status.
Training	Worker training (including mandating attendance at training sessions) indicates that the entity for which services are performed wants the services performed in a particular manner and is an indication of employee status.
Integration	Integration of the worker's services into the business operations of the entity for which services are performed is an indication of employee status.
Services Rendered Personally	If the services must be performed personally, the entity for which services are performed is interested in the methods used to accomplish the work; this is an indication of employee status.
Hiring, Supervising, and Paying Assistants	If the entity for which services are performed hires, supervises, or pays assistants, this is an indication of employee status. If, however, the worker hires and supervises others under a contract whereby the worker agrees to provide material and labor and is responsible only for the result, this is an indication of independent contractor status.
Continuing Relationship	A continuing relationship between the worker and entity for which the services are performed is an indication of employee status.

Set Hours of Work	Establishing set hours for the worker is an indication of employee status.
Full-Time Required	If the worker must devote substantially full time to the business of the entity for which services are performed, this is an indication of employee status. If, however, the worker is free to work when and for whom they choose, this is an indication of independent contractor status.
Doing Work on Employer's Premises	If the work is performed on the premises of the entity for which the services are performed (even though the work can be performed elsewhere), this is an indication of employee status.
Order or Sequence Set	If the worker must perform services in the order or sequence set by the entity for which services are performed (that is, the worker is not free to follow their own pattern of work), this is an indication of employee status.
Oral or Written Reports	If the worker must submit regular reports, this is an indication of employee status.
Payment by Hour, Week, or Month	Payment by the hour, week, or month is an indication of employee status, whereas payment by the job or in the form of commission is an indication of independent contractor status.
Payment of Business and/or Traveling Expenses	If the entity for which the services are performed pays expenses, this is an indication of employee status.
Furnishing of Tools and Materials	If the worker is furnished with significant tools and materials, this is an indication of employee status.
Significant Investment	Investment in facilities used by the worker is an indication of independent contractor status.
Realization of Profit or Loss	If a worker can realize a profit or loss as a result of the services performed (in addition to any profit or loss typically realized by employees), this is an indication of independent contractor status.
Working for More Than One Firm at a Time	If the worker performs more than de minimis services for several entities at the same time, this is an indication of independent contractor status.

Making Service Available to the General Public	If the worker regularly and consistently makes their services available to the public, this is an indication of independent contractor status.
Right to Discharge	The right to discharge the worker is an indication of employee status.
Right to Terminate	If the worker has the right to terminate the relationship with the entity for which services are performed at any time without incurring a liability, this is an indication of employee status

The factors in the table above are not equally weighted; rather, the importance of each factor depends on the nature of the occupation and the context in which the services are performed.

An entity based in a foreign jurisdiction must assess employee status based on the laws of that jurisdiction.

APPLY JUDGMENT WHEN CLASSIFYING GRANTEES

An entity must consider ASC 718 in conjunction with the IRS guidance above and exercise judgment to determine whether to classify a grantee as an employee or nonemployee. Consultation with legal counsel may be necessary.

1.3.2 Directors

FASB REFERENCES

ASC 718-10-55-90 through 55-91

While nonemployee members of an entity's board of directors do not meet the definition of a common law employee, they are considered employees for accounting purposes under a limited exception in ASC 718. Specifically, board members are treated as employees if they are:

- Either elected by the entity's shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires **and**
- Provide services solely in their role as a board member.

Individuals that provide advisory or consulting services in a nonelected capacity or provide such services beyond their role as a board member (for example, legal, marketing, or investment banking advice) are treated as nonemployees.

ASSESSING A DIRECTOR PERFORMING MULTIPLE TASKS

When directors perform other tasks in addition to serving on the board, any share-based payment awards issued to the directors are evaluated to determine whether the awards were issued in exchange for the director's service as a board member, for an incremental service, or both. Factors to consider in that evaluation include:

- Fee charged by a third party that has provided similar services
- Number, terms (including forfeiture provisions), and timing of share-based payment awards issued to other directors that carry out similar director duties.

EXAMPLE 1-7: AWARDS ISSUED TO A DIRECTOR

FACTS

An entity issues share-based payment awards to a director who is elected by the entity's shareholders. The director provides services to the entity solely in her role as a member of the entity's board.

CONCLUSION

The director is treated as an employee for accounting purposes.

ANALYSIS

The director is elected by the entity's shareholders and provides services solely as a member of the entity's board of directors. Therefore, the director is treated as an employee in accordance with ASC 718-10-55-91.

EXAMPLE 1-8: AWARDS ISSUED TO AN ADVISORY DIRECTOR

FACTS

Assume the same facts as in Example 1-7, except that the awards are issued to the director in exchange for her legal advice regarding a patent infringement lawsuit related to one of the entity's products.

Before the start of the director's term as a board member, the entity was a party to a patent infringement lawsuit related to a similar product the entity previously sold but has since discontinued. The entity paid a third-party legal advisory firm $100,000 for services rendered in that patent infringement case.

The fair value of the awards to the director is $110,000, and the fair value of the awards issued to each of the other members of the board of directors is $10,000.

CONCLUSION

The awards for the director's service as a board member are accounted for as employee awards. The awards for the director's legal advice are accounted for as nonemployee awards.

ANALYSIS

The entity considered the following facts in determining the appropriate accounting for the awards:

- A third-party legal advisory firm charged a $100,000 fee for work related to a prior patent infringement lawsuit on a similar product.
- The fair value of the awards issued to each of the other board members is $10,000.
- The entity determined that the portion of the awards ($10,000) issued for the director's service as a board member is accounted for as employee awards, whereas the remaining awards ($100,000) issued for the director's legal advice are accounted for as nonemployee awards.

BDO INSIGHTS — STANDALONE SUBSIDIARY FINANCIAL STATEMENTS

Subsidiary entities in a consolidated group may have separate boards of directors. In that circumstance, a member of a subsidiary's board is considered an employee under ASC 718 in the consolidated financial statements if the member is elected by subsidiary shareholders that are not controlled directly or indirectly by the parent or another entity in the consolidated group. A member of a subsidiary's board of directors that is elected by the parent is considered a nonemployee service provider to the consolidated group.

We believe that in the subsidiary's standalone financial statements, a member of the subsidiary's board of directors would be considered an employee under ASC 718 regardless of whether the member is elected by the controlling or noncontrolling shareholders of the parent or another entity in the consolidated group.

EXAMPLE 1-9: AWARDS TO A DIRECTOR ELECTED BY NONCONTROLLING SHAREHOLDERS

FACTS

An entity consolidates a subsidiary, which is governed by a board of directors. The entity appoints four out of seven board members, and the subsidiary's noncontrolling shareholders appoint the other three. The entity issues 1,000 restricted shares to a member of the subsidiary's board of directors elected by the subsidiary's noncontrolling shareholders.

CONCLUSION

The restricted shares issued to the director are accounted for as employee awards in the entity's consolidated financial statements.

ANALYSIS

Because the director is elected by the subsidiary's noncontrolling shareholders and cannot be elected by the controlling shareholders, the restricted shares issued to the director are treated as awards issued to an employee in the entity's consolidated financial statements.

The restricted shares issued to the director are also accounted for as employee awards in the subsidiary's separate financial statements.

If the entity had issued restricted shares to a board member it appoints, those awards would also be accounted for as employee awards in the subsidiary's separate financial statements. However, those awards would be accounted for as nonemployee awards in the entity's consolidated financial statements.

1.3.3 Leased Employees

FASB REFERENCES

ASC 718-10-20: Employee

As discussed in Section 1.3.1, being subject to payroll taxes is often a good indication that an individual meets the definition of a common law employee. However, under a lease or co-employment agreement, an entity that leases its employees to another entity is generally the employer of record for payroll tax purposes. For such a leased individual to be considered the lessee's employee under ASC 718, **all** of the following conditions must be met:

- 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.

- The lessor and lessee agree in writing to all of the following conditions regarding the leased individual:
  - The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
  - The lessee has a right to hire, fire, and control the individual's activities (the lessor also may have that right).
  - 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 is able to participate in any of the lessee's employee benefit plans on the same basis as other comparable employees of the lessee.
  - The lessee remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before any contractually agreed dates.

1.3.4 Nonemployees

ASC 718 applies to shared-based payment awards issued to nonemployees in exchange for goods and services to be used or consumed in the grantor's own operations. While ASC 718 substantially aligns the accounting for share-based payment awards issued to employees and nonemployees, differences remain, primarily in expense attribution and some aspects of award measurement (see Chapter 6). Fees paid in the form of warrants or shares to an underwriter or placement agent in connection with a capital raising transaction are in the scope of ASC 718 if they are issued in exchange for services provided by the underwriter or placement agent.

EXAMPLE 1-10: AWARDS ISSUED TO AN UNDERWRITER

FACTS

As part of its IPO, an entity granted an underwriter 1,000 warrants to purchase the entity's common stock in exchange for transaction services provided by the underwriter. When the IPO transaction is consummated, the warrants will become fully vested and exercisable by the underwriter.

CONCLUSION

The warrants issued to the underwriter are in the scope of ASC 718.

ANALYSIS

Although the entity granted the warrants in connection with a broader financing transaction subject to other guidance, the warrants issued to the underwriter vest based on service provided to the entity and upon consummation of the IPO. Therefore, they are accounted for in accordance with ASC 718. In other words, the classification of the warrants would be assessed under ASC 718 rather than ASC 480 or ASC 815, *Derivatives and Hedging*. Further, the compensation cost may be charged against the proceeds of the offering under SAB Topic 5A.

1.3.5 Customers

FASB REFERENCES

ASC 606-10-32-25 through 32-27, ASC 606-10-55-88A through 55-88B, and ASC 718-10-15-5A

Sometimes, an entity pays consideration to a customer in the form of share-based payments. Share-based payments an entity grants to a customer are measured and classified in accordance with ASC 718. However, they reduce the transaction price in accordance with ASC 606's guidance for consideration payable to a customer unless the payment is for a distinct good or service (and does not exceed the fair value of the distinct good or service (see Section 6.6)).

Share-based payments issued to customers in exchange for distinct goods or services that do not reduce the transaction price are presented consistent with other nonemployee awards under ASC 718. See BDO's Blueprint, [Revenue Recognition Under ASC 606](), for further guidance on accounting for consideration payable to a customer.

FASB PROJECT — SHARE-BASED CONSIDERATION PAYABLE TO A CUSTOMER

In September 2024, the FASB proposed to clarify how to distinguish between service conditions and performance conditions in share-based consideration payable to a customer. The proposed amendments would revise the definition of the term “performance condition” for share-based consideration payable to a customer to incorporate conditions (including vesting conditions) that are based on the volume of a customer’s purchases of goods or services from the entity. The revised definition would also incorporate performance targets based on the volume of purchases made by other parties that purchase the entity’s goods or services from its customers. Also, the proposed amendments would eliminate the policy election allowing entities to account for forfeitures as they occur for customer awards containing service conditions, requiring estimation instead. The FASB tentatively decided to proceed with a final ASU in February 2025.

1.4 GRANTORS OTHER THAN THE DIRECT BENEFICIARY OF GOODS OR SERVICES

An entity other than the employer or direct beneficiary of the grantee’s goods or services may issue a share-based payment award. For example, an award may be issued by an entity in a consolidated group to a grantee of another entity in that group, by an investor to a grantee of an equity method investee, or by a related party or other economic interest holder. Those awards may be in the scope of ASC 718 even if the reporting entity does not grant them.

1.4.1 Entities in a Consolidated Group

An entity in a consolidated group may issue a share-based payment award to a grantee that provides goods or services to a different entity within the group. While accounting for the award at the consolidated level is straightforward because the grantee provides goods or services to an entity within the consolidated group, it may be complex if an entity within the consolidated group prepares separate financial statements.

ASC 718 provides guidance on share-based payment awards issued to an entity’s grantee in exchange for goods or services that are consumed by the entity itself. It does not address share-based payment transactions between entities within the consolidated group.

BDO INSIGHTS — STANDALONE FINANCIAL STATEMENTS

Historically, FASB Interpretation No. (FIN) 44, *Accounting for Certain Transactions Involving Stock Compensation — an interpretation of APB Opinion No. 25* (FIN 44), and Emerging Issues Task Force (EITF) Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44* (EITF 00-23), addressed such transactions. Although those standards have been superseded, we believe an entity should continue to apply the concepts in FIN 44 and EITF 00-23 for share-based payment transactions between entities in a consolidated group, as discussed in the table below.

SCENARIO	PARENT'S CONSOLIDATED FINANCIAL STATEMENTS	SUBSIDIARY A'S SEPARATE FINANCIAL STATEMENTS	SUBSIDIARY B'S SEPARATE FINANCIAL STATEMENTS
Parent issues awards based on its shares to grantees of Subsidiary A.	The awards are accounted for under ASC 718.	The awards are accounted for under ASC 718. Compensation cost is recognized with an offset to equity that represents a capital contribution from the parent if Subsidiary A does not provide consideration to (or is not obligated to reimburse) the parent. If Subsidiary A provides consideration to (or is obligated to reimburse) the parent, the offset is recognized based on the nature of the consideration or obligation (e.g., cash or liability).	N/A
Subsidiary A issues awards based on its shares to grantees of the parent.	The awards are accounted for under ASC 718.	The awards are excluded from the scope of ASC 718. They are measured at fair value on grant date and recognized as a dividend to the parent with an offset to equity. There is no effect on Subsidiary A's income statement.	N/A
Subsidiary A issues awards based on its shares to grantees of Subsidiary B.	The awards are accounted for under ASC 718.	The awards are excluded from the scope of ASC 718. Instead, they are accounted for as if they were issued to the parent, which then issued them to Subsidiary B. Accordingly, the awards are measured at fair value on grant date and recognized as a dividend to the parent with an offset to equity. There is no effect on Subsidiary A's income statement.	Compensation cost is recognized with an offset to equity that represents a capital contribution from the parent if Subsidiary B does not have an obligation to settle the awards. However, because the awards are based on the shares of another entity (Subsidiary A), they are measured at fair value on the grant date and each reporting period thereafter until exercise or expiration. Changes in fair value are recognized as compensation cost (see Section 1.5).

1.4.2 Equity Method Investments

FASB REFERENCES

ASC 323-10-25-3 through 25-6, ASC 323-10-30-3, ASC 323-10-55-19 through 55-26, ASC 323-10-S99-4, ASC 505-10-25-3, and ASC 718-10-15-3A through 15-4

An investor may issue to an employee or nonemployee of an equity method investee a share-based payment award based on the investor's own equity in exchange for goods or services provided by the employee or nonemployee and consumed by the investee. ASC 323, *Investments — Equity Method and Joint Ventures*, applies to that type of share-based payment award if **all** the following conditions are met:

- No proportionate funding by the other investors occurs
- The investor's relative ownership percentage in the investee does not increase
- The share-based payment award was not agreed to be issued in connection with the investor's acquisition of its interest in the investee.

The table below summarizes the accounting by the investee, contributing investor, and other investors (assuming all the conditions listed above are met for such arrangements).

INVESTEE	The investee recognizes the compensation cost of the award with an offset to equity, which represents a capital contribution from the investor. The cost of the award is measured at fair value and recognized in accordance with ASC 718.
CONTRIBUTING INVESTOR	The contributing investor recognizes compensation cost in the same period the investee recognizes the costs. The award's cost is measured at fair value based on the guidance in ASC 718. The offsetting entry is recognized in equity. The contributing investor recognizes an increase in its equity method investment for its share of the investee's cost and an expense for the portion of the cost attributable to the noncontributing investors. Also, when recognizing its equity method income (loss), the contributing investor recognizes its share of the investee's net income (loss), which includes any compensation cost recognized by the investee.
NONCONTRIBUTING INVESTOR	The noncontributing investor recognizes income for its share of the increase in the investee's net book value (that is, the noncontributing investor's share of the contributed capital recognized by the investee). Also, when recognizing its equity method income (loss), the noncontributing investor recognizes its share of the investee's net income (loss), which includes any compensation cost recognized by the investee.

See ASC 323-10-55-19 through 55-26 for an example in which a contribution from an investor is not reimbursed.

BDO INSIGHTS — ACCOUNTING WHEN THE INVESTEE REIMBURSES THE CONTRIBUTING INVESTOR

The equity method accounting described above applies only when there is no proportional funding by the other investors and the other conditions are met.

When an equity method investor grants share-based payments to the investee's employees and the investee agrees to reimburse the grantor, we believe that all investors are proportionately funding the grant through a proportionate decrease in their share of the investee's net assets upon reimbursement. Therefore, we believe the investor accounting described above does not apply. Instead, we believe the investor (grantor) would recognize its share of the investee's accounting for the share-based payments (in accordance with ASC 718), as part of the investor's recurring equity method accounting in which it recognizes its share of the investee's net income (loss), with an adjustment to its equity method investment.

A slightly different scenario could arise if an equity method investee grants to its employees awards that are **both**:

- Settled in the stock of the equity method investor or in cash based on the share price of the equity method investor's stock
- Granted and fulfilled by the equity method investee, either by directly purchasing the investor's stock or buying the shares on the open market, if publicly traded.

In that scenario, the equity method investee is the grantor and must first determine the awards' appropriate accounting and classification (for example, whether the awards meet the definition of a derivative in ASC 815 or are liability-classified in accordance with ASC 718). Like the reimbursement scenario described above, we believe the equity method investor recognizes its share of the investee's net income (loss) (inclusive of the accounting for the award), with an adjustment to its equity method investment.

In all scenarios, both contributing and noncontributing investors that are SEC registrants present any income or expense from applying ASC 323 in the same income statement caption as the equity method income (loss). We believe it is appropriate for other entities that are not SEC registrants to consider using the same presentation.

1.4.3 Related Parties and Economic Interest Holders

FASB REFERENCES

ASC 718-10-15-4 and ASC 718-10-20: Economic Interest in an Entity, Related Parties

A related party or economic interest holder of an entity may also issue an award to a grantee. Unless clearly issued for purposes other than compensation, the award is considered a capital contribution to the entity by the related party or economic interest holder and subject to ASC 718.

ASC 718 defines an economic interest in an entity broadly. The term includes **any** type or form of interest or arrangement 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.

BDO INSIGHTS — EQUITY ISSUED FOR LESS THAN ITS FAIR VALUE

We believe there is a presumption that an equity instrument issued in exchange for less than its fair value is compensatory. Therefore, if a related party or other economic interest holder sells an equity instrument to the investee's employee for an amount less than its fair value, we believe the investee generally must recognize compensation expense for the difference.

EXAMPLE 1-11: AWARD BY SHAREHOLDER FOR A PURPOSE OTHER THAN COMPENSATION

FACTS

A shareholder owns 10% of an entity's shares. The shareholder transfers a portion of the entity's shares to a key employee of the entity. The employee pays cash for the entity's shares equal to fair value on the date of payment.

CONCLUSION

The transaction is not subject to ASC 718 because it was entered into for purposes other than compensation.

ANALYSIS

The shareholder entered the transaction with the entity's key employee for immediate cash needs to meet personal obligations. Further, the shareholder received cash consideration based on the fair value of the entity's shares, which is more akin to a financing transaction than compensation to the employee. As a result, the transaction is not in the scope of ASC 718 and not recognized in the entity's financial statements.

EXAMPLE 1-12: AWARD BY SHAREHOLDER ACCOUNTED FOR AS COMPENSATION

FACTS

Assume the same facts as in Example 1-11, except the employee pays less than fair value for the entity's shares. The employee rendered no additional services to the shareholder.

CONCLUSION

The discount from fair value on the entity's shares is considered a capital contribution from the shareholder to the entity and a share-based payment award from the entity to the employee.

ANALYSIS

The shareholder transferred the entity's shares to the entity's employee at a discounted price. Further, the shareholder is an economic interest holder of the entity. As a result, the difference between the fair value of the entity's shares and the cash consideration paid by the employee is recognized as compensation cost in the entity's income statement and as a capital contribution in the entity's statement of equity.

1.4.3.1 Secondary Market Transactions

FASB REFERENCES

ASC 718-10-15-4

Transactions in which a nonpublic entity's investors or employees sell shares to other investors (or back to the issuing entity) are commonly referred to as "secondary market transactions." Such transactions provide a way for investors or employees to monetize their shares in the absence of an established public market for the shares. Secondary market transactions may be initiated by new investors or existing investors seeking to increase their holdings or by employees or other investors seeking to liquidate their shares. In some cases, secondary market transactions are arranged or initiated by the entity that issued the shares.

An investor's purchase of shares from an employee at fair value does not typically require accounting recognition by the entity that issued the shares (that is, it is a transaction among shareholders). However, if the transaction price exceeds the fair value of the shares, the entity must evaluate the transaction to determine the accounting. The entity may be required to recognize compensation for the excess of the transaction price over the fair value of the shares if it has significant involvement in the secondary transaction or if the purchasers are otherwise acting on behalf of the entity in accordance with ASC 718-10-15-4.

BDO INSIGHTS — DETERMINING SIGNIFICANT INVOLVEMENT IN A SECONDARY TRANSACTION

We believe the following factors may indicate that an entity had significant involvement in the secondary transaction or that the purchasers are acting on the entity's behalf:

- The entity facilitated the transaction by connecting the buyers and sellers.
- The entity assisted with negotiating the terms of the transaction.
- The transaction involves high-level current or former executives of the entity.
- The entity agrees to modify the terms of equity interests in connection with the transaction.
- The entity provides information that is not publicly available.
- The entity must approve the secondary transaction.
- The purchaser has a significant economic interest in the entity.
- The transaction occurred concurrently, or as part of, other equity issuances.

Determining whether a secondary transaction is conducted on behalf of the entity (and therefore must be accounted for by the entity) requires the application of professional judgment based on the facts and circumstances.

1.5 AWARDS BASED ON OR SETTLED IN SHARES OF AN UNRELATED ENTITY

FASB REFERENCES

ASC 718-10-15-5 and ASC 815-10-45-10

An entity may issue share-based payment awards that are based on or settled in another entity's shares. Those awards are not subject to ASC 718 because they are neither based at least in part on the price of the entity's shares nor settled in the entity's shares. Instead, they are generally accounted for in accordance with ASC 815 as derivatives and are recognized at fair value at inception with subsequent changes in fair value recorded in earnings. ASC 815 requires changes in the fair value of share-based payment awards before vesting to be recognized as compensation cost, while changes in fair value after vesting may be reflected elsewhere in the entity's income statement. Because the awards are not subject to ASC 718, fair value is measured under ASC 820, so the likelihood that the award will be forfeited is incorporated into the award's fair value at each reporting period.

EXAMPLE 1-13: AWARDS SETTLED IN SHARES OF AN UNRELATED ENTITY

FACTS

On January 1, 20X2, Entity X issues restricted (nonvested) stock to an employee. The award will vest upon the employee providing one year of service to Entity X and will be settled in 100 common shares of Entity Y, an unrelated publicly traded entity. The fair value of the restricted stock on January 1, 20X2, and December 31, 20X2 is $10 and $18, respectively.

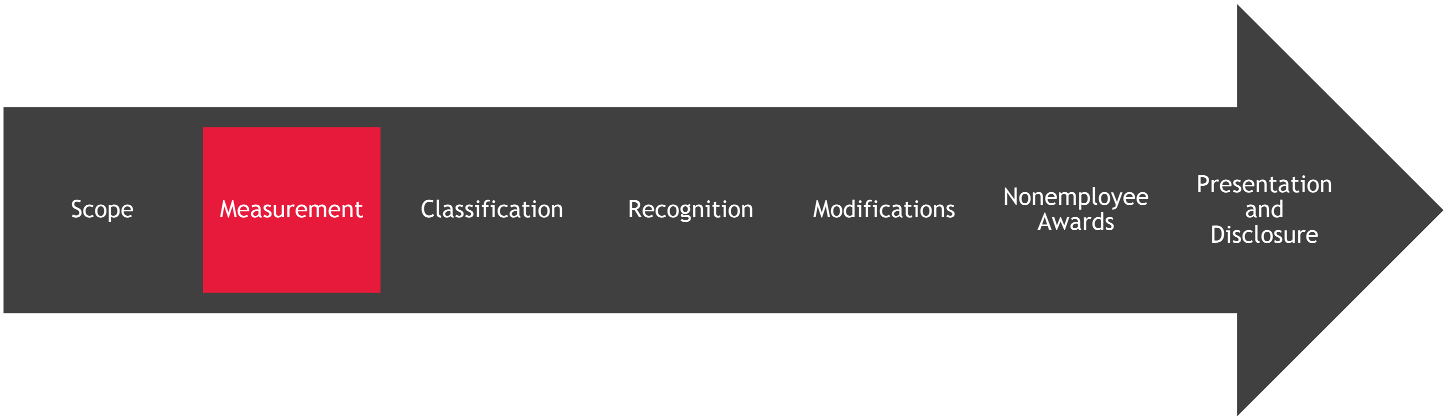
CONCLUSION

The restricted stock is accounted for as a derivative liability in accordance with ASC 815 and measured at fair value at the issuance date. Changes in the awards' fair value are recognized as compensation cost during the employee's requisite service period of one year.

ANALYSIS

The restricted stock is subject to ASC 815 because it is for common shares of an unrelated publicly traded entity. The awards' fair value on the issuance date is reflected as a derivative liability with an offset to a prepaid compensation asset, which is subsequently amortized as compensation cost over the one-year service period.

Chapter 2 — Measurement



2.1 OVERVIEW

Entities that grant share-based payment awards generally must recognize the cost of the awards using a fair-value-based measure. The measure required by ASC 718 is closely aligned with fair value in accordance with ASC 820, but has some differences, primarily related to typical provisions of share-based payment awards. For example, a fair-value-based measure in accordance with ASC 718 excludes the effects of service and performance conditions, reload features, and some contingent features (see Section 2.3). Unless noted otherwise, this Blueprint refers to the fair-value-based measurement required by ASC 718 as “fair value.”

The measurement objective for equity-classified share-based payment awards is to estimate the grant-date fair value of the awards (see Section 2.2). The objective for liability-classified awards is to ultimately recognize the settlement-date fair value of the awards. As such, for liability-classified awards, entities initially recognize the awards at the grant-date fair value but subsequently remeasure the awards at fair value at the end of each reporting period until the liability is settled (see Section 4.4).

ASC 718 also provides nonpublic entities with several alternatives and expedients in measuring the fair value of awards because there are often limited (or no) observable market prices for their shares (see Section 2.4).

2.2 GRANT DATE

FASB REFERENCES

ASC 718-10-20: Grant Date and Measurement Date

The measurement date of a share-based payment award is the date when the share price and other factors, such as expected volatility, are estimated for the award. For equity-classified awards, the measurement date is the grant date. For liability-classified awards, the measurement date is the settlement date. As such, for liability-classified awards, entities initially recognize the awards at the grant-date fair value but subsequently remeasure them at fair value at the end of each reporting period until the award is settled. This section discusses the determination of a grant date. See Section 4.4 for guidance on the accounting for liability-classified awards.

The entity becomes contingently obligated to issue equity instruments or transfer assets to a grantee that delivers goods or renders services or purchases goods or services as a customer on the grant date, which is the date when **all** the following requirements are met:

All necessary approvals are obtained	Section 2.2.1
Grantee and grantor reach a mutual understanding of the award's key terms and conditions	Section 2.2.2
Grantee begins to benefit from, or be adversely affected by, changes in the entity's share price	Section 2.2.3
For an award issued to an employee, the grantee must meet the definition of an employee	Section 1.3.1

An entity does not recognize compensation cost until a grant date is established, except for awards in which the service inception date precedes the grant date (see Section 4.3.2).

2.2.1 All Necessary Approvals Are Obtained

FASB REFERENCES

ASC 718-10-20: Grant Date and ASC 718-10-25-5

Except for share-based payment awards in which the service inception date precedes the grant date (see Section 4.3.2), an entity begins to recognize compensation cost for an award when all the criteria for a grant date to be established are met. One of those criteria is that the entity must obtain all necessary approvals related to the share-based payment award, which may include approval by shareholders, the board of directors, the compensation committee, management, or a combination thereof. For example, share-based payment awards to some executives may require shareholder approval, whereas awards to other employees may require only board approval.

An award subject to shareholder approval is not granted until that approval is obtained unless approval is considered a mere formality (or to be perfunctory). For example, shareholder approval might not be necessary if management and the board control enough shareholder votes to approve the award.

Further, if a grantee (such as an executive) has the ability to negotiate key terms and conditions of the award, the necessary approvals may also require acceptance by the grantee.

BDO INSIGHTS — DISREGARD THE PROBABILITY OF OBTAINING A REQUIRED APPROVAL

An entity may believe that obtaining required approval is probable based on its history of obtaining approvals for similar awards. However, we believe that the probability of obtaining a required approval is disregarded in establishing a grant date. For example, if shareholder approval is required, an entity must determine whether management and the board of directors control enough shareholder votes to determine whether shareholder approval is perfunctory without considering whether the shareholders will approve the award.

Examples 2-1 and 2-2 illustrate the evaluation of whether all necessary approvals were obtained.

EXAMPLE 2-1: DELEGATION OF APPROVAL RIGHTS

FACTS

- On January 1, 20X4, an entity establishes a compensation plan whose share-based payment awards require board approval.
- At its March 20, 20X4 meeting, the board delegates its right to approve awards under the plan to the entity's chief executive officer (CEO).
- On March 31, 20X4, the entity's management presents a plan to the CEO to grant awards to a group of employees. Under the relevant grant agreements, each employee that completes two years of service will be entitled to 200 stock options to purchase the entity's common stock.
- On March 31, 20X4, the entity's CEO approves the awards and communicates their key terms and conditions to each employee.
- At its June 30, 20X4 meeting, the board acknowledges the grant of the awards.

CONCLUSION

The entity obtained all necessary approvals on March 31, 20X4.

ANALYSIS

The board delegated its right to approve awards under the plan to the CEO on March 20, 20X4, effectively removing the plan requirement for the board's approval. Therefore, as of March 20, 20X4, the CEO had the discretion and authority to approve awards to the employees according to the plan. The acknowledgement by the board of directors in a subsequent meeting on June 30, 20X4 does not affect the conclusion because board approval is no longer required.

If the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date is March 31, 20X4.

EXAMPLE 2-2: PROBABILITY OF SHAREHOLDER APPROVAL

FACTS

- On July 30, 20X2, an entity's board of directors approves the grant of 10,000 stock options to each member of the executive suite and communicates the terms of the awards to all such members.
- The compensation plan requires the entity to obtain shareholder approval for all awards.
- Management and the board do not control a sufficient number of shareholder votes to approve the awards. However, because the shareholders have previously approved similar awards, the entity believes that obtaining shareholder approval is probable.

CONCLUSION

The grant date is not established until shareholder approval occurs.

ANALYSIS

Because management and the board do not control enough shareholder votes to approve the awards, the shareholder approval is not considered perfunctory. Also, the entity must disregard the probability of obtaining shareholder approval. As such, the grant date is not established until shareholder approval occurs.

BDO INSIGHTS — DELEGATION OF APPROVAL RIGHTS

Share-based payment awards are approved by shareholders, the board of directors, the compensation committee, management, or a combination thereof. Sometimes, the governing body (for example, the board of directors or the compensation committee) that is authorized to approve awards delegates its approval rights to others. For example, the full board may delegate its approval rights to the compensation or other board committee or to a specific board member, such as the compensation committee chair. Alternatively, the board or a committee thereof may delegate its approval rights to specific members of management (for example, the CEO). When approval rights are delegated to another individual or group, we believe there must be appropriate documentation of that delegation. Without appropriate documentation, subsequent approval by the delegate is not sufficient, the award is not authorized, and there is no grant date for the award.

2.2.2 Mutual Understanding of Key Terms and Conditions

FASB REFERENCES

ASC 718-10-20: Grant Date, ASC 718-10-25-5, and ASC 718-10-55-80 through 55-82

Except for share-based payment awards in which the service inception date precedes the grant date (see Section 4.3.2), an entity begins to recognize compensation cost for awards when all the criteria for a grant date to be established are met. One of those criteria is that the entity and grantee must reach a mutual understanding of (that is, both parties must have sufficient information) and agree to the key terms and conditions of the share-based payment award. The terms of an award may be established through a formal written agreement, an informal oral agreement, or an entity's past practice.

In some cases, entities may obtain the necessary approvals for share-based-payment awards (see Section 2.2.1) but communicate the key terms and conditions to the grantees at a later date. Further, entities may communicate the terms of the approved awards to each of the grantees on different dates. In either case, a mutual understanding exists as of the approval date (rather than the communication date) if **both** conditions below are met:

ONE WAY

The award is a unilateral grant; therefore, the grantee does not have the ability to negotiate the award's key terms and conditions with the entity.

The entity expects to communicate the award's key terms and conditions to the individual grantee within a relatively short period after the award's approval date. A relatively short period is one in which an entity could reasonably complete all actions necessary to communicate the awards to the grantees in accordance with its customary practices.

The key terms and conditions of an award necessary to establish a mutual understanding may include the type of the award, the number of underlying shares, the vesting conditions, and the exercise price.

BDO INSIGHTS — A RELATIVELY SHORT PERIOD OF TIME IS GENERALLY MEASURED IN DAYS OR WEEKS

We believe that in most circumstances, communication of an award's key terms and conditions to the grantee within a "relatively short period of time" means days or weeks. Also, the period deemed reasonable may depend on factors such as the method of communicating the awards to grantees and the number of grantees. For example, if the key terms and conditions of the awards are communicated to the grantees via email or the entity's internal website, a relatively short period may be a few days, reflecting the reasonable amount of time required to provide the information in that chosen communication channel and notify the grantees that the information is available. However, if the entity communicates the key terms and conditions of the awards to each grantee individually, the relatively short period of time may be longer (for example, up to a few weeks).

Determining whether the period of time between an award's approval and communication to an individual grantee constitutes a relatively short period in accordance with ASC 718 requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS — EVIDENCE TO SUPPORT THE EXISTENCE OF A MUTUAL UNDERSTANDING

While most entities formalize the key terms and conditions of share-based payment awards through written agreements, some may assert that the terms and conditions have been established informally through oral agreements or based on the entity's past practice. Although ASC 718 indicates that such informal arrangements could be used to establish the key terms and conditions, we believe it is challenging to support such an assertion because the parties might not always have the same understanding or recollection of the key terms and conditions. Further, an entity's intent could change over time such that its past practice of including some terms and conditions might no longer be relevant.

Even so, a mutual understanding of an award's key terms and conditions that is less formal than a signed agreement by both parties may be used to establish a grant date. For example, an entity may communicate the key terms and conditions of a unilateral award to grantees by email in lieu of (or in addition to) a formal written agreement. As such, an entity must consider whether informal communications may establish (or modify) a mutual understanding of the key terms and conditions.

Determining the sufficient level of evidence to support an assertion that a mutual understanding exists without a formal written agreement requires the application of professional judgment and sometimes may require the advice of legal counsel based on the facts and circumstances.

Examples 2-3 and 2-4 illustrate the evaluation of whether the entity and grantee have a mutual understanding of the award's key terms and conditions.

EXAMPLE 2-3: DETERMINING WHEN A MUTUAL UNDERSTANDING EXISTS — COMMUNICATION OF AWARDS' KEY TERMS AND CONDITIONS WITHIN A RELATIVELY SHORT PERIOD AFTER APPROVAL

FACTS

- On December 1, 20X4, an entity's board of directors approves the grant of 1,000 stock options to each employee of its research and development department in exchange for their services.
- The employees do not have the ability to negotiate the terms and conditions of the stock options.
- On December 7, 20X4, the board communicates the awards' key terms and conditions to each employee.

CONCLUSION

A mutual understanding of the awards' key terms and conditions exists as of December 1, 20X4.

ANALYSIS

The board communicated the key terms and conditions of the awards to the employees within a relatively short time after the approval of the award. Additionally, the award is a unilateral grant because the employees are unable to negotiate the terms and conditions of the award.

If the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date is December 1, 20X4.

EXAMPLE 2-4: DETERMINING WHEN A MUTUAL UNDERSTANDING EXISTS — UNALLOCATED AWARDS

FACTS

- On May 1, 20X4, the board of directors approved the grant of 55,000 RSUs to its employees as follows:
  - 20,000 RSUs allocated to the CEO
  - 10,000 RSUs allocated to the chief financial officer (CFO)
  - 25,000 RSUs approved as a pool for other employees without any allocation.
- On May 1, 20X4, the board authorized the CEO to allocate the 25,000 RSUs to individual employees at a future date.
- On the same day as the approval date, the board communicated the RSUs' terms and conditions to the CEO and CFO through email. Both the CEO and CFO accepted the RSUs' terms and conditions by responding to the email. The board also notified the other employees about the pool of awards that would be allocated by the CEO.
- On June 30, 20X4, the CEO allocated the pool of 25,000 RSUs among the other employees and communicated the respective number of units awarded (as well as the key terms and conditions of the awards) to each employee.

CONCLUSION

A mutual understanding of the key terms and conditions for the RSUs awarded to the CEO and CFO exists on May 1, 20X4. However, a mutual understanding of the key terms and conditions for the RSUs awarded to other employees does not exist until June 30, 20X4.

ANALYSIS

The board of directors approved the grant of 20,000 RSUs and 10,000 RSUs to the CEO and CFO, respectively, on May 1, 20X4. On that date, the RSUs' key terms and conditions were mutually agreed by all parties through an email exchange. Therefore, if the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date for the RSUs to the CEO and CFO is May 1, 20X4.

For the 25,000 RSUs granted to the other employees, a mutual understanding of the key terms and conditions was not reached on May 1, 20X4, because the number of RSUs was not allocated to each employee until June 30, 20X4. Also, the RSUs' key terms and conditions were not mutually agreed by the parties until June 30, 20X4, when they were communicated by the CEO. Therefore, if the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the RSUs' grant date is June 30, 20X4.

2.2.2.1 Unknown Vesting or Market Conditions

FASB REFERENCES

ASC 718-10-55-92 through 55-95

Except for share-based payment awards in which the service inception date precedes the grant date (see Section 4.3.2), an entity begins to recognize compensation cost for awards when all the criteria for a grant date to be established are met. One of those criteria is that the entity and grantee must reach a mutual understanding of (that is, both parties must have sufficient information) and agree to the key terms and conditions of the share-based payment award. To reach a mutual understanding, all key terms and conditions of the share-based payment award (including vesting conditions) must be understood by the entity and grantee. For example, some awards establish performance targets at the date the awards are authorized, while others establish the performance targets at a later date. If the performance targets are not established when the award is authorized, a grant date may not have occurred.

Performance and market conditions that must be achieved for the grantee to vest in the award need to be objectively determinable and measurable, as well as clearly defined. For example, a performance condition stating that an award will vest if the entity's revenues increase by 5% in each of the following two years is objectively determinable. Similarly, a market condition stating that an award will vest if the entity's share price increases by 20% in the next two years is objectively determinable. On the other hand, a performance or market condition that cannot be objectively determined or that can be adjusted by the entity in its sole discretion does not enable the parties to reach a mutual understanding of the award's key terms and conditions until the performance condition has been established (and can no longer be adjusted arbitrarily) and communicated to the grantee.

If the performance condition is based on the grantee's performance, such as an employee's annual performance review, an entity must consider all facts and circumstances in determining whether the evaluation process is well-established and understood by the grantee, is objective and clear to the grantee (that is, goals and metrics are specified, and meeting those goals and metrics would result in a defined payout to the grantee), and is used for other forms of compensation (cash bonuses or employee salary increases).

Examples 2-5 through 2-7 illustrate these concepts.

EXAMPLE 2-5 (ADAPTED FROM CASE A, ASC 718-10-55-92 THROUGH 55-94): PERFORMANCE TARGETS SET AT ARRANGEMENT INCEPTION

FACTS

- On January 1, 20X5, an entity and its CEO enter an arrangement regarding 40,000 stock options with an exercise price of $30 per option.
- The arrangement is structured such that 10,000 stock options will vest or be forfeited in each of the next four years (20X5 through 20X8) depending on whether annual performance targets relating to the entity's revenues and net income are achieved. In other words, the CEO could earn a total of 40,000 stock options if the performance targets are met for all four years.
- Each of the annual performance targets are set at the arrangement's inception.

CONCLUSION

A mutual understanding of the award's key terms and conditions exists as of January 1, 20X5.

ANALYSIS

All annual performance targets are set at the inception of the arrangement. Because the entity and CEO have a mutual understanding of the key terms and conditions on January 1, 20X5, each tranche of the arrangement has a grant date of January 1, 20X5.

EXAMPLE 2-6 (ADAPTED FROM CASE B, ASC 718-10-55-95): PERFORMANCE TARGETS ARE ESTABLISHED IN THE FUTURE

FACTS

Assume the same facts as in Example 2-5, except that the performance targets are established on January 1 of each of the four years (20X5 through 20X8).

CONCLUSION

A mutual understanding of the key terms and conditions exists only for the first tranche of the award (January 1 through December 31, 20X5) as of January 1, 20X5. A mutual understanding of the key terms and conditions of the remaining tranches (20X6 through 20X8) of the award does not exist as of January 1, 20X5.

ANALYSIS

The annual performance targets will be established on January 1 of each year, so the grant date for each tranche will be January 1 of each year (20X5 through 20X8). In other words, the performance condition is not known until the beginning of each year, so a mutual understanding of the key terms and conditions for the tranches that begin on January 1, 20X6 through 20X8 would not be reached until those dates, respectively.

EXAMPLE 2-7: DETERMINING WHEN A MUTUAL UNDERSTANDING EXISTS — UNKNOWN MARKET CONDITION

FACTS

- On October 1, 20X4, an entity grants 1,000 stock options to each of its employees and communicates the awards' key terms to the employees the same day.
- The awards will vest if the entity's share price on October 1, 20X6, is at least $20 and the employees are still employed on October 1, 20X6.

CONCLUSION

A mutual understanding of the award's key terms and conditions exists as of October 1, 20X4.

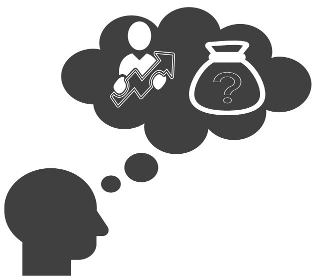
ANALYSIS

As of October 1, 20X4, the entity and its employees cannot predict what the share price will be on October 1, 20X6. However, the market condition (the achievement of a share price of at least $20) is clear, objectively determinable, and nondiscretionary. Accordingly, the entity and its employees reach a mutual understanding of the key terms and conditions of the award on October 1, 20X4, which is the date when the entity communicates the key terms and conditions to the employees. Therefore, if the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date is October 1, 20X4.

2.2.2.2 Unknown Exercise Price

FASB REFERENCES

ASC 718-10-55-83 and ASC 718-10-55-97 through 55-99



Except for share-based payment awards in which the service inception date precedes the grant date (see Section 4.3.3), an entity begins to recognize compensation cost for awards when all the criteria for a grant date to be established are met. One of those criteria is that the entity and grantee must reach a mutual understanding (that is, both parties must have sufficient information) of the award's key terms and conditions and agree to them. To reach a mutual understanding, all key terms and conditions of the award, including the exercise price, must be understood by the entity and grantee. As such, if an entity grants an award that establishes the exercise price at a subsequent date, a mutual understanding generally does not occur until the exercise price is known. For example, an entity grants a number of stock options to an employee that vest at the end of each year over three years. The exercise price of each tranche of stock options will be based on the market price of the entity's common stock at the end of each year. Therefore, a mutual understanding does **not** exist at arrangement inception because the exercise price is unknown at that date. Instead, if all other criteria for establishing a grant date are met (see Section 2.2) and the service inception date does not precede the grant date (see Section 4.3.2), the grant date for each tranche of stock options would be the end of each year.

Alternatively, an entity may issue look-back options, which are stock options in which the exercise price is defined as the lower of the current share price or the share price at a future date (for example, after one year). For that type of arrangement, while the ultimate exercise price of a look-back option is unknown at inception, it cannot be greater than the current share price, which provides sufficient information for both parties (the entity and grantee) to understand the award's key terms and conditions. Further, the grantee begins to benefit from any increases in the entity's share price (see Section 2.2.3) because the current share price caps the exercise price. As such, the entity and grantee generally have a mutual understanding of the key terms and conditions of a look-back option at its inception.

Examples 2-8 and 2-9 illustrate the effect of an unknown exercise price in determining whether the entity and grantee have a mutual understanding of the award's key terms and conditions.

EXAMPLE 2-8: UNKNOWN EXERCISE PRICE AT ISSUANCE DATE

FACTS

- On September 1, 20X3, an entity's board of directors approves the grant of 5,000 stock options to employees in exchange for their services.
- On the same day, the board communicates all the key terms and conditions of the stock options to the employees. However, the stock options' exercise price will be the market price of the entity's common stock at a future date, specifically, November 1, 20X3.
- The stock options cliff vest at the end of a five-year period that commences on November 1, 20X3.

CONCLUSION

A mutual understanding of the awards' key terms and conditions does not exist until the exercise price is known on November 1, 20X3.

ANALYSIS

Because the stock options' exercise price is not known as of September 1, 20X3, the parties do not have a mutual understanding of the awards' key terms and conditions on that date. If the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date would be November 1, 20X3, when the exercise price becomes known.

EXAMPLE 2-9: UNKNOWN EXERCISE PRICE — LOOK-BACK OPTIONS

FACTS

Assume the same facts as in Example 2-8, except that:

- The stock options vest after two years of service (that is, on November 1, 20X5).
- The exercise price of the stock options is equal to the lower of the entity's share price on September 1, 20X3, or November 1, 20X5.

CONCLUSION

A mutual understanding of the awards' key terms and conditions exists as of September 1, 20X3.

ANALYSIS

The stock options are considered look-back options because the exercise price is defined as the lower of the current share price or the share price at a future date. Although the ultimate exercise price is unknown as of September 1, 20X3, it cannot be greater than the current share price, which provides sufficient information for both the entity and the employees to understand the award's key terms and conditions. Further, the employees begin to benefit from subsequent increases in share price as of September 1, 20X3 (see Section 2.2.3). Therefore, the parties have a mutual understanding regarding the exercise price. If the remaining criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date is September 1, 20X3.

2.2.2.3 Discretionary Clauses

Some share-based payment awards allow the entity to adjust the terms and conditions of the awards at its discretion. For example, an award that requires achievement of an EBITDA target as a performance condition may allow the board of directors to adjust the EBITDA target based on the occurrence of future events, such as a business combination or the sale of a division. If the allowable adjustments are well defined or the events that can trigger the adjustments are sufficiently objective, the right to adjust the award's terms and conditions might not preclude a conclusion that a mutual understanding of the key terms and conditions has been reached.

However, sometimes, the events that could trigger an adjustment to the award's terms and conditions are not clearly defined or are not objective. If an award includes subjective provisions that allow the entity significant discretion to adjust the award's key terms and conditions, the entity and the grantee have not reached a mutual understanding until those terms and conditions are finalized or the subjective adjustments to the award's terms and conditions can no longer be made. For example, a provision that allows the board of directors discretion to adjust an EBITDA target (that is, the performance vesting condition) upon any unusual or nonrecurring event may not be sufficiently objective to conclude that the parties have a mutual understanding of the award's key terms and conditions.

If a discretionary clause is sufficiently objective such that the parties have a mutual understanding of the key terms and conditions of the awards, a grant date is established (if the remaining criteria for establishing a grant date are met (see Section 2.2) and the service inception date does not precede the grant date (see Section 4.3.2)). Once a grant date is established, any discretionary adjustments to the awards must be evaluated to determine whether modification accounting applies (see Chapter 5).

BDO INSIGHTS — DISCRETION IN CLAWBACK PROVISIONS

Clawback provisions may provide entities with discretion to call back all (or a portion) of awards in some circumstances (for example, upon violation of a noncompete agreement). Although the event triggering the clawback may be largely objective, entities must consider all facts and circumstances before reaching a conclusion that the parties have a mutual understanding of the key terms and conditions at inception of the award. See Section 4.5 for guidance on clawback and noncompete provisions.

Example 2-10 illustrates the effect of discretionary clauses in determining whether the entity and the grantee have a mutual understanding of the award's key terms and conditions.

EXAMPLE 2-10: DISCRETIONARY CLAUSES — MUTUAL UNDERSTANDING IS NOT REACHED

FACTS

On October 1, 20X3, an entity's board of directors approved the grant of 12,000 stock options to its CEO. The award contains the following vesting conditions:

- The CEO must complete three years of service.
- The entity must achieve annual EBITDA and operating cash flow targets predetermined at inception.

Also, the terms of the stock options allow the board discretion to adjust the operating performance targets (both the annual EBITDA and operating cash flow targets) at its discretion.

CONCLUSION

A mutual understanding of the key terms and conditions of the stock options is not reached until the performance targets are finalized and can no longer be adjusted at the board's discretion.

ANALYSIS

The discretionary clause provides the board of directors with a high degree of latitude to adjust the specified performance targets. Accordingly, the entity and the CEO have not reached a mutual understanding of the key terms and conditions of the awards until the performance targets are finalized (and can no longer be adjusted at the board's discretion).

2.2.3 Grantee Begins to Benefit From or Be Adversely Affected by Changes in the Entity's Share Price

FASB REFERENCES

ASC 480-10-25, ASC 718-10-20: Grant Date, and ASC 718-10-55-82

Except for share-based payment awards for which the service inception date precedes the grant date (see Section 4.3.2), an entity begins to recognize compensation cost for awards when all the criteria for a grant date to be established are met (see Section 2.2). To establish a grant date, a grantee must begin to benefit from increases in the entity's share price (or value of other underlying equity) or be adversely affected by decreases in the entity's share price. If a grantee is exposed to **either** the benefits or the adverse effects of the entity's changing share prices, this condition is met; that is, both conditions are not required to be met. The entity and the grantee must reach a mutual understanding of the award's key terms and conditions to assess that financial exposure.

Example 2-11 illustrates this concept.

EXAMPLE 2-11: DETERMINING WHEN GRANTEE BEGINS TO BE AFFECTED BY CHANGES IN SHARE PRICE

FACTS

- On February 1, 20X1, an entity's board of directors approved the grant of 1,000 stock options to its CEO.
- The stock options will vest on February 1, 20X2.
- The exercise price of the stock options is the entity's share price on February 1, 20X2.

CONCLUSION

The grantee does not begin to benefit from or be adversely affected by changes in share price until the exercise price of the stock options is established on February 1, 20X2.

ANALYSIS

Because the stock options' exercise price is not established until February 1, 20X2, the grantee does not begin to benefit from or be adversely affected by changes in share price before that date. For further guidance, see:

Example 2-8: Unknown exercise price at issuance date

Example 2-9: Unknown exercise price — Look-back options

If all other criteria for establishing a grant date (see Section 2.2) are met and the service inception date does not precede the grant date (see Section 4.3.2), the grant date is February 1, 20X2.

BDO INSIGHTS — AWARDS SETTLED IN A VARIABLE NUMBER OF SHARES BASED ON A FIXED MONETARY AMOUNT

Despite share-based payment awards being outside the scope of ASC 480, entities must still apply the classification requirements in ASC 480-10-25 to freestanding financial instruments issued to employees and nonemployees in exchange for goods or services. One criterion in ASC 480-10-25 requires a freestanding financial instrument to be classified as a liability if the instrument obligates (or may obligate) the entity to settle it in a variable number of shares based solely or predominantly on a fixed monetary amount known at inception (see Section 3.2.1.3).

For those instruments, because the settlement amount is fixed at inception, the grantee is not affected by changes in the price of the entity's shares until the number of shares is determined at the settlement date. Even so, we believe those instruments do not preclude the establishment of a grant date because the liability is based on a fixed amount known to both the entity and the grantee at inception. Therefore, assuming all other criteria for establishing a grant date (see Section 2.2) are met, in this situation an entity may establish the grant date at inception of the award.

2.3 FAIR-VALUE-BASED MEASUREMENT

FASB REFERENCES

ASC 718-10-20: Fair Value, ASC 718-10-30-2 through 30-4, ASC 718-10-30-7 through 30-9, and ASC 718-10-55-10 through 55-11

ASC 718 generally requires an entity to measure a share-based payment award based on its fair value. Equity-classified awards are generally measured based on their grant-date fair value and liability-classified awards are measured based on the fair value of the liabilities incurred and ultimately settled.

ASC 718 defines fair value as "*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.*" Although the definition of fair value refers only to assets and liabilities, it also applies to equity instruments.

The best evidence of an award's fair value is an observable market price of an identical or similar equity or liability instrument in an active market. If such observable market price is available, an entity must use it for measuring the award. For example, for an award such as restricted stock that is subject only to service or performance conditions, the market price of a share of common stock would be used as the fair value measure for the restricted stock. Determining whether an equity or a liability instrument is similar to the award requires judgment based on an analysis of the terms of the instruments and other facts and circumstances.

In many cases, observable market prices of identical or similar equity or liability instruments are unavailable. For example, observable market prices for stock options and similar instruments frequently are unavailable. Accordingly, an entity must estimate the fair value of the award using a valuation technique that meets **all** the criteria below.

	It is applied in a manner consistent with the fair value measurement objective and other requirements of ASC 718.
	It is based on established principles of financial economic theory and generally applied in that field.
	It reflects all substantive characteristics of the instrument, except for items that are explicitly excluded by ASC 718, such as vesting conditions and reload features.

Also, a valuation technique must take into account, at a minimum, assumptions such as the award's exercise price and expected term, the current price of the underlying share, the risk-free interest rate for the expected term, the expected volatility of the underlying share price over the expected term, and any expected dividends on the underlying share over the expected term (see Sections 2.3.1 and 2.3.2 for guidance on valuation techniques and assumptions, respectively).

An entity generally must apply ASC 820 when measuring fair value for share-based payment awards unless it is inconsistent with ASC 718. While the fair-value-based measure required by ASC 718 is for the most part closely aligned with fair value measured in accordance with ASC 820, the fair-value based measure required by ASC 718 has some differences, primarily related to typical provisions of share-based payment awards. For example, a fair-value-based measure in accordance with ASC 718 excludes the effects of service and performance conditions that affect only vesting or exercisability, reload features, and some contingent features, which would be reflected in the fair value in accordance with ASC 820.

ASC 718 provides several exceptions from the fair-value-based measure:

- An intrinsic value measurement alternative when an entity is unable to reasonably estimate fair value because of the complexity of the award's terms (see Section 2.3.4)
- A calculated value measurement alternative for nonpublic entities (see Section 2.4.2.1)
- An intrinsic value measurement alternative for nonpublic entities (see Section 2.4.2.2)

An entity must select a valuation technique that reflects the instrument's substantive characteristics and apply that technique consistently to awards with similar characteristics. However, subsequent to selection of a valuation technique, an entity may determine that a different technique results in a better estimate of the award's fair value. In that case, the entity must change the valuation technique (see Section 2.3.3).

2.3.1 Valuation Techniques

FASB REFERENCES

ASC 718-10-55-11 through 55-17, ASC 718-10-55-19, and ASC 718-10-S99-1

ASC 718 does not specify a preferred valuation technique for share-based payment awards. Rather, if observable market prices of identical or similar equity or liability instruments are not available for an award, an entity must estimate the award's fair value using a valuation technique that meets **all** three criteria discussed in Section 2.3. In other words, the award's fair value is estimated by applying a valuation technique that would be used in determining an amount at which instruments with the same characteristics would be exchanged.

Consistent with the measurement objective, a fair value estimate does not incorporate the entity's expectations of the probability the awards would vest. Said differently, the effects of service and performance vesting conditions and other restrictions on fair value are disregarded because they are already reflected by recognizing compensation cost only for awards that are expected to vest. However, market conditions are not considered vesting conditions for this purpose; instead, they are incorporated into the award's fair value.

The assumptions used in a valuation technique may be based on external data (for example, the current share price assumption) or the entity's own past experience with share-based payments (for example, assumptions about employees' expected exercise behavior). In each case, the assumptions used must reflect all the information available to the entity that does not represent the biases of a specific party.

To estimate the fair value of a stock option or similar instrument, an entity considers its substantive characteristics. Section 2.3.2 lists the minimum set of substantive characteristics that must be considered in estimating those instruments' fair value. However, an award may contain other characteristics that need to be included in the fair value estimate, such as a market condition.

Valuation techniques estimate the fair value of stock options and similar instruments at a single point in time and incorporate assumptions and expectations at the measurement date that reflect all available information on that date. The fair value of such instruments will change as factors used in the estimate, for example fluctuations in the share price, risk-free interest rate, or changes to dividend streams, change. Such changes are normal and do not indicate that the original expectations were incorrect. The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future.

Some common techniques for valuing stock options and similar instruments that satisfy the requirements in ASC 718 are open-form models (for example, a lattice model and a Monte Carlo simulation; see Section 2.3.1.2) and closed-form models (for example, a Black-Scholes-Merton (Black-Scholes) model; see Section 2.3.1.1). An entity must select a valuation technique that reflects the instrument's substantive characteristics. For example, an entity may use either a Black-Scholes or open-form model to estimate the fair value of stock options or similar instruments that include only service or performance conditions. However, the use of an open-form model may be more appropriate for complex awards such as those that include market conditions because a closed-form model like the Black-Scholes model would not take into account all the substantive characteristics of that award. As such, for awards with complex terms, an entity may need to use an open-form model such as the lattice model or a Monte Carlo simulation.

Regardless of the valuation technique selected, an entity must develop reasonable and supportable estimates for each assumption used (see Section 2.3.2).

Once a valuation technique is selected, an entity must apply it consistently to awards with similar characteristics. However, it may use different valuation techniques for different types of instruments. Also, an entity must change its valuation technique if it determines that a different technique results in a better estimate of the award's fair value (see Section 2.3.3).

The SEC staff provided the following guidance related to the valuation of share-based payment awards:

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

C. Valuation Methods

> ***Question 2****: In order to meet the fair value measurement objective in FASB ASC Topic 718, are certain valuation techniques preferred over others?*
>
> ***Interpretive Response:*** *FASB ASC paragraph 718-10-55-17 clarifies that the Topic does not specify a preference for a particular valuation technique or model. As stated in FASB ASC paragraph 718-10-55-11 in order to meet the fair value measurement objective, a company should select a valuation technique or model that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of FASB ASC Topic 718, (b) is based on established principles of financial economic theory and generally applied in that field and (c) reflects all substantive characteristics of the instrument (except for those explicitly excluded by FASB ASC Topic 718).*
>
> *The chosen valuation technique or model must meet all three of the requirements stated above. In valuing a particular instrument, certain techniques or models may meet the first and second criteria but may not meet the third criterion because the techniques or models are not*

designed to reflect certain characteristics contained in the instrument. For example, for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton closed-form model would not generally be an appropriate valuation model because, while it meets both the first and second criteria, it is not designed to take into account that type of market condition.

Further, the staff understands that a company may consider multiple techniques or models that meet the fair value measurement objective before making its selection as to the appropriate technique or model. The staff would not object to a company's choice of a technique or model as long as the technique or model meets the fair value measurement objective. For example, a company is not required to use a lattice model simply because that model was the most complex of the models the company considered. [Footnotes omitted.]

2.3.1.1 Black-Scholes-Merton Model

FASB REFERENCES

ASC 718-10-20: Closed-Form Model, ASC 718-10-55-11, and ASC 718-10-55-18

A closed-form model is a valuation technique that meets all the criteria in ASC 718-10-55-11 for estimating the fair value of a stock option and similar instruments (see Section 2.3.1) and uses a simple equation to estimate the fair value of such instruments. The Black-Scholes model is an example of a closed-form model commonly used to estimate the fair value of noncomplex stock options and similar instruments (for example, a stock option with only service or performance conditions). Therefore, it might not be appropriate to use the Black-Scholes model for complex awards, such as those with market conditions.

The Black-Scholes model uses specific valuation assumptions that are assumed to be held constant throughout the instrument's term (see Section 2.3.2).

2.3.1.2 Lattice Model and Monte Carlo Simulation

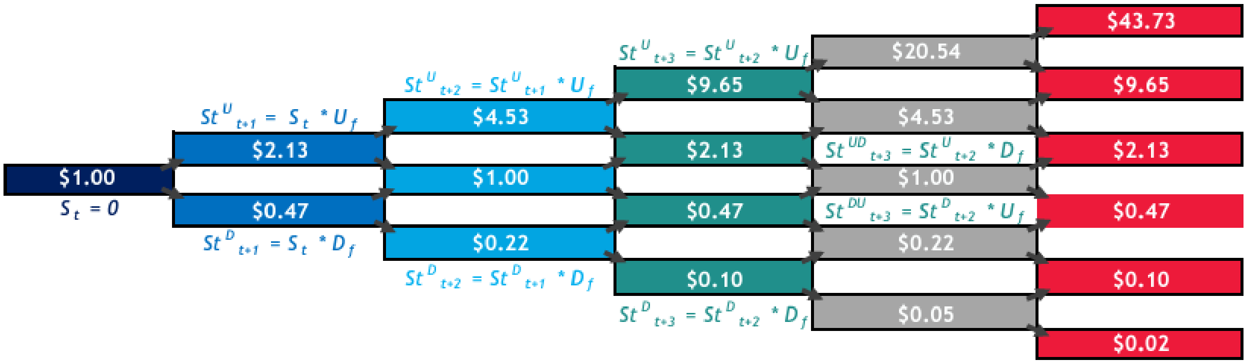
FASB REFERENCES

ASC 718-10-20: Lattice Model, ASC 718-10-55-11, and ASC 718-10-55-18

A lattice model is a valuation technique that meets all the criteria in ASC 718-10-55-11 for estimating the fair value of stock options and similar instruments (see Section 2.3.1). It produces an estimated fair value for an instrument based on the assumed changes in prices of the underlying share over successive periods of time. In each period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable in valuing a financial instrument.

Below is an illustration of a simple lattice model.

Payment Date	12/31/2023	12/30/2024	12/30/2025	12/31/2026	12/31/2027	12/31/2028
Time Step #	0	1	2	3	4	5



Unlike a closed-form model (the Black-Scholes model, for example), a lattice model is used for complex awards, such as those with market conditions. A lattice model is appropriate for complex awards because it can accommodate dynamic assumptions, such as expected volatility, dividends, and grantees' exercise behavior during the instruments' contractual term, including the effect of blackout periods. Therefore, a lattice model typically provides a better estimate of fair value than a closed-form model because it takes into account all the substantive characteristics of an instrument.

Alternatively, awards may contain provisions that require a Monte Carlo simulation, which is a type of stochastic (random) model that can be used to estimate the fair value of complex stock options and similar instruments whose exercise value (or payoff) is path dependent. It is a mathematical technique that predicts the possible outcomes of an uncertain event by taking into account thousands (or even hundreds of thousands) of potential scenarios that consider variations in the conditions and assumptions over the instrument's contractual life. For example, an award may limit vesting until the stock price meets a series of thresholds for 20 out of any given 30 days over a stated time period. Vesting conditions such as those create path dependency because both the amount that vests, as well as the timing of such vesting, depend on future stock price movements.

2.3.2 Valuation Assumptions

FASB REFERENCES

ASC 718-10-55-11, ASC 718-10-55-19, ASC 718-10-55-21, ASC 718-10-55-23 through 55-24, and ASC 718-10-55-27

As discussed in Section 2.3, the best evidence of fair value of a share-based payment award is an observable market price of an identical or similar equity or liability instrument in an active market. If such observable market price is available, it must be used to measure the award. For example, an entity must use the market price of its common stock as the fair value measure for a restricted stock award subject only to a service or performance condition. However, if observable market prices of identical or similar equity or liability instruments are not available for a share-based payment award, an entity must estimate the award's fair value using a valuation technique that meets all the criteria in ASC 718-10-55-11. That valuation technique must consider, at a minimum, **all** the following:

- Exercise price of the award
- Current price of the underlying share (see Section 2.3.2.1)
- Risk-free interest rate for the award's expected term (see Section 2.3.2.2)
- Expected volatility of the price of the underlying share for the award's expected term (see Section 2.3.2.3)
- Expected term of the award (see Section 2.3.2.4)
- Expected dividends on the underlying share for the award's expected term (see Section 2.3.2.5)

Some assumptions (for example, the risk-free interest rate) are generally based on external data, while others (for example, the expected term) may be derived from the entity's historical experience. Regardless, the assumptions used in the valuation technique must be reasonable and supportable and ignore biases.

Supportable	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.

Often, a range of estimates may be reasonable for some assumptions, such as expected volatility, dividends, and award term. If no amount in the range is more or less likely than any other, an average of the amounts in the range (the expected value) must be used in the valuation technique.

Although historical experience is typically the starting point for developing expectations about the future, entities may need to make adjustments to the historical data if future results are expected to differ from past results. Determining the relative weight to place on historical experience requires professional judgment based on the facts and circumstances. For example, an entity may have two distinct business lines of approximately the same size with one line being less volatile and generating more cash. If the entity disposes of the less volatile business line, it might place relatively little weight on historical data related to volatility, expected dividends, and grantees' exercise and post-vesting termination behavior during the predisposition period and would adjust that data in developing reasonable expectations about the future. However, an entity that has not undergone such a restructuring of operations might conclude that its historical experience provides a reasonable estimate of future results and thereby place heavier weight on historical data.

BDO INSIGHTS — DETERMINING VALUATION ASSUMPTIONS IN A CONSISTENT MANNER

As discussed in Section 2.3.3, a change in the valuation technique used to estimate the fair value of an award is allowed **only** if the new technique is expected to result in a better estimate of fair value. Similarly, the assumptions used in the valuation technique must be determined in a consistent manner from period to period unless circumstances have changed such that a change in assumptions is warranted and the change provides a better estimate of the award's fair value. For example, for the current share price assumption on the grant date, an entity might use the closing share price or the share price at another specified time. Either may be acceptable, but the approach selected must be applied consistently.

Nonpublic entities may apply practical expedients to estimate current share price and expected term used in measuring the fair value of share-based payment awards (see Section 2.4.3).

2.3.2.1 Current Share Price

FASB REFERENCES

ASC 718-10-55-11, ASC 718-10-55-21, ASC 718-10-55-27, and ASC 718-10-S99-1

As discussed in Section 2.3.2, an entity may use the closing share price or the share price at another specified time when determining the current share price as an assumption to include in the valuation technique as long as it consistently applies the selected approach.

However, it may be necessary to adjust the current share price assumption in some situations. For example, an entity may grant share-based payment awards in connection with (or shortly before) publicly announcing information that is likely to increase its share price (for example, an earnings release with better-than-expected results or a disclosure of a significant acquisition). Those awards are commonly referred to as "spring-loaded" awards. The SEC staff issued the following guidance on such spring-loaded awards:

SEC STAFF GUIDANCE

[Staff Accounting Bulletin Topic 14: Share-Based Payment]

D.3 Current Price of the Underlying Share (Including Considerations for Spring-Loaded Grants)

> *FASB ASC paragraph 718-10-55-21 states that "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 requires such valuation technique or model to take into account, at a minimum a number of factors including the current price of the underlying share.*
>
> *FASB ASC paragraph 718-10-55-27 states, "Assumptions used to estimate the fair value of equity and liability instruments granted in share-based payment transactions 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."*
>
> *For a valuation technique to be consistent with the fair value measurement objective and the other requirements of Topic 718, the staff believes that a consistently applied method to determine the current price of the underlying share should include consideration of whether adjustments to observable market prices (e.g., the closing share price or the share price at another specified time) are required. Such adjustments may be required, for example, when the observable market price does not reflect certain material non-public information known to the company but unavailable to marketplace participants at the time the market price is observed.*
>
> *Determining whether an adjustment to the observable market price is necessary, and if so, the magnitude of any adjustment, requires significant judgment. The staff acknowledges that companies generally possess non-public information when entering into share-based payment transactions. The staff believes that an observable market price on the grant date is generally a reasonable and supportable estimate of the current price of the underlying share in a share-based payment transaction, for example, when estimating the grant-date fair value of a routine annual grant to employees that is not designed to be spring-loaded.*
>
> *However, companies should carefully consider whether an adjustment to the observable market price is required, for example, when share-based payments arrangements are entered into in contemplation of or shortly before a planned release of material non-public information, and such information is expected to result in a material increase in share price. The staff believes that non-routine spring-loaded grants merit particular scrutiny by those charged with compensation and financial reporting governance. Additionally, when a company has a planned release of material non-public information within a short period of time after the measurement date of a share-based payment, the staff believes a material increase in the market price of the company's shares upon release of such information indicates marketplace participants would have considered an adjustment to the observable market price on the measurement date to determine the current price of the underlying share.*
>
> ***Facts**: Company D is a public company that entered into a material contract with a customer after market close. Subsequent to entering into the contract but before the market opens the next trading day, Company D awards share options to its executives. The share option award is non-routine, and the award is approved by the Board of Directors in contemplation of the material contract. Company D expects the share price to increase significantly once the announcement of the contract is made the next day. Company D's accounting policy is to*

consistently use the closing share price on the day of the grant as the current share price in estimating the grant-date fair value of share options.

Question 1: *Should Company D make an adjustment to the closing share price to determine the current price of shares underlying share options?*

Interpretive Response: *Prior to awarding share options in this fact pattern, the staff expects Company D to consider whether such awards are consistent with its policies and procedures, including the terms of the compensation plan approved by shareholders, other governance policies, and legal requirements. The staff reminds companies of the importance of strong corporate governance and controls in granting share options, as well as the requirements to maintain effective internal control over financial reporting and disclosure controls and procedures.*

In estimating the grant-date fair value of share options in this fact pattern, absent an adjustment to the closing share price to reflect the impact of Company D's new material contract with a customer, the staff believes the closing share price would not be a reasonable and supportable estimate and, without an adjustment the valuation of the award would not meet the fair value measurement objective of FASB ASC Topic 718 because the closing share price would not reflect a price that is unbiased for marketplace participants at the time of the grant.

BDO INSIGHTS — APPLICATION OF SAB TOPIC 14.D RELATED TO SPRING-LOADED AWARDS

Determining whether adjustments to the current share price assumption of a share-based payment award are appropriate when the award is granted or modified in contemplation of or shortly before the release of material nonpublic information requires professional judgment based on the facts and circumstances. However, we believe that SAB Topic 14.D must not be applied to the determination of fair value beyond ASC 718 (for example, it should not be extended to the determination of fair value under ASC 820).

Also, while SAB Topic 14.D provides an example in which material nonpublic information is expected to result in an **increase** in share price, it does not provide an example in which the information is expected to result in a **decrease** in share price. We believe a downward adjustment in share price assumption would be rare in practice.

The FASB provided nonpublic entities with a practical expedient for determining the current share price assumption in estimating the fair value of equity-classified share-based payment awards (see Section 2.4.3.1).

2.3.2.2 Risk-Free Rate

FASB REFERENCES

ASC 718-10-55-28

To reflect the time value of money, option-pricing models require an entity to use a risk-free interest rate. A U.S. entity issuing options on its own shares uses the U.S. Treasury zero-coupon yield curve to determine the risk-free interest rate as shown below.

Closed-form model	Implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the option’s expected term
Open-form model	Implied yields currently available on U.S. Treasury zero-coupon yield curve over the option’s contractual term

For non-U.S. entities, the risk-free rate is the implied yield currently available on zero-coupon government issues denominated in the currency of the market in which the shares (or underlying shares of the instrument) primarily trade. It may be necessary to use an appropriate substitute if such government issues do not exist or when the implied yield on zero-coupon government issues is not representative of a risk-free interest rate.

2.3.2.3 Expected Volatility

FASB REFERENCES

ASC 718-10-20: Volatility, ASC 718-10-55-35 through 55-41, and ASC 718-10-S99-1

Consistent with the fair value measurement objective in ASC 718, an entity must determine the expected volatility that market participants would likely use to determine an exchange price for an option, and its estimate of such expected volatility must be reasonable and supportable.

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 of a share price is the standard deviation of the compounded rates of return on the share over a specified period and usually is expressed as an annualized percentage.

Option pricing models must consider the expected volatility of the share price because an option’s value depends on the potential share returns over the option’s term. The higher the volatility, the more the returns on the underlying shares can be expected to vary, whether up or down. Greater volatility results in a wider range of potential returns on the underlying shares, both positive and negative. However, an option or similar instrument with a higher volatility is more valuable to its holder because expected negative returns on the shares do not affect an option's value.

ASC 718 does not specify a method of estimating expected volatility, but instead lists the following factors to consider:

Volatility of share price

- The volatility of the underlying share price, including changes in that volatility and possible mean reversion of that volatility (see Section 2.3.2.3.1). Mean reversion is the tendency of a financial variable to revert to some long-term average level. For example, in computing historical volatility, an entity might disregard a period in which its share price was extraordinarily volatile because of a failed takeover bid if a similar event is not expected to recur during the option’s expected or contractual term. Similarly, if the entity's share price was extremely volatile as a result of a general market decline, the entity might place less weight on its volatility during that period because of possible mean reversion.
- If a lattice model is used to estimate fair value, volatility over the most recent period is generally commensurate with the contractual term of the option. However, if a closed-form model is used, volatility is commensurate with the expected term.

Implied volatility	▶ The implied volatility of the share price determined from the market prices of traded options or other traded financial instruments, if any (for example, an outstanding convertible debt) (see Section 2.3.2.3.2).
Trading period	▶ A public entity must consider the length of time that its shares have been publicly traded. ▶ If that period is shorter than the expected or contractual term of the option, the volatility for the longest period for which trading activity is available is more relevant.
Similar entities	▶ A newly public entity or a nonpublic entity might consider the expected volatility of similar entities. In evaluating similarity, entities should consider factors such as industry, stage of life cycle, size, and financial leverage (see Section 2.3.2.3.3). ▶ A nonpublic entity may consider the expected volatilities of similar entities that have publicly traded securities.
Intervals	▶ If an entity considers historical volatility in estimating expected volatility, it must use intervals that are appropriate and provide the basis for a reasonable fair value estimate. ▶ For example, a public entity would likely use daily price observations, while a nonpublic entity with less trading activity might use monthly price observations.
Corporate and capital structure	▶ The corporate structure might affect the estimated volatility. For example, an entity that has not undergone restructuring might place heavier weight on historical experience than an entity that has completed a restructuring. ▶ Entities with high leverage tend to have higher volatilities.

Historical experience is typically the starting point for determining future expectations (see Section 2.3.2.3.1). However, entities may need to make adjustments to expectations because a market participant would not use historical volatility without considering the extent to which currently available information indicates that future volatility is expected to differ from historical volatility. In other situations, an entity may place exclusive reliance on historical or implied volatility when estimating expected volatility (see Section 2.3.2.3.4).

Closed-form models such as the Black-Scholes model use a single estimate of the expected volatility at the valuation date. In other words, closed-form models cannot incorporate a range of expected volatilities over the option's expected term. However, open-form models provide more flexibility and can incorporate a range of expected volatilities over an option's contractual term. Determining how to incorporate such a range of volatility estimates into an open-form model requires the application of judgment based on the facts and circumstances.

An entity must develop a process for estimating the expected volatility of its share price and apply it consistently from period to period. That process includes identifying available information and applicable factors, including a procedure for evaluating and weighing such information, as discussed above.

The SEC staff issued the following guidance regarding estimates of expected volatility:

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

D.1 Expected Volatility

FASB ASC paragraph 718-10-55-36 states, "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 an estimate of 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 share can be expected to vary – up or down. Because an option's value is unaffected by expected negative returns on the shares, other things [being] equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility."

Facts: *Company B is a public entity whose common shares have been publicly traded for over twenty years. Company B also has multiple options on its shares outstanding that are traded on an exchange ("traded options"). Company B grants share options on January 2, 20X6.*

Question 1: *What should Company B consider when estimating expected volatility for purposes of measuring the fair value of its share options?*

Interpretive Response: *FASB ASC Topic 718 does not specify a particular method of estimating expected volatility. However, the Topic does clarify that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option. FASB ASC Topic 718 provides a list of factors entities should consider in estimating expected volatility. Company B may begin its process of estimating expected volatility by considering its historical volatility. However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility. Implied volatility can be useful in estimating expected volatility because it is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility.*

The staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility. The staff believes companies that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. The extent of the ultimate reliance on implied volatility will depend on a company's facts and circumstances; however, the staff believes that a company with actively traded options or other financial instruments with embedded options generally could place greater (or even exclusive) reliance on implied volatility. …

The process used to gather and review available information to estimate expected volatility should be applied consistently from period to period. When circumstances indicate the availability of new or different information that would be useful in estimating expected volatility, a company should incorporate that information. [Footnotes omitted.]

2.3.2.3.1 Historical Volatility

FASB REFERENCES

ASC 718-10-55-24, ASC 718-10-55-38, and ASC 718-10-S99-1

As discussed in Section 2.3.2.3, historical experience is typically the starting point for determining future expectations. However, an entity may need to make adjustments to expectations because a market participant would not use historical volatility without considering the extent to which currently available information indicates that future volatility is expected to differ from historical volatility. For example, if an entity's share price was extraordinarily volatile over a period of time because of a failed liquidity event, the entity may disregard the volatility in that period if such an event is not expected to recur during the award's term. The relative weight to place on historical experience requires professional judgment based on the facts and circumstances. In SAB Topic 14.D.1, the SEC staff indicated that an entity should consider the factors below in computing historical volatility.

Method of computing volatility	▶ The selected method should produce an estimate that is representative of a market participant's expectations about the entity's future volatility over either the expected or contractual term of the option. ▶ Some methods might not be appropriate for longer-term stock options if they weight the most recent periods of the entity's historical volatility much more heavily than earlier periods. For example, a method that applies a factor to some historical share price volatility data to reflect the fact that it is no longer relevant weights the most recent historical periods more heavily. Therefore, it would likely lead to an estimate bias by favoring recent history.
Amount of historical data	▶ An entity may use a period of historical data longer than the option's expected or contractual term (as applicable) if it reasonably believes the additional historical information will improve the overall estimate. For example, an entity uses a Black-Scholes closed-form model to estimate the fair value of stock options granted on January 1, 20X4, and determines that the expected term of the stock options is six years. The entity may use historical data longer than six years if it concludes that volatility during the expected term was exceptionally high and believes that high volatility was an anomaly. However, such instances are expected to be rare, and an entity generally must use the expected or contractual term as the starting point in determining the estimate.
Frequency of price observations	▶ An entity should consider the trading frequency of its shares and the length of its trading history in determining the appropriate frequency of share price observations. ▶ Daily, weekly, or monthly share price observations may provide a sufficient basis for estimating the expected volatility if the history provides enough data points to establish an estimate. When selecting the data points, an entity should select a consistent point in time within each interval.

Consideration of future events	▶ An entity should consider future events a market participant would reasonably be expected to consider in estimating volatility. For example, if an entity has recently announced a merger that would change its business risk in the future, it should consider the impact of the merger if it reasonably believes a market participant would consider it. ▶ Professional judgment is required to determine whether material nonpublic information is available (or would be available) to the entity that a market participant would consider in estimating the expected volatility. For example, if, before granting equity instruments, an entity has entered but not yet announced a material transaction, the specific facts and circumstances might lead the entity to conclude that the impact of the event should be included in estimating the expected volatility.
Exclusion of historical data	▶ Based on an entity's particular situation, a period of historical volatility data might not be relevant in evaluating expected volatility. In those rare instances, that period is disregarded. The entity should support its conclusion that its historical share price during that previous period is not relevant because of any discrete and specific historical events and that similar events are not expected to occur during the option's expected term.

2.3.2.3.2 Implied Volatility

FASB REFERENCES

ASC 718-10-55-37(b) and ASC 718-10-S99-1

If an entity has options or other financial instruments that are traded on an exchange, it must consider the implied volatility of the share price based on such exchange-traded instruments when estimating expected volatility. The extent to which entities may rely on implied volatility to estimate the expected volatility will depend on the specific facts and circumstances.

When determining the extent of reliance to place on implied volatility, the SEC staff indicated in SAB Topic 14.D.1 that an entity should consider the factors below.

Volume of market activity	▶ An entity should consider the trading volume of its underlying shares as well as the traded options. ▶ Prices in actively traded markets are more likely to reflect the expectations of market participants regarding expected volatility.
Synchronization of the variables	▶ An entity should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, an entity should use market prices of the traded options and its shares measured at the same point in time and synchronized with the grant of the stock options. ▶ If it is not reasonably practicable to synchronize the variables, the entity should derive implied volatility as of a point in time as close to the grant of the stock options as reasonably practicable.

Similarity of the exercise prices	▶ When valuing an at-the-money stock option (that is, a stock option for which the exercise price equals the market price of the underlying share at issuance), the implied volatility derived from at- or near-the-money traded options generally is most relevant. ▶ If it is not possible to find at- or near-the-money traded options, an entity should select multiple traded options with an average exercise price close to the exercise price of the stock option.
Similarity of length of terms	▶ When valuing a stock option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term is most relevant. However, if there are no traded options with similar maturities, the entity could consider traded options with a remaining maturity of six months or greater because there is an expectation that traded options with various maturities will include some options with a remaining maturity of at least six months. ▶ However, when using traded options with a term of less than one year, the entity should also consider other relevant information in estimating expected volatility. ▶ In general, more reliance on the implied volatility derived from a traded option is expected if the remaining term of the traded option is closer to the expected or contractual term, as applicable, of the stock option.
Material nonpublic information	▶ Professional judgment is required to determine whether material nonpublic information is available (or would be available) to the entity that a market participant would consider in estimating the expected volatility. For example, if an entity has initiated a material transaction that has not yet been announced before its grant of equity instruments, the specific facts and circumstances may lead the entity to conclude that the impact of this event should be included in estimating the expected volatility.

2.3.2.3.3 Expected Volatility Using Similar Entities

FASB REFERENCES

ASC 718-10-55-25, ASC 718-10-55-37(c), and ASC 718-10-S99-1

A newly public entity or nonpublic entity might not have sufficient entity-specific historical or implied volatility data to estimate its expected volatility. Accordingly, a newly public entity may supplement its entity-specific historical volatility data by considering the expected volatilities of other similar entities, and a nonpublic entity may base its expected volatility on the average volatilities of similar public entities.

When evaluating similarity, an entity considers factors such as industry, size, stage of life cycle, and financial leverage. Because an industry sector index may include a diverse group of entities, the volatility of that index cannot be used to estimate an entity's expected volatility. Instead, if the entity has insufficient information to estimate its own volatility, it must calculate the average volatilities of a group of specific entities that are similar.

The SEC staff issued the following guidance regarding the estimation of expected volatility based on similar entities:

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

D.1 Expected Volatility

> ***Question 6****: What other sources of information should Company C consider in order to estimate the expected volatility of its share price?*
>
> ***Interpretive Response****: FASB ASC Topic 718 provides guidance on estimating expected volatility for newly-public and nonpublic entities that do not have company-specific historical or implied volatility information available. Company C may base its estimate of expected volatility on the historical, expected or implied volatility of similar entities whose share or option prices are publicly available. In making its determination as to similarity, Company C would likely consider the industry, stage of life cycle, size and financial leverage of such other entities.*
>
> *The staff would not object to Company C looking to an industry sector index (e.g., NASDAQ Computer Index) that is representative of Company C's industry, and possibly its size, to identify one or more similar entities. Once Company C has identified similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its share price as an assumption in its valuation model. Because of the effects of diversification that are present in an industry sector index, Company C should not substitute the volatility of an index for the expected volatility of its share price as an assumption in its valuation model.*
>
> *After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to Company C. Until Company C has sufficient information available, the staff would not object to Company C basing its estimate of expected volatility on the volatility of similar entities for those periods for which it does not have sufficient information available. Until Company C has either a sufficient amount of historical information regarding the volatility of its share price or other traded financial instruments are available to derive an implied volatility to support an estimate of expected volatility, it should consistently apply a process as described above to estimate expected volatility based on the volatilities of similar entities.* [Footnotes omitted.]

2.3.2.3.4 Exclusive Reliance on Historical or Implied Volatility

FASB REFERENCES

ASC 718-10-S99-1

An entity may place exclusive reliance on historical or implied volatility when estimating expected volatility. However, the extent to which an entity may rely on historical or implied volatility depends on the facts and circumstances.

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

The SEC staff said it would not object to relying exclusively on historical volatility or implied volatility to estimate expected volatility if an entity applies such methodology consistently and **all** the following factors are present:

EXCLUSIVE RELIANCE ON HISTORICAL VOLATILITY	EXCLUSIVE RELIANCE ON IMPLIED VOLATILITY
▶ The entity has no reason to believe that its future volatility over the expected or contractual term (as applicable) is likely to differ from its historical volatility. ▶ The computation of historical volatility uses a simple average calculation method. ▶ A sequential period of historical data at least equal to the expected or contractual term (as applicable) is used. ▶ A reasonably sufficient number of price observations, measured at a consistent point throughout the historical period, are used.	▶ The valuation model is based on a constant volatility assumption. ▶ The implied volatility is derived from actively traded options. ▶ The 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 measurement date of the stock options. ▶ The traded options' exercise prices are near-the-money and approximate the stock options' exercise price. ▶ The remaining maturities of the traded options on which the estimate is based are at least one year. ▶ There is no material nonpublic information a market participant would consider in estimating expected volatility.

2.3.2.4 Expected Term

FASB REFERENCES

ASC 718-10-55-29 through 55-34 and ASC 718-10-S99-1

The fair value of a traded (or transferable) option is based on its contractual term because it is rarely advantageous to exercise the option rather than sell it before the end of its contractual term. However, the exercise behavior of a nontransferable stock option does not follow that same pattern because exercising the award before the end of the contractual term may be the best (or only) way for the stock option holder to benefit from the award. Further, the terms of an award may prevent the employee from exercising it during periods when an entity is legally prohibited from issuing new shares (referred to as "blackout periods"). An employee's inability to sell a stock option effectively reduces the option's value because employees often exercise their options before the end of the contractual term, thus truncating the option's time value. To reflect the effect of those restrictions, ASC 718 requires an entity to use the expected (rather than contractual) term in measuring the fair value of an employee stock option or similar instrument. In other words, the effect of nontransferability of the option is considered by reflecting the effects of employees' expected exercise and post-vesting termination behavior in estimating fair value. See Section 6.3 for guidance on expected term for nonemployee awards.

The expected term is the period over which the entity expects the stock option or similar instrument to be outstanding (that is, the period from the service inception date to the date of expected exercise or other expected settlement). In a closed-form model (such as the Black-Scholes model), the expected term of a stock option considers the option's contractual term and the effects of grantees' expected exercise and termination behavior after the award vests. While the expected term of the stock option is an assumption (that is, an input) in closed-form valuation models, it represents an output of an open-form valuation model such as a lattice model. Therefore, if an entity uses a lattice model, the expected term is generally the award's contractual term.

However, if an entity modifies a lattice model to consider both 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 may indicate that employees tend to exercise their options when the share price reaches 150 percent of the option's exercise price. If so, the entity may use a lattice model that assumes exercise of the option at each share price path for which the early exercise expectation is met, assuming the option will be vested and exercisable at that point. For share price paths along the lattice in which the exercise expectation is not met but the options are in-the-money at the end of the contractual term, the lattice would assume exercise at the end of the contractual term.

The factors below also may affect expectations about an employee's exercise and post-vesting employment termination behavior.

FACTOR	CONSIDERATIONS
Vesting period	▶ An option's expected term must at least include the vesting period (as an employee typically cannot exercise an award before it vests). Under some arrangements, an option holder may exercise an award before vesting (usually to obtain a specific tax treatment). However, such arrangements generally require that the shares obtained upon exercise of the option be returned to the entity if the vesting conditions are not met. Thus, the exercise of the award is not substantive for accounting purposes (see Section 4.2.6).
Employees' historical exercise and post-vesting termination behavior for similar grants	▶ An entity must evaluate the terms of previous awards in determining whether they are similar to the current award. If similar, the exercise and post-vesting termination behavior for those previous awards are considered in determining the expected term of the current award.
Expected volatility of the price of the underlying shares	▶ The evolution of an entity's share price may affect an employee's exercise behavior. For example, if a stock option has been out-of-the-money for a long period, an employee may be more likely to exercise the option shortly after it becomes in-the-money. ▶ Higher volatility often encourages employees to exercise their stock options to capitalize on increases in the share price.
Blackout periods and other coexisting arrangements	▶ Blackout periods and other coexisting arrangements (that is, agreements that may allow for exercise to automatically occur during blackout periods if specific conditions are met) may affect employees' exercise and post-vesting termination patterns.
Employees' ages, lengths of service, and jurisdictions	▶ Differences in employees' ages or other demographics and lengths of service may influence exercise and post-vesting termination patterns. ▶ Historical exercise and post-vesting termination patterns may differ between domestic and foreign employees.

An entity may also use other relevant and supportable information, such as industry averages and published academic research, about an employee's expected exercise and post-vesting employment termination behavior.

The SEC staff issued the following guidance about the estimation of an expected term for options and similar instruments:

SEC STAFF GUIDANCE

[Staff Accounting Bulletin Topic 14: Share-Based Payment]

D.2 Expected Term

> ***Facts***: *Company D utilizes the Black-Scholes-Merton closed-form model to value its share options for the purposes of determining the fair value of the options under FASB ASC Topic 718. Company D recently granted share options to its employees. Based on its review of various factors, Company D determines that the expected term of the options is six years, which is less than the contractual term of ten years.*
>
> ***Question 1***: *When determining the fair value of the share options in accordance with FASB ASC Topic 718, should Company D consider an additional discount for nonhedgability and nontransferability?*
>
> ***Interpretive Response***: *No. FASB ASC paragraph 718-10-55-29 indicates that nonhedgability and nontransferability have the effect of increasing the likelihood that an employee share option will be exercised before the end of its contractual term. Nonhedgability and nontransferability therefore factor into the expected term assumption (in this case reducing the term assumption from ten years to six years), and the expected term reasonably adjusts for the effect of these factors. Accordingly, the staff believes that no additional reduction in the term assumption or other discount to the estimated fair value is appropriate for these particular factors.*
>
> ***Question 2***: *Should forfeitures or terms that stem from forfeitability be factored into the determination of expected term?*
>
> ***Interpretive Response***: *No. FASB ASC Topic 718 indicates that the expected term that is utilized as an assumption in a closed-form option-pricing model or a resulting output of a lattice option pricing model when determining the fair value of the share options should not incorporate restrictions or other terms that stem from the pre-vesting forfeitability of the instruments. Under FASB ASC Topic 718, these pre-vesting restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for which grantees deliver the good or render the service.*
>
> ***Question 3***: *Can a company's estimate of expected term ever be shorter than the vesting period?*
>
> ***Interpretive Response***: *No. The vesting period forms the lower bound of the estimate of expected term.*
>
> ***Question 4***: *FASB ASC paragraph 718-10-55-34 indicates that an entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term, regardless of the valuation technique or model used to estimate the fair value. How many groupings are typically considered sufficient?*
>
> ***Interpretive Response***: *As it relates to employee groupings, the staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.*
>
> ***Question 5***: *What approaches could a company use to estimate the expected term of its employee share options?*

> ***Interpretive Response:*** *A company should use an approach that is reasonable and supportable under FASB ASC Topic 718's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in determining an exchange price for the share options. If, in developing its estimate of expected term, a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the staff will not object to the use of the historical share option exercise experience to estimate expected term.*
>
> *A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants, or a lack of variety of price paths that the company may have experienced.*
>
> *FASB ASC Topic 718 describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model. In addition, FASB ASC paragraph 718-10-55-32 states that "expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research." For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used.* [Footnotes omitted.]

An entity may elect for each award to use the contractual term as the expected term in estimating the fair value of nonemployee stock options and similar awards. However, if an entity does not elect that alternative, it must apply the guidance in this section in estimating the expected term of a nonemployee award, which may be shorter than the contractual term (see Section 6.3).

2.3.2.4.1 Aggregation Into Homogenous Groups

FASB REFERENCES

ASC 718-10-55-33 through 55-34 and ASC 718-10-S99-1

There is a direct relationship between the expected term of an option and its value. Specifically, the longer the expected term, the more valuable the option. For most options, however, an increase in the term does not result in a linear increase in value; rather, the option value increases at a decreasing rate as the term lengthens. For example, a two-year option generally is worth less than twice as much as a one-year option. Accordingly, if an entity measures the fair value of an option using a single expected term that averages the exercise and post-vesting employment termination behaviors of different groups of employees, it could misstate the value of the awards.

To reduce the potential for such misstatement, entities must aggregate individual awards into relatively homogenous groups and separately estimate the expected term for each group based on the group’s exercise and post-vesting termination behaviors. In SAB Topic 14.D.2, the SEC staff indicated that an entity may generally make a reasonable fair value estimate with as few as one or two groupings. For example, an entity may aggregate its awards into two groups representing executives and non-executives because the expected exercise behavior of such groups is significantly different. Similarly, based on history, an entity that grants stock options to all its employees may determine that hourly employees tend to exercise for a smaller percentage gain than do salaried employees and therefore aggregate stock options into those two groups.

2.3.2.4.2 Simplified Method

FASB REFERENCES

ASC 718-10-S99-1

In SAB Topic 14.D.2, the SEC staff acknowledged that entities that cannot rely on historical exercise data may find it challenging to obtain alternative information, such as exercise data for employees of other entities. Accordingly, the SEC staff allows the use of a simplified method to estimate the expected term of "plain vanilla" options when sufficient historical data does not exist. The simplified method calculates the expected term by using the following formula, as applicable:

AWARDS THAT CLIFF VEST

$$\frac{\text{Vesting Term} + \text{Original Contractual Term}}{2} = \text{Expected Term}$$

For example, if an award cliff vests in four years and has a contractual term of 10 years, the expected term is seven years [(4 + 10) / 2].

AWARDS SUBJECT TO GRADED VESTING

$$\frac{\dfrac{\text{Sum }(T\_i)}{\text{Award Vesting Period}} + \text{Contractual Term}}{2} = \text{Expected Term}$$

Where:

- Sum (T_i) is the sum of the respective vesting periods for each specific tranche.
- Award vesting period is the total vesting period.

For example, if an award is subject to graded vesting in four equal annual installments, it has a sum (T_i) of 10, reflecting vesting terms of one year, two years, three years, and four years, whereas the total vesting period of the award is four years. Therefore, the expected term is 6.25 years [(10 / 4) + 10] / 2].

A stock option is plain vanilla and therefore qualifies for the simplified method if it has **all** the following characteristics:

- The option is granted at-the-money (that is, the exercise price equals the market price of the underlying share at issuance).
- Exercisability is conditional only on satisfying a service vesting condition through the vesting date (that is, the stock option cannot include a performance or market condition).
- If an employee terminates service before vesting, the employee would forfeit the option.
- If an employee terminates service after vesting, the employee would have a limited time (typically 30-90 days) to exercise the option.
- The option is nontransferable and nonhedgeable.

If an entity has sufficient historical exercise data for some, but not all, of its plain vanilla stock option awards, it can apply the simplified method only to those without sufficient historical data. Also, the simplified method may be used to estimate the expected term in periods before the entity's shares traded in a public market. An entity is also not required to consider the use of a lattice model before it determines that the simplified method can be applied.

Using the simplified method may be appropriate in the scenarios below.

Because of the limited period its equity shares have been publicly traded, an entity does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate the expected term.
An entity significantly changes the terms of its stock options or the types of employees that receive stock options such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.
An entity has or expects to have significant structural changes in its business such that its historical exercise data may no longer provide a reasonable basis upon which to estimate the expected term.

An entity must stop using the simplified method when sufficient data to estimate employee exercise patterns becomes available.

Examples 2-12 and 2-13 illustrate the application of the simplified method to cliff vesting and graded vesting awards.

EXAMPLE 2-12: SIMPLIFIED METHOD — CLIFF VESTING

FACTS

On December 1, 20X3, an entity grants stock options to its employees. The entity was established on June 1, 20X3, and therefore does not have sufficient historical exercise data to estimate the expected term of the stock options.

Assume the following:

- The stock options cliff vest after the employee completes five years of service (the requisite service period (see Section 4.2.1)). There are no other vesting conditions.
- If an employee terminates before completing the requisite service period, the employee forfeits the award.
- If an employee terminates after completing the requisite service period, the employee has 60 days to exercise the stock option.
- The stock options are nontransferable and nonhedgeable.
- The contractual term of the stock options is 10 years.

CONCLUSION

The entity is eligible to use the simplified method and calculates the expected term as 7.5 years.

ANALYSIS

The entity does not have sufficient historical data about its employees' exercise patterns and the stock options are plain vanilla as defined in SAB Topic 14.D.2. Therefore, the entity is eligible to use the simplified method for estimating the expected term. The entity calculates the expected term as the average of the vesting period and the original contractual term of the option as follows:

$$\frac{\text{Vesting Term (5 years)} + \text{Original Contractual Term (10 years)}}{2} = \text{Expected Term (7.5 years)}$$

EXAMPLE 2-13: SIMPLIFIED METHOD — GRADED VESTING

FACTS

Assume the same facts as in Example 2-12, except that the stock options are subject to graded vesting in five equal tranches (20% vest for each tranche).

CONCLUSION

The entity is eligible to use the simplified method and calculates the expected term as 6.5 years.

ANALYSIS

The entity does not have sufficient historical data about its employees' exercise patterns and the stock options are plain vanilla as defined in SAB Topic 14.D.2. Therefore, the entity is eligible to use the simplified method for estimating the expected term. The entity calculates the expected term by considering the respective vesting terms of each individual tranche as follows:

$$\frac{\dfrac{\text{Sum (T\_i) (15 Years)}}{\text{Award Vesting Period (5 years)}} + \text{Contractual Term (10 years)}}{2} = \text{Expected Term (6.5 years)}$$

Where:

- Sum (T_i) is the sum of the respective vesting periods for each specific tranche. In other words, the sum of one year, two years, three years, four years, and five years (or 15 years).
- Award vesting period is the total vesting period of five years.

2.3.2.5 Expected Dividends

FASB REFERENCES

ASC 718-10-55-42 through 55-44

Option-pricing models incorporate assumptions about expected dividends on the award's underlying shares because dividend distributions reduce the fair value of the underlying shares and option holders typically do not participate in dividend distributions. Accordingly, the higher the expected dividend assumption, the lower the resulting fair value of the award. To estimate the fair value of share-based payment awards, an entity may use its expected dividend yield or expected dividend payments as an assumption in the option-pricing model.

The objective is to determine the expected dividend assumption that market participants would likely use in determining the exchange value of the option. In estimating expected dividends, an entity must consider historical patterns of dividend increases or decreases. For example, if the entity has historically increased dividends by 2% per year, it may not be appropriate to assume a fixed expected dividend amount in estimating the fair value of the stock option. Further, if an entity intends to increase or decrease its expected dividends compared to its historical pattern, such expectations should be reflected in the estimate.

The terms of some awards may provide grantees with dividend protection rights such that the value of the awards will not be affected by dividend distributions. Dividend protection rights can take many forms. For example, an option holder could be entitled to receive a reduction in the exercise price of an option if dividends are declared on the underlying shares. Any such dividend protection rights must be reflected in the option's estimated fair value. If the dividends paid on the underlying shares reduce the option's exercise price, the effect of dividend protection is appropriately reflected by using an expected dividend assumption of zero.

In some cases, a grantee may receive dividends or dividend equivalents on a share-based payment award that is subject to vesting requirements. Those awards are commonly called "dividend-protected awards" (see Section 4.7).

2.3.2.6 Credit Risk and Dilution

FASB REFERENCES

ASC 718-10-55-46 and ASC 718-10-55-48 through 55-50

An entity may need to include a credit risk adjustment when estimating the fair value of liability-classified awards with cash settlement features because the potential cash payoffs from such awards depend on the entity's risk of default.

BDO INSIGHTS — CREDIT RISK ADJUSTMENTS ARE TYPICALLY RARE

For awards with cash payoffs that increase as the price of the award's underlying shares increase, credit risk adjustments are typically de minimis because increasing share prices are positively associated with an entity's ability to repay its liabilities. However, a credit risk adjustment may be needed for awards in which the cash payoff **increases** when the price of the award's underlying shares **decreases** because decreases in an entity's share price generally are negatively associated with an entity's ability to repay its liabilities. For example, a freestanding instrument may include a written put option or forward purchase option with an underlying share price that decreases and a fixed exercise price. Because the instrument may or must be settled by the grantee in cash, the grantee is exposed to credit risk. In that case, a credit risk adjustment may be needed based on the entity's credit standing. However, we believe those types of instruments are rare because they typically do not align with the holder's interest (that is, the holder economically benefits from the instrument when the share price decreases).

An entity may also need to incorporate an adjustment to an option's fair value if the potential dilutive effect of exercising the option is not already factored into the underlying share price. For example, when an option is exercised, it results in the issuance of new shares of the entity. The resulting dilution may reduce the fair value of the underlying shares and, as a result, the realized benefit from the exercise of the option.

If the market for an entity's shares is reasonably efficient, the effect of potential dilution is reflected in the market price of the underlying shares such that no adjustment for potential dilution is needed. Thus, for public entities, the effect of such potential dilution will generally be reflected in the market price of the shares and a separate adjustment for potential dilution is expected to be rare. An exception may occur if the public entity grants a large number of options the market is not expecting and does not believe will result in commensurate benefit to the entity.

For a nonpublic entity, potential dilution may not be fully reflected in the share price if sufficient information about the frequency and size of the entity's option awards is not available for third parties that may exchange the entity's shares to anticipate the dilutive effect. As such, a nonpublic entity must consider whether any adjustment is necessary in estimating the fair value of its options.

2.3.3 Change in Valuation Technique

FASB REFERENCES

ASC 718-10-55-20, ASC 718-10-55-27, and ASC 718-10-S99-1

An entity must select a valuation technique that reflects the substantive characteristics of the instrument and apply that technique consistently to awards with similar characteristics. After selecting a valuation technique, an entity may determine that a different technique results in a better estimate of the award's fair value. In that case, it must change the valuation technique. For example, if new information becomes available, an entity may conclude that an open-form model, such as a lattice model, provides a better estimate of the award's fair value than a closed-form model.

Changing the valuation technique used to estimate an award's fair value is allowed **only** if the new technique is expected to result in a better estimate of fair value. A change in a valuation technique is a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*, and is applied prospectively.

The SEC staff provided the following guidance on a change in valuation technique:

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

C. Valuation Methods

> ***Question 3****: In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?*
>
> ***Interpretive Response****: As long as the new technique or model meets the fair value measurement objective as described in Question 2 above, the staff would not object to a company changing its valuation technique or model. A change in the valuation technique or model used to meet the fair value measurement objective would not be considered a change in accounting principle. As such, a company would not be required to file a preferability letter from its independent accountants as described in Rule 10-01(b)(6) of Regulation S-X when it changes valuation techniques or models. However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. Disclosure in the footnotes of the basis for any change in technique or model would be appropriate*. [Footnotes omitted.]

BDO INSIGHTS — CHANGING VALUATION TECHNIQUES

A change in option pricing models is a change in estimate (not a change in accounting principle) and therefore is accounted for prospectively in accordance with ASC 250. As such, a preferability letter (for SEC registrants) is not required. However, ASC 718-10-55-27 indicates that the valuation technique for a particular type of instrument must be used consistently and cannot be changed unless a different valuation technique is expected to produce a better estimate of fair value. Because an open-form model (such as the lattice model or the Monte Carlo simulation) generally provides a better estimate of fair value than a closed-form model (such as the Black-Scholes model), we believe it will be difficult for an entity to justify switching from an open-form model to a closed-form model for the same type of award.

2.3.4 Difficulty in Estimating Fair Value

FASB REFERENCES

ASC 718-10-20: Intrinsic Value, ASC 718-10-30-21 through 30-22, and ASC 718-20-35-1

Entities can generally estimate the fair value of share-based payment awards. However, in rare cases, an entity might not be able to reasonably estimate an award's fair value because of the complexity of its terms.

In those rare circumstances, an entity measures the award using its intrinsic value, which is defined as the excess of the fair value of the underlying equity instrument over the exercise price of an option. An entity then remeasures the award at the end of each reporting period through the settlement date using the intrinsic value. If an entity determines that it cannot reasonably estimate an award's fair value, it must continue to use the intrinsic value method through the settlement date even if it can reasonably estimate the award's fair value at a subsequent reporting period.

BDO INSIGHTS — INABILITY TO ESTIMATE FAIR VALUE IS VERY RARE

We believe that in most cases, the fair value of share-based payment awards can be reasonably determined. As such, it would be rare for an entity to conclude that it cannot reasonably estimate an award's fair value and instead use the intrinsic value to measure the award. Determining whether the use of the intrinsic value method is appropriate requires the application of professional judgment based on the facts and circumstances.

2.3.5 Impact of Other Features on Valuation

Entities must identify all features included in a share-based payment award and consider their effect on the award's valuation. The most common features in awards are vesting conditions that determine whether a grantee earns the awards. As previously discussed, service and performance vesting conditions do not affect valuation. However, service and performance conditions that affect factors other than vesting (such as the exercise price), as well as market conditions, are incorporated in the grant-date fair value (see Section 2.3.5.1). Awards that are indexed to factors other than service, performance, or market conditions are classified as liabilities (see Section 3.2.5).

Some awards include a reload feature that provides for automatic grants of additional options if a grantee satisfies the exercise price of an existing option award using the entity's shares, rather than paying cash. Further, a clawback feature allows the entity to recover value from grantees upon the occurrence of specific events. Reload and clawback features are excluded in the measurement of grant-date fair value of an award (see Section 2.3.5.2).

The grant-date fair value of an award excludes the effect of restrictions that apply only during the employee's requisite service, such as transfer restrictions or the inability to hedge the stock option. However, post-vesting transfer restrictions must be factored into the grant-date fair value (see Section 2.3.5.3).

2.3.5.1 Vesting Conditions

FASB REFERENCES

ASC 718-10-30-13, ASC 718-10-30-15, ASC 718-10-30-27, and ASC 718-10-55-64

Entities that issue share-based payment awards often require grantees to fulfill specific requirements to earn (or vest in) the awards. Those requirements are referred to as "vesting conditions." ASC 718 discusses three types of conditions that affect an award's exercisability: a service condition (see Section 4.2.1), a performance condition (see Section 4.2.2), and a market condition (see Section 4.2.3).

While a service or performance condition or combination thereof typically affects timing and recognition of compensation cost, in some instances, they can also affect the measurement of awards. For example, if a performance condition is met, an award's exercise price may be adjusted, or the number of awards may change. Such conditions that affect factors other than vesting or exercisability of an award are considered when determining the amount of the award's compensation cost. A fair value is determined for each potential outcome at the grant date, and the final compensation cost is recognized based on the actual outcome of the performance condition (see Section 4.2.4).

Conversely, a market condition affects the exercise price, exercisability, or other factors used to determine the fair value of an award in a share-based payment arrangement that relates to a specified price of the entity's shares, a specified amount of intrinsic value indexed solely to the entity's shares, or a specified price of the entity's shares for a similar (or index of a similar) award (see Section 4.2.2). Awards with market conditions that affect factors other than vesting or exercisability incorporate all potential outcomes into the grant-date fair value, which is then recognized over the requisite service or vesting period. That treatment is different for awards with service or performance conditions whereby separate grant-date fair values are determined for each possible outcome (see Section 4.2.4).

2.3.5.2 Reload Features and Clawback Provisions

FASB REFERENCES

ASC 718-10-20: Reload Feature and Reload Option, ASC 718-10-30-5, ASC 718-10-30-23 through 30-24, ASC 718-10-55-8, and ASC 718-20-35-2

Some share-based payment awards include a reload feature that provides for automatic grants of additional options if a grantee satisfies the exercise price of an existing option award using the entity's shares, rather than paying cash. At the exercise date, there is an automatic grant of new options for the shares used to exercise the previous option. Reload features are excluded in determining the fair value of the award. Instead, in accordance with the reload provisions, an entity must account for reload options as separate awards once they are granted.

Further, some awards may include contingent features (such as clawback provisions) that require a grantee to return vested awards or realized gains from the sale of vested awards in exchange for consideration in an amount that is less than the award's fair value (or no consideration) on the return date. It serves as a protective provision that requires or allows the recovery of value from grantees upon specific events. Such features are not considered in determining the grant-date fair value or in recognizing compensation cost. Rather, their effects are recognized **only** upon the occurrence of the contingent event (see Section 4.5).

2.3.5.3 Nontransferability and Nonhedgeability

FASB REFERENCES

ASC 718-10-20: Restriction, ASC 718-10-30-10 through 30-11, ASC 718-10-55-5, and ASC 718-10-55-12

In measuring the fair value of a share-based payment award, an entity must consider restrictions and conditions inherent in equity instruments. 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 period of time. Such restrictions and conditions are treated differently depending on whether they remain in effect after the award vests, as shown below.

Restrictions that apply only during the vesting period	Restrictions do not affect the fair value estimate	For example, restrictions on the grantees' ability to exercise a nonvested stock option or transfer nonvested shares
Restrictions that remain in effect after the awards have vested	Restrictions are considered in the fair value estimate at the grant date	For example, restrictions on the transfer of vested equity options or shares

If an entity grants shares that include post-vesting transfer restrictions, those restrictions must be factored into the grant-date fair value of the award. The grant-date fair value of a share that has post-vesting transfer restrictions may be less than the value of an unrestricted share. Conversely, transfer restrictions that exist only while a share is unvested do not affect the fair value of an award in accordance with ASC 718. In other words, the fair value of an unvested share that is not subject to post-vesting transfer restrictions is the value of an unrestricted share.

However, ASC 718 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.*" Also, the SEC staff provided the following guidance regarding post-vesting restrictions when estimating the fair value of share-based payment awards:

SEC STAFF GUIDANCE

[Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments]

Barry Kanczucker, Associate Chief Accountant, Office of the Chief Accountant

December 9, 2015

> *I would now like to turn to an observation regarding the impact of post-vesting restrictions on the measurement of share-based awards. The measurement of share-based awards impacts compensation expense. Post-vesting restrictions, such as transfer or sale restrictions, are a common feature of many share-based payment arrangements.*
>
> *ASC 718 provides guidance on the accounting for share-based awards when the sale of the underlying shares is prohibited for a period of time subsequent to the award's vesting date. The post-vesting restrictions should be considered when estimating the grant-date fair value of the award [ASC 718-10-30-10]. I would expect that a post-vesting restriction may result in a discount relative to the market value of common stock to reflect that the market shares can be freely traded while restricted shares cannot. The assumptions used in determining the value of*

> *the share-based award should be attributes that a market participant would consider related to the underlying award, rather than an attribute related to the individual holding the award.*
>
> *Some market participants have indicated that post-vesting holding restrictions on share-based payment awards can result in significantly lower stock compensation expense. While post-vesting restrictions should be considered in estimating the fair value of share-based payments [ASC 718-10-30-10], when evaluating the appropriateness of measurement in this area, we continue to look to the guidance in ASC 718-10-55-5, which 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." With that being said, I would encourage you to consult with the Staff if you believe that you have a fact pattern in which a post-vesting restriction results in a significant discount being applied to the grant-date fair value of a share-based award.* [Footnotes omitted.]

Similarly, for stock options and similar instruments that are not transferable (which is typically the case for employee awards), the effect of nontransferability is incorporated by adjusting the expected term of the stock option or similar instrument to reflect the grantees' expected exercise and post-vesting termination behavior (see Section 2.3.2.4). However, if the entity's underlying shares have transfer restrictions, such restrictions must be factored into the determination of the fair value of the stock option. That is accomplished by using the value of the underlying restricted share as an assumption in the option pricing model (rather than the value of an unrestricted share). Because the fair value of a restricted share may be less than the fair value of an unrestricted share, the fair value of a stock option that is exercisable for a restricted share may also be less than the fair value of a stock option that is exercisable for an unrestricted share.

2.4 VALUATION OF NONPUBLIC ENTITY AWARDS

FASB REFERENCES

ASC 718-10-20: Nonpublic Entity

A nonpublic entity is any entity **other than** one that meets **any** of the following criteria:

- 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
- Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market
- 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 for purposes of applying ASC 718.

The fair value of an entity's share is an assumption in an option pricing model or is used directly to determine the value of a share-based payment award. Nonpublic entities must typically estimate the fair value of their shares using valuation techniques because there are often limited (or no) observable market prices for their shares (see Section 2.3.1). However, the entity must consider whether secondary market transactions provide information about the fair value of its securities (see Section 2.4.4).

In some scenarios, the valuations of awards by a nonpublic entity in periods before an IPO may be significantly lower than the estimated IPO price (commonly referred to as "cheap stock"). The SEC often challenges such discrepancies and may require the entity to record an incremental compensation cost (see Section 2.4.1).

Nonpublic entities may use the following alternatives and expedients in measuring the fair value of awards:

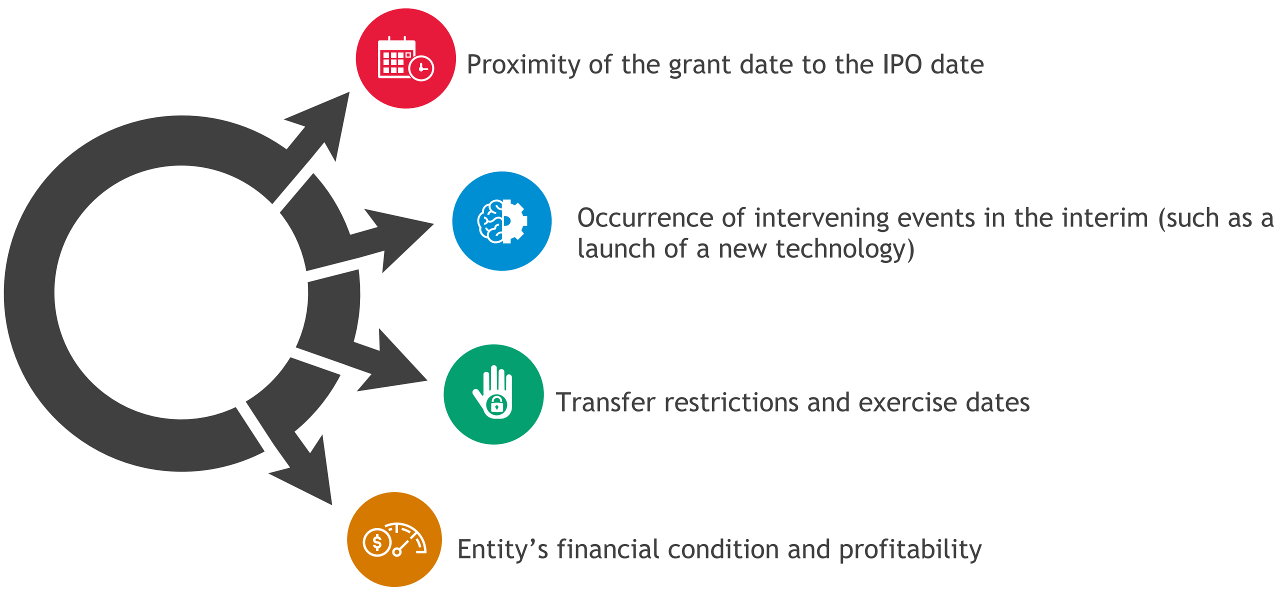
	If it is impracticable to estimate the expected volatility of the share price, a nonpublic entity measures the calculated value of the award by using the historical volatility of an appropriate industry sector index.	Section 2.4.2.1
	A nonpublic entity may elect an accounting policy to measure all its liability-classified awards (except awards issued as consideration payable to a customer) at intrinsic value or fair value. However, if the entity later becomes a public entity, the SEC requires remeasuring any vested but unsettled liability-classified awards at fair value upon becoming a public entity.	Section 2.4.2.2
	A nonpublic entity may elect to use, on a measurement date-basis, a current share price value determined by the reasonable application of a reasonable valuation method, for example, Treasury Regulation §1.409A(b)(5)(iv)(B) (409A valuation or Section 409A) as the share price assumption in determining the fair value of an equity-classified award at the grant date or upon modification.	Section 2.4.3.1
	A nonpublic entity may elect an accounting policy to estimate the expected term for some awards that do not include a market condition and meet other specified criteria using the contractual term of the option or the midpoint between the employee's requisite service period and the contractual term, depending on whether the service period is explicitly stated in the award or is implicit.	Section 2.4.3.2

BDO INSIGHTS — DETERMINATION OF FAIR VALUE FOR AWARDS ISSUED BY NONPUBLIC ENTITIES

Nonpublic entities must make an effort to measure share-based payment awards using the fair value method. For example, they may look to recent sales of common stock to third-party investors (including secondary market transactions (see Section 2.4.4)) as observable market prices. However, in some cases, observable market prices might not exist (for example, a nonpublic entity may be in the early stages of its life cycle), so it may be difficult for nonpublic entities to use the fair value method. In those cases, we believe those entities may apply the principles in ASC 820 to determine the fair value of their common stock. Also, the AICPA has issued nonauthoritative valuation guidance for estimating the fair value of a nonpublic entity's equity instruments in its *Accounting and Valuation Guide: Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the AICPA valuation guide). Although the guide is nonauthoritative, it provides helpful measurement guidance and illustrations that nonpublic entities should consider, especially if they intend to go public.

2.4.1 Cheap Stock and IPO

An entity must appropriately estimate the value of share-based payment awards in periods before an IPO. The SEC staff included specific guidance in Section 7520.1 of its Financial Reporting Manual (FRM) that registrants should consider in determining the assumptions used in valuation techniques for share-based payment awards, including:



PRE-IPO AWARDS WITH A VALUE SIGNIFICANTLY LOWER THAN THE REGISTRANT’S IPO PRICE

The SEC staff often scrutinizes the valuations of share-based payment awards in periods before an IPO to determine whether an entity has appropriately estimated the value of such awards. If the share price assumption used for valuations of pre-IPO awards is significantly lower than the registrant’s public offering price, the SEC staff may ask the registrant to reconcile the difference. If the registrant cannot provide a sufficiently supportable basis for the difference, the SEC staff may require the registrant to revalue its awards and recognize incremental compensation cost (often referred to as a “cheap stock charge”).

Because fair value estimates of a nonpublic entity’s awards can be complex and subjective, Section 9520.1 of the FRM clarifies that the SEC staff expects a nonpublic entity with significant share-based payment arrangements that anticipates an IPO to provide critical accounting estimate disclosures, including:

- The methods that management used to determine the fair value of the entity’s shares and the nature of the material assumptions involved. For example, entities using the income approach should disclose that this method involves estimating future cash flows and discounting those cash flows at an appropriate rate.
- The extent to which the estimates are considered highly complex and subjective.
- The fact that estimates will not be necessary to determine the fair value of new awards once the underlying shares begin trading.

In management’s discussion and analysis for awards granted during the 12 months before the date of the entity’s most recent balance sheet (year-end or interim) included in its registration statement, in addition to the disclosures required by the SEC staff, the AICPA valuation guide recommends including the information below.

- Significant factors, assumptions, and valuation techniques used in estimating the fair value of the awards.
- Each significant factor contributing to the difference between the fair value of the awards as of the date of each grant and the estimated IPO price. Those disclosures generally include significant intervening events, reasons for changes in assumptions, weighting of expected outcomes, and the selected valuation techniques.

2.4.2 Alternatives to Fair Value-Based Measurement for Nonpublic Entities

FASB REFERENCES

ASC 718-10-20: Calculated Value and Intrinsic Value, ASC 718-10-30-2, ASC 718-10-30-4, ASC 718-10-30-20, ASC 718-30-30-2, and ASC 718-10-S99-1

To measure an award's fair value, nonpublic entities may apply the alternatives below.

Calculated value	A measure of the value of a stock option or a similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option pricing model. A nonpublic entity must use a calculated value if it is not practicable to estimate the expected volatility of its share price.	Section 2.4.2.1
Intrinsic value	The amount by which the fair value of the underlying stock exceeds the option's exercise price. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. A nonpublic entity may elect an accounting policy to measure all its liability-classified awards at intrinsic value. However, it must initially and subsequently measure awards determined to be consideration payable to a customer (as described in ASC 606-10-32-25) at fair value (see Sections 1.3.5 and 6.6).	Section 2.4.2.2

In most cases, a nonpublic entity that has elected the alternatives must retrospectively reverse that election upon filing an IPO. However, the SEC staff provided guidance regarding retrospective application of a fair-value-based measure to awards issued by a nonpublic entity, excerpted below.

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

B. Transition From Nonpublic to Public Entity Status

> ***Facts:*** *Company A is a nonpublic entity that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8. As a nonpublic entity, Company A had been assigning value to its share options under the calculated value method prescribed by FASB ASC Topic 718, Compensation —÷ Stock Compensation, and had elected to measure its liability awards based on intrinsic value. Company A is considered a public entity on January 2, 20X8 when it makes its initial filing with the SEC in preparation for the sale of its shares in a public market.*
>
> ***Question 3****: After becoming a public entity, may Company A retrospectively apply the fair-value-based method to its awards that were granted prior to the date Company A became a public entity?*

Interpretive Response: *No. Before becoming a public entity, Company A did not use the fair-value-based method for either its share options or its liability awards. The staff does not believe it is appropriate for Company A to apply the fair-value-based method on a retrospective basis, because it would require the entity to make estimates of a prior period, which, due to hindsight, may vary significantly from estimates that would have been made contemporaneously in prior periods.* [Footnotes omitted.]

2.4.2.1 Calculated Value

FASB REFERENCES

ASC 718-10-30-19A through 30-20, ASC 718-10-55-51 through 55-58, ASC 718-10-S99-1, and ASC 718-30-35-4

A nonpublic entity may find it impracticable to estimate the expected volatility of its share price. If that is the case, the entity must measure the value of its equity stock options and similar instruments using the historical volatility of an appropriate industry sector index. That measurement is referred to as the "calculated value." A nonpublic entity's use of calculated value must be consistent between employee awards and nonemployee awards.

However, a nonpublic entity that can reasonably estimate the volatility of its own shares cannot apply the calculated value method. Often, nonpublic entities have sufficient information available to establish a reasonable and supportable estimate of the expected volatility using either the historical or implied volatility of their shares. For example, an entity may have an internal market for its shares, conduct private transactions in its shares, or issue new equity or convertible debt instruments. Also, an entity is often able to identify comparable public entities and could use the historical or implied volatilities of such entities to estimate its expected volatility (see Section 2.3.2.3.3).

Irrespective of whether a nonpublic entity applies the calculated value method or has sufficient expected volatility data to estimate fair value, it must remeasure liability-classified awards at each reporting date until the settlement date.

BDO INSIGHTS — USE OF THE CALCULATED VALUE METHOD IS EXPECTED TO BE RARE

We believe that an entity that can identify an appropriate industry sector index to determine the calculated value of an award would likely be able to identify comparable public entities (for example, entities from the identified industry sector index) such that it could calculate its expected volatility based on such comparable entities. Accordingly, we believe most entities will not qualify to use the calculated value method.

A nonpublic entity that qualifies to use the calculated value method uses the historical volatility of an appropriate industry sector index as its expected volatility assumption in the valuation model. An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and reflects the entity's size. If a nonpublic entity operates in several different industry sectors, it may select an index for the sector that is most representative of operations or use a number of different sector indices and weight them according to the nature of its operations. However, using a broad-based market index such as the S&P 500 is inappropriate because such an index is not representative of the industry sector (or sectors) in which the nonpublic entity operates because of the entity's significant diversification.

The selected industry sector index must be applied consistently unless a change to the nature of the entity's operations indicates that there is a more appropriate index. Moreover, if an entity that applies the calculated value method can subsequently estimate its expected volatility, it must stop using the calculated method and use the fair-value-based measurement. A change in the valuation technique is considered a change in accounting estimate; accordingly, the fair-value-based measurement is applied prospectively to new or modified awards.

The calculation of the historical volatility of the selected industry sector index uses the daily historical closing values of the index for the period before the award's grant date (or service inception date, if applicable) that equals the expected term of the stock option. If daily values are not readily available, an entity must use the most frequent observable historical closing values of the selected index. If historical closing values of the index selected are not available for the entire expected term, the closing values for the longest period available are used. A nonpublic entity must apply the selected method consistently.

Also, the SEC staff provided guidance in SAB Topic 14.B for newly public entities that previously granted share-based payment awards and measured those awards using the calculated value method, as shown in the graphic.

If the award is modified, repurchased, or canceled →	Evaluate in accordance with the modification guidance (see Chapter 5)
If there are no changes to the award →	Continue to apply the calculated value method

2.4.2.2 Intrinsic Value

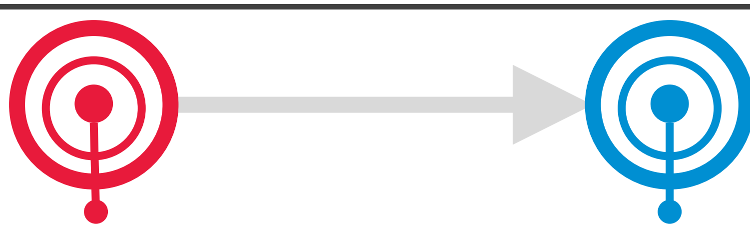
FASB REFERENCES

ASC 606-10-32-25, ASC 718-10-S99-1, ASC 718-30-30-2, and ASC 718-30-35-4

A nonpublic entity may elect an accounting policy to measure all its liability-classified awards at intrinsic value or fair value. However, that election does not apply to liability-classified awards issued as consideration payable to a customer. A nonpublic entity must initially and subsequently measure at fair value awards determined to be consideration payable to a customer (as described in ASC 606-10-32-25) (see Sections 1.3.5 and 6.6).

Regardless of the elected policy, an entity must remeasure its liability-classified awards at each reporting date until the awards are settled (see Section 4.4). If a nonpublic entity decides to change its accounting policy, ASC 718 indicates that the fair-value-based measurement is preferable for justifying a change in accounting principle in accordance with ASC 250.

Also, the SEC staff provided guidance in SAB Topic 14.B for newly public entities that previously granted liability-classified awards and measured those awards using the intrinsic value method, as summarized below.



Grant Date
Accounting policy to measure liability-classified awards at intrinsic value

Becoming a public entity
Remeasure liability-classified awards at fair value

- Assume the intrinsic value in the reporting period immediately before the entity becomes public (fiscal 2024) was $10 per award.
- At the end of the first reporting period ending after the entity becomes public (Q1 2025), the intrinsic value is $12 per award and the fair value in accordance with ASC 718 is $15 per award.
- The entity records an incremental compensation cost of $5 per vested award in Q1 2025.
- The fair value of any unvested portion of the award will be remeasured at each subsequent reporting period and will be recognized as compensation cost as it vests (see Section 4.4).

2.4.3 Practical Expedients for Nonpublic Entities

Nonpublic entities may apply some practical expedients in measuring the fair value of share-based payment awards. Those practical expedients relate to the current price of a nonpublic entity's underlying share in determining the fair value of its award (see Section 2.4.3.1) and the expected term assumption used in a valuation model for an award (see Section 2.4.3.2).

2.4.3.1 Practical Expedient for Current Price Assumption

FASB REFERENCES

ASC 718-10-20: Measurement Date and ASC 718-10-30-20C through 30-20H

A nonpublic entity may use a current share price value determined by the reasonable application of a reasonable valuation method in determining the fair value of an equity-classified award at the grant date or upon modification. A nonpublic entity that elects to use that practical expedient must apply that valuation method on a measurement date-basis. In other words, it applies the practical expedient to all equity-classified awards having the same underlying share and same measurement date.

Determining whether a valuation method or its application is reasonable is based on the facts and circumstances as of the measurement date. ASC 718 defines a measurement date as "*the date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed.*" Factors to consider in the determination of a reasonable valuation method include (as applicable):

The value of the nonpublic entity's tangible and intangible assets
The present value of the nonpublic entity's anticipated future cash flows
The market value of shares or equity interests in similar entities engaged in businesses substantially similar to those engaged in by the nonpublic entity, provided the nonpublic entity can readily determine such market value through nondiscretionary, objective means
Recent arm's-length transactions involving the sale or transfer of the nonpublic entity's shares or other equity interests
Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the nonpublic entity, its stockholders, or its creditors
The nonpublic entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including those unrelated to compensation of service providers

A valuation performed in accordance with Section 409A that has the characteristics described above is an example of a reasonable valuation method that qualifies for the practical expedient.

The use of a valuation method is not reasonable if it does not consider all available information material to the value of the nonpublic entity. Further, the use of a value previously calculated in accordance with a reasonable valuation method is no longer reasonable if **either** of the following conditions is met:

- The calculation fails to reflect information available after the date of the calculation that could materially affect the value of the nonpublic entity (for example, the resolution of material litigation or the issuance of a patent).
- The value was calculated for a date that is more than 12 months earlier than the date for which the valuation is being used.

CONSIDER UPDATING THE VALUATION UNDER SECTION 409A

ASC 718-10-30-20G states that a valuation performed in accordance with Section 409A is generally an example of a reasonable valuation method that qualifies for the practical expedient described here. Accordingly, a nonpublic entity can use the valuation under Section 409A in determining the current price of its underlying share for a period of 12 months from the measurement date. However, nonpublic entities must gather all relevant information to determine whether updates to the valuation under Section 409A are required. Examples of information that could materially affect the value of nonpublic entities include the consummation of or anticipated mergers or acquisitions, disposals of business units, financing transactions, or launches of key products.

2.4.3.2 Practical Expedient for Expected Term Assumption

FASB REFERENCES

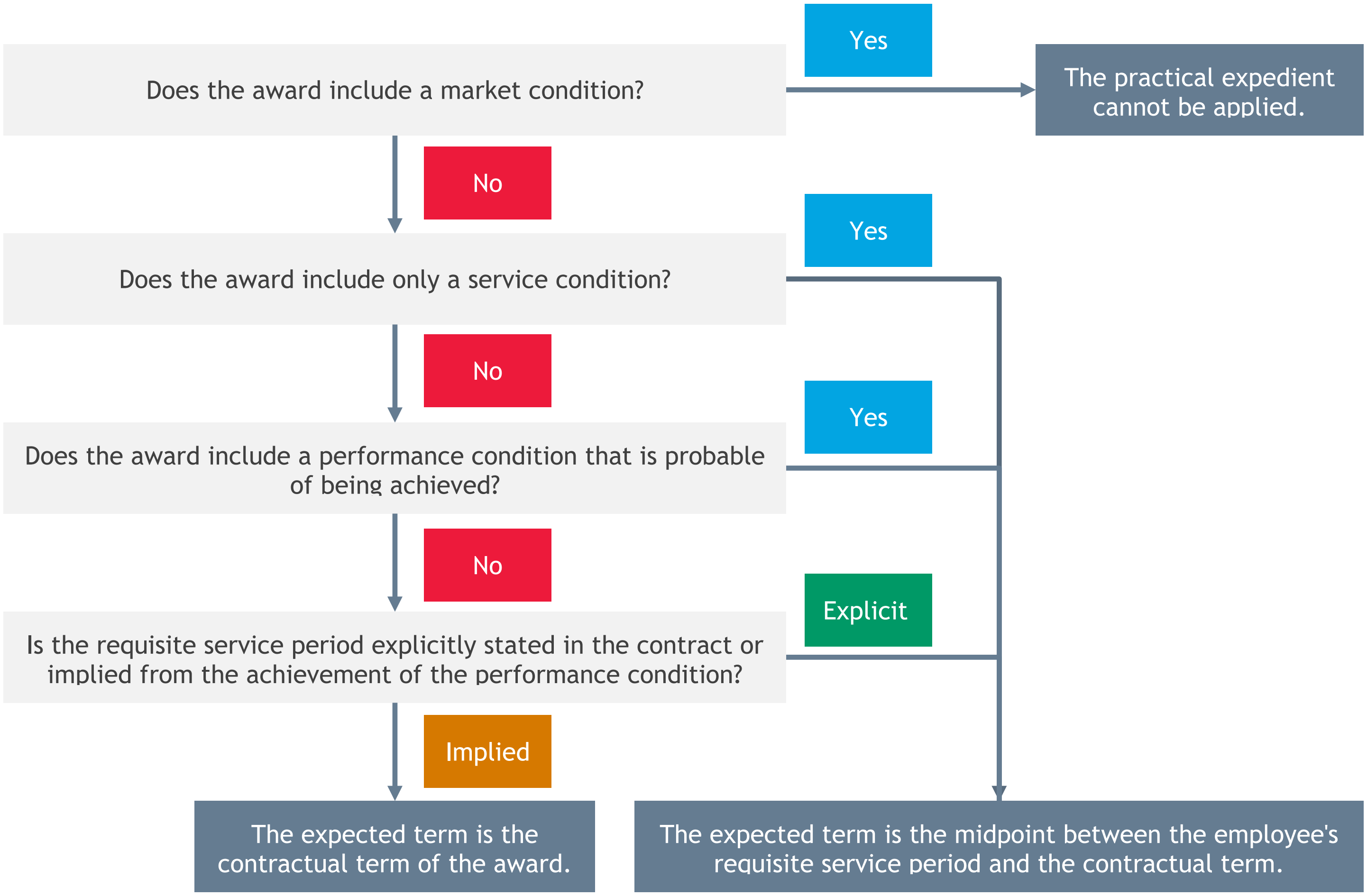
ASC 718-10-30-20A through 30-20B, ASC 718-10-55-34A, and ASC 718-10-55-50A

A nonpublic entity may elect an entity-wide accounting policy to apply a practical expedient to estimate the expected term for stock options and similar awards that have **all** the following characteristics:

- The stock option or similar award is granted at-the-money.
- The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods, terminates service after vesting, or ceases to be a customer.
- The grantee can only exercise the award (that is, the grantee cannot sell or hedge the award).
- The award does not include a market condition.

The practical expedient available to nonpublic entities is similar to the simplified method available to public entities (see Section 2.3.2.4.2), except that the practical expedient may be applied by nonpublic entities to awards that contain a performance condition.

An entity that elects the practical expedient for qualifying awards determines the expected term of an award as shown in the flowchart.



For liability-classified awards, the estimate of the expected term is updated each reporting period until settlement. That updated estimate must factor in the loss of value caused by the passage of time related to the award. Further, if the award contains a performance condition, the entity must consider any change to the probability of whether a performance condition will be achieved in the updated estimate of the expected term.

A nonpublic entity that makes an entity-wide accounting policy election to apply the practical expedient can still elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award. If, however, it chooses not to use the contractual term as the expected term, the nonpublic entity must apply the practical expedient to nonemployee awards that have the characteristics above (see Section 6.3.1.1).

2.4.4 Valuation from Secondary Market Transactions

Transactions in which a nonpublic entity's investors or employees sell shares to other investors (or back to the issuing entity) are commonly referred to as "secondary market transactions." Such transactions provide a way for investors or employees to monetize their shares even in the absence of an established public market for the shares and may require accounting under ASC 718 (see Section 1.4.3.1).

When estimating the fair value of its equity securities under ASC 718, an entity must consider whether secondary market transactions provide information about the fair value of its securities. Although secondary transactions are observable, they might not always represent fair value transactions. As such, an entity must assess the relevance of the secondary transactions in determining the fair value of its equity and determine how much weight to place on the information obtained from those transactions.

While the definitions of fair value in ASC 718 and ASC 820 are not the same, they both require the entity to use a price representing a transaction other than a forced sale or liquidation sale between willing parties. Accordingly, entities may consider ASC 820 in assessing the relevance of secondary market transactions to the fair value of equity securities.

BDO INSIGHTS — DETERMINING WHETHER A SECONDARY MARKET TRANSACTION SUPPORTS THE FAIR VALUE OF AN ENTITY'S SHARE PRICE

To evaluate whether a secondary transaction involving the same class of security as that underlying an award provides relevant information to support the award's valuation, we believe an entity might consider the following:

FACTOR	CONSIDERATIONS
Volume	▶ A higher volume of shares sold through secondary market transactions could indicate the existence of an active market for the entity's shares. ▶ A lower volume of shares sold through secondary markets transactions could indicate there is not an active market for the entity's shares.
Proximity of the transaction to the valuation date	▶ The shorter the period between the secondary transaction date and measurement date of the entity's equity securities, the more relevant the information is likely to be. ▶ There may be a delay between the date the price is agreed upon and the closing date (usually 30–60 days), during which the entity can exercise its right of first refusal. If so, consider whether the transaction is binding as of the agreement date and any price changes between the agreement date and the closing date. ▶ The point when a transaction becomes stale will vary depending on specific facts and circumstances, and an adjustment to the transaction price may be necessary.
Counterparty to the transaction	▶ Involvement of the entity in the transaction. For example, an entity's repurchase of shares from its employee might not necessarily reflect market terms. ▶ Whether the counterparty is a new investor in the entity or has an existing economic interest in the entity. ▶ Whether the counterparty is a related party. ▶ Whether the counterparty is considered sophisticated.
Pricing variance and pattern of trades	▶ Whether the pricing of secondary market transactions is consistent. Multiple transactions executed within a reasonable period at a similar price could indicate that the pricing represents fair value. ▶ Transactions that involve only one or two investors bidding on acquisition of a specific ownership percentage might not reflect a market price. If the transactions involve many investors and sellers, and the pattern of bidding reflects a reasonably low disparity between the lowest and highest bids among the winning bidders, the transactions might provide a better indication of fair value.
Available information for investors	▶ Nonpublic entities and public entities do not have to comply with all the same financial reporting requirements, which could result in limited available information for investors to reasonably predict the entity's potential. ▶ If investors lack sufficient financial information about the entity to value their investment and make informed decisions, secondary market transactions may be less relevant indicators of fair value.

The AICPA valuation guide also provides interpretive guidance on incorporating information from secondary market transactions in an estimate of the fair value of a nonpublic entity's common stock.

Chapter 3 — Classification

3.1 OVERVIEW

The accounting for share-based payment awards differs depending on whether the awards are classified as equity or liabilities. Awards are typically equity-classified if their terms result in settlement in the entity's stock and are typically liability-classified if their terms result in settlement in cash or other assets. Examples of equity-classified awards include stock options and restricted shares or units. For such awards, the measurement is generally fixed on the grant date, with compensation cost recognized over the requisite service period.

A share-based payment award is generally classified as a liability if it meets any of the classification conditions in ASC 480-10-25 (see Section 3.2.1) or any of the criteria in ASC 718-10-25-6 through 25-19A (see Sections 3.2.2 through 3.2.6). Examples of liability-classified awards include cash-settled SARs and phantom shares. Such awards are remeasured at fair value each reporting period until they are settled (see Section 4.4).

If the award is not liability-classified, SEC registrants must further consider whether the award must be classified as temporary equity (often referred to as temporary or mezzanine equity) in accordance with ASC 480-10-S99 (see Section 3.3).

There are additional considerations for nonpublic entities. For example, those entities are not required to apply the classification guidance in ASC 480-10-25 to mandatorily redeemable financial instruments (see Section 3.4.1). Further, some awards issued under a book value plan are not considered compensatory for nonpublic entities (see Section 3.4.2).

3.2 LIABILITY VERSUS EQUITY CLASSIFICATION

FASB REFERENCES

ASC 480-10-25 and ASC 718-10-25-6 through 25-19A

An entity must assess the terms and conditions of each award to determine whether it is classified as equity or liability. ASC 718-10-25-6 through 25-19A list the criteria that result in liability classification, as summarized in the table below.

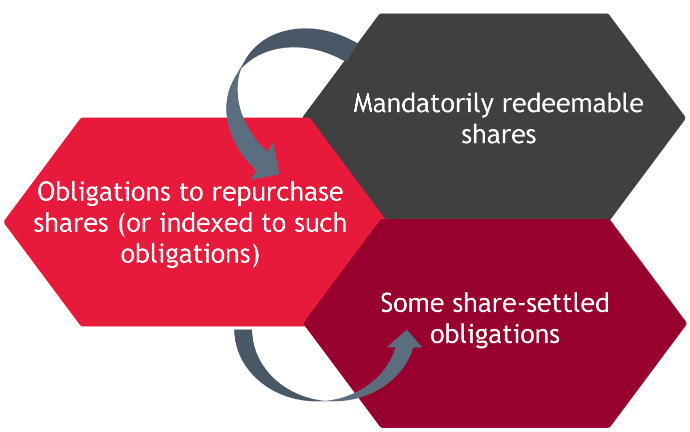
CRITERIA	GUIDANCE
The award meets any of the classification conditions in ASC 480-10-25	Section 3.2.1
The award includes a repurchase feature that allows the grantee to avoid bearing the award’s risks and rewards for a reasonable period of time	Section 3.2.2
Underlying shares of options or similar instruments are liability-classified	Section 3.2.3
The award’s terms explicitly state that the award will be settled in cash or other assets	Section 3.2.3
The award is linked to a factor other than a service, performance, or market condition	Section 3.2.5
The substance of the award indicates the award is a liability arrangement (for example, there is a history of cash settlement or the grantee has the choice of settlement in cash or stock)	Section 3.2.6
The award includes a provision that allows the grantee to effect a broker-assisted cashless exercise	Section 3.2.4.1
Awards in which the aggregate fair value of the shares withheld (or the shares that may be withheld at the employee’s choice) to cover the entity’s statutory tax withholding requirements exceeds the employee’s maximum statutory rate	Section 3.2.4.3

3.2.1 Criteria in ASC 480

FASB REFERENCES

ASC 480-10-25-4 through 25-14, and ASC 718-10-25-7 through 25-8

Despite share-based payment awards being excluded from the scope of ASC 480, the FASB still requires an entity to apply the classification requirements in ASC 480-10-25-4 through 25-14 to freestanding financial instruments issued to grantees in exchange for goods or services. ASC 480 indicates that some instruments represent obligations of the entity and should be classified as liabilities.



Share-based payment awards with **any** of the characteristics in the table below generally result in liability classification under ASC 480-10-25.

CHARACTERISTICS	EXAMPLES	CONSIDERATIONS
▶ Mandatorily redeemable shares for cash or other property at a stated (or determinable) time or following a specified event unless the redemption must occur only upon the liquidation or termination of the reporting entity (see Section 3.2.1.1).	▶ Common stock or restricted shares that must be repurchased by the entity as of specified or determinable dates (for example, upon the employee's death or any termination event). ▶ Preferred stock that must be repurchased as of specified or determinable dates. ▶ A deferred compensation plan that forces an employee into a diversified account (for example, a rabbi trust in which an award is settled in non-employer securities).	▶ Applies to outstanding shares (for example, restricted shares, common stock, and preferred stock); does not apply to stock options or similar instruments. ▶ Applies to unconditional obligations to redeem shares (under which shares are certain to be redeemed).
▶ Financial instruments that do or may obligate the entity to buy back some of its shares (or are indexed to such an obligation) in exchange for cash or other assets (see Section 3.2.1.2).	▶ A stock option settled in redeemable preferred stock. ▶ A stock option grant that includes a provision whereby an entity must repurchase the underlying shares at the grantee's request on a specified future date at a fixed price.	▶ Applies to stock options or similar instruments. ▶ Applies to unconditional or conditional obligations to repurchase shares (or indexed to such an obligation) by transferring cash or other assets (for example, stock options exercisable for preferred shares that are redeemable upon a change in control.
▶ Obligations the entity must or may settle with a variable number of shares, if, at inception, the obligation's monetary value is based solely or predominantly on: • A fixed monetary amount • A variable other than the fair value of the entity's shares, such as a market index • A variable inversely related to the fair value of the entity's shares (see Section 3.2.1.3).	▶ A bonus to a key executive for services to be rendered over a specified period that will be settled through the issuance of a variable number of the entity's shares valued at a fixed amount known at contract inception on the basis of the entity's share price at the end of the specified period. ▶ ESPPs that require the employee to purchase a specific dollar amount of the employer's stock on the purchase date; the amount of compensation cost is fixed and known on the service inception date.	▶ Applies to outstanding shares and stock options or similar instruments. ▶ Applies to both unconditional and conditional obligations to issue a variable number of shares (for financial instruments other than shares). ▶ Applies to an unconditional obligation to issue a variable number of shares (for outstanding shares) with a monetary value that is based solely or predominantly on any of the conditions in ASC 480-10-25-14.

See Chapter 2 of BDO's Blueprint, [Issuer's Accounting for Complex Financial Instruments], for further discussion of ASC 480.

AN AWARD CLASSIFIED AS A LIABILITY UNDER ASC 480 MUST APPLY THE MEASUREMENT AND RECOGNITION GUIDANCE IN ASC 718

In addition to the classification requirements in ASC 718, entities must apply the classification requirements in ASC 480 to freestanding financial instruments issued to grantees in exchange for goods or services. However, if the instruments are in the scope of ASC 718 (see Chapter 1), the entity must apply the measurement and recognition guidance in ASC 718. In other words, if an instrument is classified as a liability in accordance with ASC 480 because it met any of the characteristics in ASC 480-10-25, it still must be measured (see Chapter 2) and recognized (see Chapter 4) in accordance with ASC 718.

3.2.1.1 Mandatorily Redeemable Shares

FASB REFERENCES

ASC 480-10-20: Mandatorily Redeemable Financial Instrument, ASC 480-10-25-4 through 25-5, and ASC 480-10-25-7

ASC 480-10-25-4 requires entities to classify mandatorily redeemable shares as liabilities unless a scope exception applies. Mandatorily redeemable shares are instruments issued in the form of shares an entity must redeem for cash or other assets at a fixed or determinable date or upon an event that is certain to occur. For example, restricted shares that must be repurchased by the entity as of specified or determinable dates, such as the employee's death or any termination event, are mandatorily redeemable shares.

Mandatorily redeemable shares do not include instruments redeemable only upon the entity's liquidation or termination. In other words, if shares are redeemable only upon the occurrence of an event that is not certain to occur, they are not considered mandatorily redeemable until the event occurs or becomes certain to occur. For example, preferred stock an entity must redeem at a stated date that also has a conversion option (that the entity may or must settle in shares and is exercisable by the holder before redemption) does not meet the definition of a mandatorily redeemable share. The holder could choose to convert the preferred stock (assuming the conversion option is substantive), so there is a possibility that the stock will not be redeemed.

See Sections 2.2.4, and 2.4.2 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments for further discussion of ASC 480-10-25-4 through 25-5 and ASC 480-10-25-7.

3.2.1.2 Obligations to Repurchase Shares (or Indexed to Such Obligations)

FASB REFERENCES

ASC 480-10-25-8 and ASC 718-10-25-11(b)

An instrument other than an outstanding share is classified as a liability if it **both**:

- Embodies an obligation to repurchase the entity's equity shares or is indexed to such an obligation
- Requires or may require the entity to settle the obligation by transferring assets. That provision applies when redemption is contingent upon the occurrence of an event, such as a change in control, as illustrated in Example 3-1.

EXAMPLE 3-1: OPTIONS THAT ARE EXERCISABLE FOR REDEEMABLE PREFERRED SHARES

FACTS

As part of its compensation package, an entity granted stock options to its employees. The stock options are exercisable for preferred shares. Further, the preferred shares are redeemable for cash upon a change in control, which is considered outside the entity's control.

CONCLUSION

The stock options are exercisable for preferred equity shares that are puttable (conditionally redeemable) for cash. Therefore, the stock options are liability-classified pursuant to ASC 480-10-25-8.

ANALYSIS

The stock options are classified as a liability under ASC 480-10-25-8 because they are exercisable for the entity's preferred shares and the preferred shares are redeemable upon a change in control that is outside the entity's control. While the instrument itself (the stock option) is not settled in cash (and therefore does not require liability classification under ASC 718-10-25-11(b) (see Section 3.2.3.2)), it is indexed to the entity's preferred shares that become redeemable for cash upon the occurrence of a change in control event that is outside the entity's control. The probability of the contingent event is ignored when evaluating whether the instrument meets the criterion in ASC 480-10-25-8.

See Section 2.5 of BDO's Blueprint, [Issuer's Accounting for Complex Financial Instruments] for further discussion of ASC 480-10-25-8.

3.2.1.3 Some Share-Settled Obligations

FASB REFERENCES

ASC 480-10-25-14

A share-based payment award must be classified as a liability pursuant to ASC 480-10-25-14 if it obligates an entity to issue a variable number of shares that is based solely or predominantly on **any** of the following:

- A fixed monetary amount at inception
- A variable in something other than the fair value of the entity's stock
- A variable inversely related to changes in the fair value of the entity's stock.

That type of award does not expose the recipient to the risks and rewards typically associated with equity ownership because the award's monetary value is not tied to the fair value of the underlying shares provided upon settlement. Examples 3-2 and 3-3 illustrate this concept.

See Section 2.6 of BDO's Blueprint, [Issuer's Accounting for Complex Financial Instruments,] for further discussion of ASC 480-10-25-14.

EXAMPLE 3-2: FIXED MONETARY AMOUNT KNOWN AT INCEPTION

FACTS

An employee is granted nonvested shares of common stock with a value equal to $150,000. The award cliff vests after three years of continuous service. The number of shares the employee will receive depends on the stock's fair value at the time of settlement.

CONCLUSION

The award is classified as a liability pursuant to ASC 480-10-25-14.

ANALYSIS

The number of shares received by the employee varies based on the share price; however, the award's monetary value remains fixed at $150,000, which is known on the grant date. If the share price is $150 per share at the time of settlement, the employee will receive 1,000 shares ($150,000 / $150). However, if the share price is $200 per share, the employee will receive 750 shares ($150,000 / $200). The higher the share price at the time of settlement, the fewer shares received. Thus, the award is classified as a liability in accordance with ASC 480-10-25-14.

EXAMPLE 3-3: MONETARY VALUE BASED ON A VARIABLE OTHER THAN THE FAIR VALUE OF THE ENTITY'S SHARES

FACTS

On January 1, 20X1, an entity grants its district sales manager a restricted stock award. The award's monetary value is contingent on the percentage increase in revenues during the year 20X1 for the sales manager's specific district. The award will be settled in shares of the entity's common stock, with the number of shares determined by dividing the award's dollar amount by the share price on December 31, 20X1.

The table outlines the monetary value of the award based on the specified increases in revenues during the year.

TIER	REVENUE GROWTH	MONETARY VALUE
Tier 5	Greater than 25%	$250,000
Tier 4	Between 20% and 25%	$200,000
Tier 3	Between 15% and 20%	$150,000
Tier 2	Between 10% and 15%	$100,000
Tier 1	Less than 10%	$0

On December 31, 20X1, the entity's share price is $250 per share.

CONCLUSION

The award is classified as a liability pursuant to ASC 480-10-25-14.

ANALYSIS

The number of shares of common stock the employee will receive (as well as the monetary value of the award) varies depending solely on the revenue growth rate achieved by the entity during the year 20X1. A revenue growth rate is a variable other than the entity's share price. Therefore, the award is classified as a liability in accordance with ASC 480-10-25-14.

3.2.2 Share Repurchase Features

FASB REFERENCES

ASC 718-10-25-9 through 25-10 and ASC 718-10-55-85

The terms and conditions of some share-based payment awards, such as restricted shares or profits interests, include repurchase features that may preclude equity classification of the awards.

BDO INSIGHTS — CLASSIFICATION GUIDANCE IN ASC 718-10-25-9 THROUGH 25-10 GENERALLY APPLIES TO OUTSTANDING SHARES

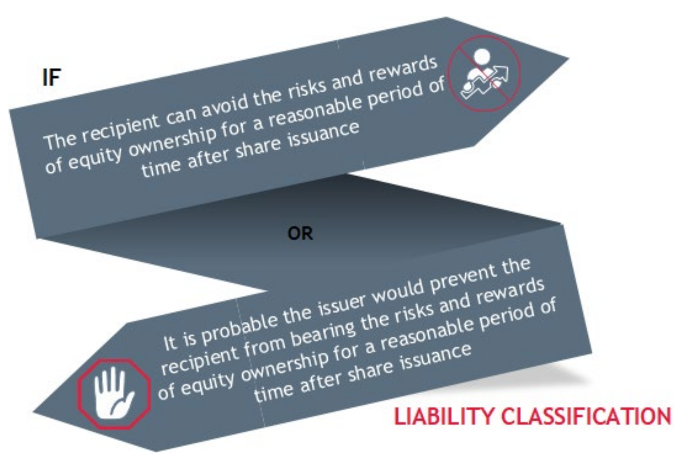
ASC 480 does not apply to outstanding shares that embody a conditional obligation to transfer assets. For example, it does not apply to shares that give the grantee the right to require the entity to repurchase the shares for cash or other assets (that is, outstanding shares that include a put option) or give the entity the right to repurchase them for cash or other assets (that is, outstanding shares that include a call option). Instead, ASC 718-10-25-9 provides guidance on awards with such repurchase features.

While ASC 718-10-25-9 generally applies to awards in the form of outstanding shares (for example, restricted shares or profits interests), we believe it may also apply to awards in the form of stock options or similar instruments in some circumstances, unless those stock options or similar instruments are already liability-classified under ASC 480. For example, a stock option's terms and conditions may include a call option on the underlying shares once the stock options are vested and exercised by the grantee. In that case, we believe the stock option must be evaluated under ASC 718-10-25-9 at its issuance date to determine whether the call option results in the stock option being liability-classified. However, stock options or similar instruments that can themselves be repurchased or settled by transferring cash or other assets are accounted for under the guidance on cash-settled awards (see Section 3.2.3).

Call options and put options are common types of repurchase features. They may be noncontingent (exercisable at any time) or contingent (exercisable upon specific events, such as termination of employment or change in control). The four most common types of repurchase features include:

- Noncontingent put option
- Contingent put option
- Noncontingent call option
- Contingent call option

A call option grants the entity the right (but not the obligation) to repurchase shares of vested awards held by a recipient. A put option grants the recipient the right (but not the obligation) to cause the entity to repurchase its vested shares. The repurchase price associated with call and put options can vary and may be based on fair value, a formula, or a fixed amount.



ASC 718 indicates that **either** of the following conditions result in the award being liability-classified:

- The repurchase feature allows the grantee to avoid the risks and rewards normally associated with equity share ownership for a reasonable period from the date the good is delivered or the service is rendered and the share is issued.
- It is probable that the grantor would prevent the grantee from bearing the risks and rewards normally associated with equity share ownership for a reasonable period after the share's issuance.

ASC 718 defines a reasonable period as a minimum of six months. Shares that have been outstanding for less than six months are referred to as "immature" shares.

An entity must analyze the terms and conditions of all relevant agreements (for example, the award agreement, operating agreement, or shareholders' agreement) when determining the proper classification for awards with repurchase features. Key considerations in the analysis include:

- Whether the repurchase price is at fair value on the repurchase date
- Whether the repurchase feature is exercisable less than six months after the award has vested and the shares are issued
- Whether the contingent event making a repurchase feature exercisable is probable of occurring less than six months after the award has vested and the shares are issued.

If an award is initially classified as a liability because of a repurchase feature but the repurchase feature expires unexercised or at least six months have passed since the grantee began bearing the risks and rewards of stock ownership, the award must be reclassified as equity. That reclassification is accounted for in the same manner as a modification that changes the classification of an award from liability to equity (see Section 5.4.2).

SEC registrants must also consider whether temporary equity classification is appropriate for awards with repurchase features that are classified as equity under ASC 718. For example, mezzanine classification would apply to shares that are redeemable at the employee's discretion after a six-month holding period (provided no other features result in liability classification) (see Section 3.3).

The chart below includes common examples of events that trigger repurchase features.

SOLELY WITHIN GRANTOR'S CONTROL	SOLELY WITHIN GRANTEE'S CONTROL	NOT CONTROLLED SOLELY BY GRANTOR OR GRANTEE
▶ Termination without cause	▶ Voluntary termination ▶ Early retirement if eligible	▶ Change in control ▶ IPO ▶ Regulatory approval ▶ Death or disability

3.2.2.1 Noncontingent Puttable Shares

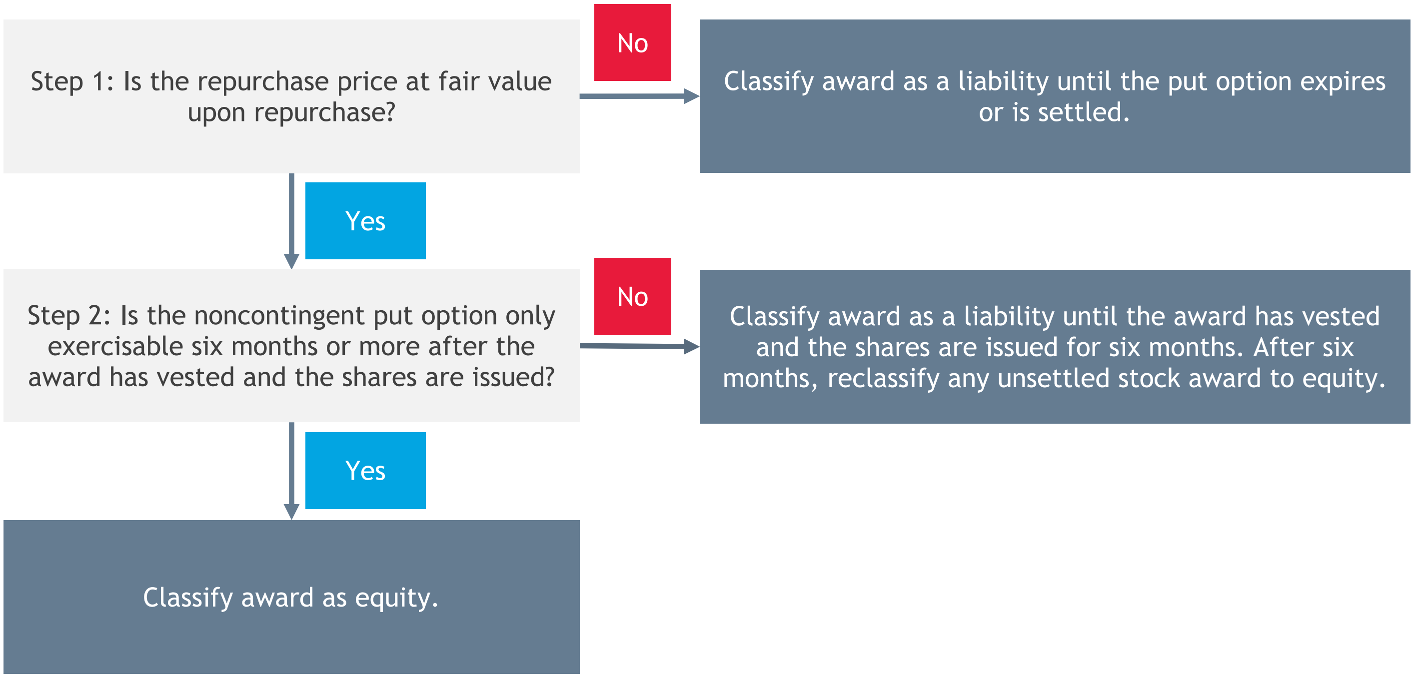
FASB REFERENCES

ASC 718-10-25-9(a)

Noncontingent put option | Contingent put option | Noncontingent call option | Contingent call option

A noncontingent put option grants the recipient the right (but not the obligation) to cause the entity to repurchase its vested shares. Liability classification is required if the grantee can avoid normal share ownership risks and rewards for a reasonable period (defined as at least six months in ASC 718) from the date the award is vested and the shares are issued. Therefore, a share with a put option that cannot be exercised before six months after vesting would be equity-classified **as long as** the repurchase price is at fair value at the time of repurchase. However, if the repurchase price is **not** at fair value, the noncontingent put option results in the award being liability-classified regardless of when the put option can be exercised. Because the repurchase price does not reflect the fair value of the shares, the grantee is not subject to the risks and rewards of share ownership until the put option expires or the award is settled.

The flowchart below illustrates that accounting model.



DISREGARD PROBABILITY OF EXERCISING A NONCONTINGENT PUT OPTION WHEN CLASSIFYING AN AWARD

An entity disregards the probability of a noncontingent put option being exercised when determining whether the option results in liability classification of the award. That is because the grantee can require the entity to repurchase the vested shares at any time (that is, the awards can be settled at any time for cash, outside the entity's control). The determining factor is the presence of the noncontingent put option rather than the exercise of the option.

In contrast, an entity must assess the probability of a noncontingent call option being exercised when determining whether the option results in liability classification of the award. Unlike a noncontingent put option, a noncontingent call option is exercisable at the entity's discretion (see Section 3.2.2.3).

'SIX-MONTH RULE' IS BASED ON SHARES' ISSUANCE DATE (NOT AWARD'S GRANT DATE)

As discussed in Section 2.2.3, a grant date is established when the grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the entity's shares. However, when considering the classification of an award, ASC 718-10-25-9(a) requires an entity to determine whether the grantee bears the risks and rewards of equity share ownership, not only the risks and rewards of the award itself. Therefore, when determining whether the grantee has borne the risks and rewards of the shares for at least six months, the holding period does **not** start from the award's grant date; rather, it begins on the date the award has vested **and** the shares are issued. That is because the grantee does not bear the risks and rewards of share ownership until it has first earned (vested in) the award and has obtained the underlying shares of the award. For stock options, the holding period begins once the stock option is vested and has been exercised; for other stock awards (for example, restricted shares and profits interests), the holding period begins once the award is vested and the shares are issued.

BDO INSIGHTS — DETERMINING WHETHER THE REPURCHASE PRICE IS AT FAIR VALUE

As discussed in Section 3.2.2, in assessing whether to classify a share-based payment award with a repurchase feature as equity or a liability, an entity must determine whether the repurchase price would be at fair value on the repurchase date. We believe the repurchase price is **not** at fair value when the repurchase price is based on:

- The fair value of the award on the employee's termination date or a date other than the repurchase date
- A formula indexed to the entity's operations, such as a multiple of revenues or EBITDA, even if the price is intended to approximate fair value
- A below-market interest rate, such as when an entity can pay the repurchase price over multiple years without incurring interest, even if the repurchase price is tied to the fair value of the award on the repurchase date.

Examples 3-4 through 3-6 illustrate the application of the classification guidance in ASC 718 when an award contains a noncontingent put option.

EXAMPLE 3-4: NONCONTINGENT PUT OPTION WITH FAIR VALUE REPURCHASE PRICE

FACTS

On January 1, 20X1, an entity grants 10,000 restricted shares to an employee that vest after three years of continuous service. Terms of the restricted share agreement include a provision that gives the employee the right to require the entity to repurchase the shares at the then-prevailing price beginning two years after the awards have vested.

CONCLUSION

The award is classified as equity.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - Yes. The repurchase price would be based on the fair value of the shares at the time of repurchase. Proceed to Step 2.
- **Step 2:** Is the noncontingent put option only exercisable more than six months after the award has vested and the shares are issued?
  - Yes. The put option is exercisable beginning two years after the vesting date. Therefore, the put option is exercisable more than six months after the award has vested and the shares are issued, and the award is classified as equity.

EXAMPLE 3-5: NONCONTINGENT PUT OPTION WITH FORMULA REPURCHASE PRICE

FACTS

Assume the same facts as in Example 3-4, except that the repurchase price is calculated as a multiple of EBITDA for the prior 12-month period divided by the number of common shares outstanding on the repurchase date. That calculation is intended to approximate fair value of the shares on the repurchase date.

CONCLUSION

The award is classified as a liability until the noncontingent put option expires or is settled.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - No. Unlike in Example 3-4, the repurchase price does not represent the fair value of the restricted shares on the repurchase date. Rather, the repurchase price is based on a formula calculated as a multiple of EBITDA divided by the number of common shares outstanding on the repurchase date. Although the formula is intended to approximate fair value, because the formula is predetermined and thus does not adjust to reflect current market terms, the resulting value may not equal fair value at the repurchase date. Therefore, the award is classified as a liability until the noncontingent put option expires or is settled.

EXAMPLE 3-6: RECLASSIFICATION FROM LIABILITY TO EQUITY ONCE AN AWARD WITH A NONCONTINGENT PUT OPTION HAS VESTED AND THE SHARES ARE ISSUED FOR SIX MONTHS

FACTS

Assume the same facts as in Example 3-4, except the employee can require the entity to repurchase the underlying shares immediately after the award is vested (January 1, 20X4).

CONCLUSION

The award is classified as a liability until it has vested, and the shares have been issued for six months. After six months, the award is reclassified to equity, assuming no other conditions require liability classification.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - Yes. Consistent with Example 3-4, the repurchase price would be at fair value upon repurchase. Proceed to Step 2.
- **Step 2:** Is the noncontingent put option only exercisable more than six months after the award has vested and the shares are issued?
  - No. Unlike in Example 3-4, the employee can exercise the put option any time after the awards vest.

Therefore, the award is classified as a liability until the award has vested and the shares have been issued for six months. After six months (July 1, 20X4), the award is reclassified as equity.

3.2.2.2 Contingent Puttable Shares

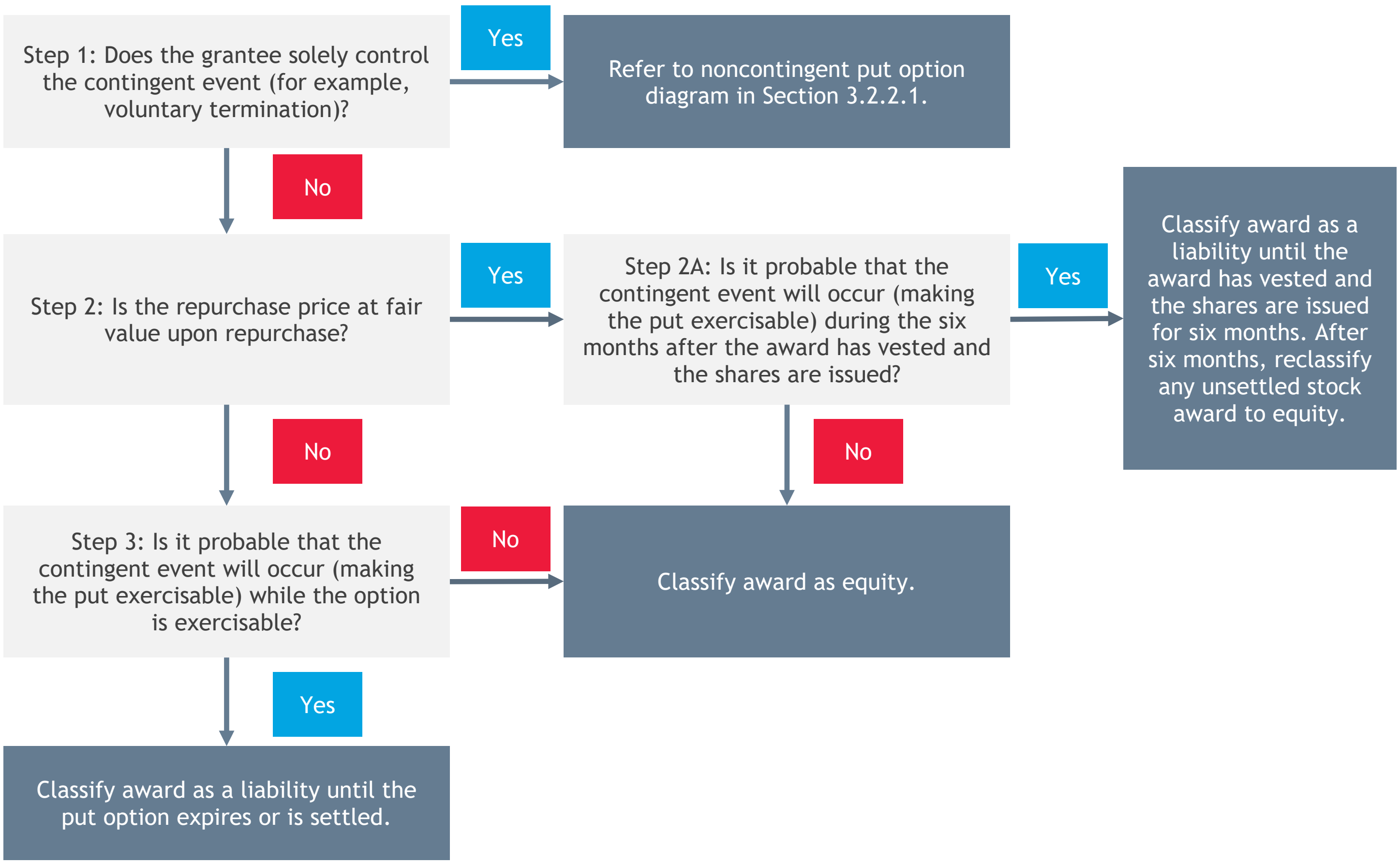
A contingent put option grants the recipient the right to require the entity to repurchase its vested shares upon specific events (for example, voluntary termination, disability, or death). The classification depends on whether the grantee solely controls the event. If the grantee solely controls the event, the probability of the contingent event occurring is disregarded and the contingent put option is assessed as a noncontingent put option (see Section 3.2.2.1).

However, if the grantee does **not** solely control the event (for example, the repurchase right becomes exercisable if the entity completes an IPO or a change in control), the award's classification depends on whether the repurchase price is at fair value on the repurchase date **and** whether the occurrence of the contingent event is probable.

If the repurchase price **is** at fair value on the repurchase date, the probability of the occurrence of the contingent event must be assessed for six months after the award has vested and the shares are issued. If it is **not** probable that the contingent event will occur during the six months after the award has vested and the shares are issued, the award is classified as equity. However, if it **is** probable that the contingent event will occur during the six months after the award has vested and the shares are issued, the award is classified as a liability.

If the repurchase price is **not** at fair value on the repurchase date, the probability of the occurrence of the contingent event must be assessed throughout the period the put option is exercisable. That concept is similar to accounting for an award with a noncontingent put option (see Section 3.2.2.1). In other words, because the repurchase price would not reflect the fair value of the shares, the grantee is not subject to the risks and rewards of share ownership until the put option expires or the award is settled. Accordingly, if the contingent event is **not** probable of occurring while the put option is exercisable, the award is classified as equity; however, if it **is** probable that the contingent event will occur while the put option is exercisable, the award is classified as a liability.

The flowchart below illustrates that accounting model.



An entity must reassess the probability of the contingent event occurring at each reporting period. If the probability of the contingent event occurring changes because of new facts and circumstances, the entity must also reassess the award's classification. Any change in award classification is accounted for in the same manner as a modification that changes classification (see Section 5.4).

BDO INSIGHTS — PROBABLE THRESHOLD

ASC 718 defines the term "probable" as a future event that is likely to occur. However, it does not specify a quantitative threshold for what is probable. In practice, the term "probable" in ASC 718 generally has the same meaning as it does in ASC 450, *Contingencies*, which we believe is a likelihood of approximately 75% or more. However, some liquidity events, such as IPOs and change-of-control transactions, are not considered probable until they occur, based on the concepts for business combinations (see BDO Insights in Section 4.2.3.1).

Examples 3-7 through 3-9 illustrate the application of the classification guidance in ASC 718 when an award contains a contingent put option.

EXAMPLE 3-7: PUT OPTION EXERCISABLE UPON A CHANGE IN CONTROL

FACTS

Assume the same facts as in Example 3-4, except that the put option is only exercisable upon a change in control.

CONCLUSION

The award is classified as equity.

ANALYSIS

- **Step 1:** Does the grantee solely control the contingent event?
  - No. A change-in-control event is not solely in the grantee's control. Proceed to Step 2.
- **Step 2:** Is the repurchase price at fair value upon repurchase?
  - Yes. Consistent with Example 3-4, the repurchase price is based on the fair value of the restricted shares at the time of repurchase. Proceed to Step 2A.
- **Step 2A:** Is it probable that the contingent event will occur during the six months after the award has vested and the shares are issued?
  - No. Unlike in Example 3-4, the put option is exercisable only in the event of a change in control. Further, a change in control event is not considered probable to occur until it is consummated (see Section 4.2.3.1). Therefore, the award is classified as equity.

EXAMPLE 3-8: PUT OPTION EXERCISABLE UPON INVOLUNTARY TERMINATION

FACTS

Assume the same facts as in Example 3-4, except the put option is exercisable only if the entity terminates the employee without cause. The entity has terminated employees without cause in only a few limited circumstances tied to strategic initiatives such as restructurings. It has no plans to initiate any actions that would result in employee terminations and thus does not believe the employee will be involuntarily terminated without cause.

CONCLUSION

The award is classified as equity. At each reporting period, the entity reassesses whether the contingent event becomes probable of occurrence.

ANALYSIS

- **Step 1:** Does the grantee solely control the contingent event?
  - No. The occurrence of an involuntary termination without cause is within the entity's (not the grantee's) control. Proceed to Step 2.
- **Step 2:** Is the repurchase price at fair value upon repurchase?
  - Yes. Consistent with Example 3-4, the repurchase price is based on the fair value of the shares at the time of repurchase. Proceed to Step 2A.
- **Step 2A:** Is it probable that the contingent event will occur during the six months after the award has vested and the shares are issued?
  - No. The entity concludes that involuntary termination without cause for the employee is not probable. The contingent put option does not result in liability classification of the award. The entity must reassess its probability conclusion each reporting period until the award has vested and the shares have been issued for six months (July 1, 20X4).

EXAMPLE 3-9: PUT OPTION EXERCISABLE UPON TERMINATION FOR ANY REASON

FACTS

Assume the same facts as in Example 3-4, except that the put option is exercisable at any time after the employee terminates for any reason, including voluntary termination.

CONCLUSION

The award is classified as liability until it has vested and the shares have been issued for six months. After six months, the award is reclassified to equity, assuming no other conditions require liability classification.

ANALYSIS

- **Step 1:** Does the grantee solely control the contingent event?
  - Yes. Voluntary termination is within the grantee's control. Therefore, the entity treats the award as a noncontingent put option at fair value (see Section 3.2.2.1).
- Evaluate as a noncontingent put option:
  - **Step 1:** The repurchase price is based on the fair value of the shares on the repurchase date. Proceed to Step 2.
  - **Step 2:** The put option is exercisable upon termination for any reason, including voluntary termination, which could be less than six months after the award vests and the shares are issued. The contingent put option results in liability classification of the award until it has vested and the shares have been issued for six months (July 1, 20X4). After six months, the award is reclassified to equity.

3.2.2.3 Noncontingent Callable Shares

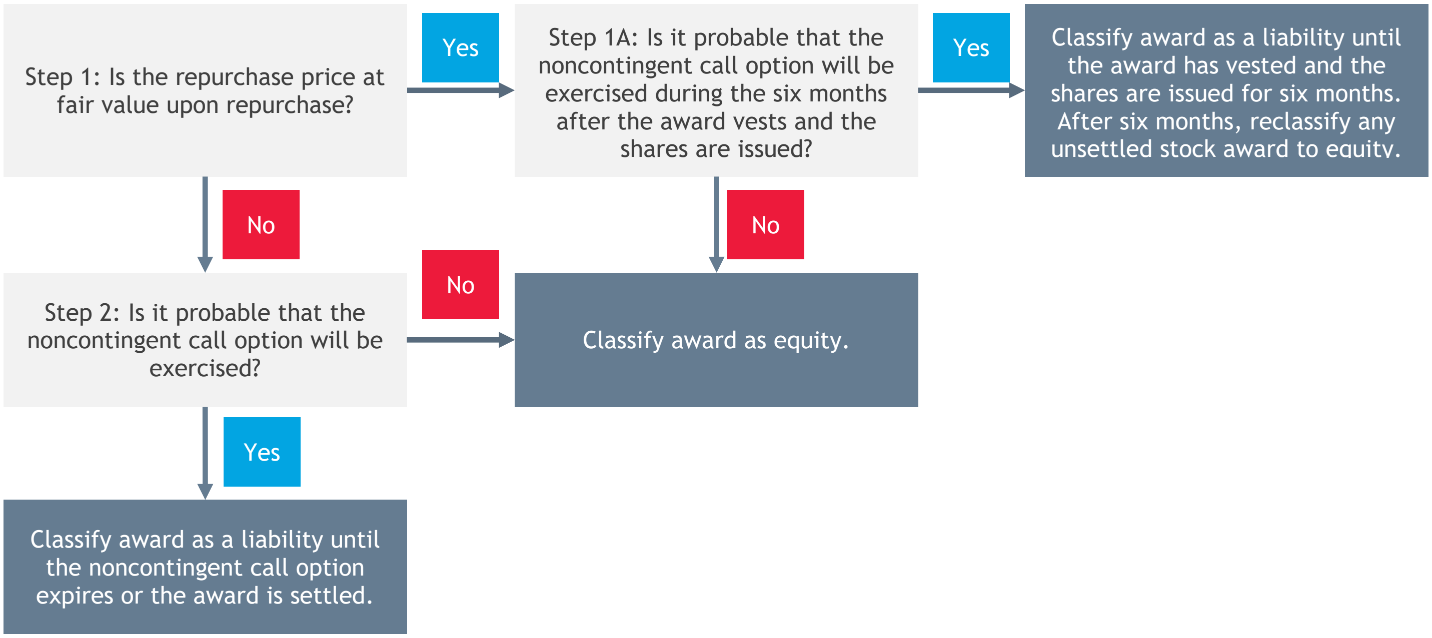
Noncontingent put option → Contingent put option → **Noncontingent call option** → Contingent call option

A noncontingent call option grants the entity the right (but not the obligation) to repurchase vested shares held by a recipient. Classification of an award with a noncontingent call option depends on whether the repurchase price is at fair value on the repurchase date **and** whether it is probable that the entity will exercise the call option.

If the repurchase price **is** at fair value on the repurchase date, the probability of the call option being exercised must be assessed for the six-month period after the award has vested and the shares are issued. If it is **not** probable that the call option will be exercised during the six months after the award has vested and the shares are issued, the award is classified as equity; however, if it **is** probable that the call option will be exercised during that period, the award is classified as a liability.

If the repurchase price is **not** at fair value on the repurchase date, the probability of the call option must be assessed regardless of whether it can be exercised before six months after the award vests and the shares are issued. That concept is similar for an award with a noncontingent put option (see Section 3.2.2.1). In other words, because the repurchase price does not reflect the fair value of the shares, the grantee is not subject to the risks and rewards of share ownership until the call option expires or the award is settled. Accordingly, an award containing a non-fair-value call option can be classified as equity **only** if it is not probable the entity will exercise it while the call option is exercisable; otherwise, the award is classified as a liability.

The flowchart below illustrates that accounting model.



BDO INSIGHTS — FACTORS TO CONSIDER WHEN ASSESSING PROBABILITY OF CALL OPTION EXERCISE

Determining the probability of whether the grantor would exercise the call right and thus prevent the grantee from bearing the risks and rewards of share ownership requires applying professional judgment based on the facts and circumstances. In that assessment, an entity should consider several factors, including those explained below.

FACTORS	CONSIDERATIONS
Management's intent	Consider management's intent. However, management's stated intent typically is insufficient to overcome a history of exercising call options on immature shares.
The frequency with which the employer has called shares in the past	Routine repurchases of immature shares generally indicate that future repurchases are probable.
The circumstances under which the employer has called shares in the past	Repurchases in connection with infrequent events typically are not indicative of an established pattern of behavior. For example, if there are no current restructuring plans, repurchases in connection with a past layoff generally would not lead to the conclusion that exercise of the call option is probable.
The repurchase price as compared to the expected market value of the shares on repurchase date	If the repurchase price of the call option as stated in the award's terms is expected to exceed the shares' market value on the repurchase date, the exercise of the call option is generally not considered probable absent other indicators. Conversely, if the repurchase price is expected to be less than the shares' market value on the repurchase date (for example, the repurchase price is calculated as a defined discount to the shares' fair value on the repurchase date), the exercise of the call option is generally probable.

FACTORS	CONSIDERATIONS
The existence of any legal, regulatory, or contractual limitations on the employer's ability to repurchase shares	Any such provision that constrains or restricts the entity's ability to repurchase shares generally indicates that the exercise of the call option is not probable.
The type of entity	A closely held, nonpublic entity with a policy that shares cannot be widely held usually indicates an increased likelihood that the employer will repurchase the shares.

BDO INSIGHTS — CALL OPTION WITH A BELOW-MARKET REPURCHASE PRICE

We believe a repurchase price designed to be below market incentivizes the grantor to exercise a noncontingent call feature. Therefore, liability classification and remeasurement at each reporting date are usually required for an award that includes a noncontingent call option with a below-market repurchase price regardless of whether other factors indicate it is probable the grantor will repurchase immature shares. However, all facts and circumstances should be considered, including whether the repurchase feature functions as an in-substance vesting condition or clawback feature (see Section 4.5).

EXAMPLE 3-10: NONCONTINGENT CALL OPTION WITH A FORMULA-BASED REPURCHASE PRICE

FACTS

On January 1, 20X1, an entity grants an employee 10,000 restricted shares with graded vesting over two years (50% of the awards vest annually). The terms of the award allow the entity to repurchase any vested and issued shares for 12 months after the vesting date at a price based on a formula intended to reflect a discount to fair value. The entity routinely repurchases shares within eight months of the award's vesting date.

CONCLUSION

The award is classified as a liability until the noncontingent call option expires.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - No. The repurchase price is based on a formula (not fair value of the award) on repurchase date. Proceed to Step 2.
- **Step 2:** Is it probable that the noncontingent call option will be exercised?
  - Yes. The repurchase price is intended to reflect a discount to fair value on the repurchase date, which indicates it is probable that the entity will exercise the call option, as further evidenced by the fact that the entity has historically exercised its call option before the option expired (usually within eight months of the award's vesting date). Therefore, it is probable that the entity will exercise the call option. The award is classified as a liability until the noncontingent call option expires on January 1, 20X3, for tranche 1 of the shares and on January 1, 20X4, for tranche 2 of the shares.

3.2.2.4 Contingent Callable Shares

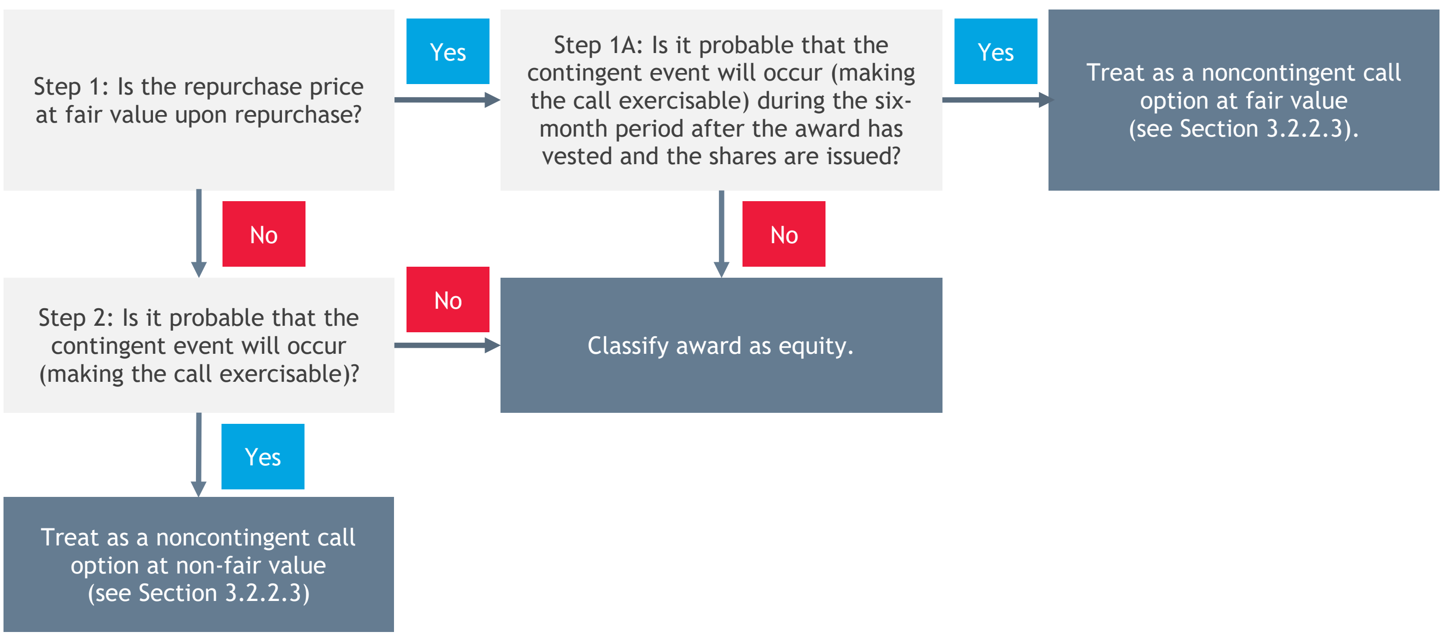
A contingent call option grants the entity the right (not the obligation) to repurchase the vested shares upon specific events (for example, voluntary termination, disability, or death). The analysis for an award with a contingent call option is similar to that for an award with a noncontingent call option (see Section 3.2.2.3), except that the analysis for an award with a contingent call option considers the probability that the contingent event will occur.

If the repurchase price **is** at fair value on the repurchase date, the probability of the event occurring must be assessed for the six-month period after the award has vested and the shares are issued. If it is **not** probable that the event will occur during the six months after the award has vested and the shares are issued, the award is classified as equity; however, if it **is** probable that the event will occur during the six months after the award has vested and the shares are issued, the award is evaluated similar to an award with a noncontingent call option (see Section 3.2.2.3).

If the repurchase price is **not** at fair value on the repurchase date, the probability of the event occurring must be assessed regardless of whether it will only occur more than six months after the award vests and the shares are issued. That concept is similar for an award with a noncontingent put option (see Section 3.2.2.1). In other words, because the repurchase price does not reflect the fair value of the shares, the grantee is not subject to the risks and rewards of share ownership until the call option expires or the award is settled. Accordingly, an award containing a non-fair-value contingent call option can be classified as equity only if **either:**

- The contingent event is not probable of occurring during the period the call option is exercisable
- The contingent event is probable of occurring but it is not probable the entity will exercise the call option.

The flowchart below illustrates that accounting model.



Examples 3-11 through 3-13 illustrate the application of the classification guidance in ASC 718 when an award contains a contingent call option.

EXAMPLE 3-11: CALL OPTION UPON EMPLOYEE TERMINATION — REPURCHASE PRICE AT FAIR VALUE ON REPURCHASE DATE

FACTS

On January 1, 20X1, an entity grants an employee 1,000 restricted shares that vest at the end of two years. The terms of the award allow the entity to repurchase any vested and issued shares upon employee termination for any reason. The repurchase price will be the fair value of the award on the repurchase date. Further, the entity believes the employee will not terminate when the shares are immature.

CONCLUSION

The award is classified as equity.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - Yes. The repurchase price is based on the shares' fair value on the repurchase date. Proceed to Step 1A.
- **Step 1A:** Is it probable that the contingent event will occur (making the call exercisable) during the six-month period after the award has vested and the shares are issued?
  - No. The entity believes the employee will not terminate when the shares are immature. The contingent event is not probable of occurring during the six-month period after the award has vested and the shares are issued. As such, the award is equity-classified.

EXAMPLE 3-12: CALL OPTION UPON EMPLOYEE TERMINATION — REPURCHASE PRICE AT FAIR VALUE WITH HISTORY OF REPURCHASING IMMATURE SHARES

FACTS

Assume the same facts as in Example 3-11, except that employees have historically left the entity shortly after their shares have vested, and the entity routinely elects to exercise its call option within a few weeks of employee termination, resulting in repurchase of shares within a few months of vesting.

CONCLUSION

The award is classified as a liability until the award has vested and shares are issued for six months. After six months, reclassify any unsettled stock awards to equity.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - Yes. The repurchase price is based on the shares' fair value on the repurchase date. Proceed to Step 1A.
- **Step 1A:** Is it probable that the contingent event will occur (making the call exercisable) during the six-month period after the award has vested and the shares are issued?
  - Yes. Employees have historically left the entity shortly after the vesting date. Accordingly, it is probable that the contingent event will occur. Therefore, the entity treats the award as a noncontingent call option at fair value (see Section 3.2.2.3).

- Evaluation as a noncontingent call option:
  - **Step 1:** The repurchase price is based on the shares' fair value on the repurchase date. Proceed to Step 1A.
  - **Step 1A:** It is probable that the call option will be exercised during the six months after the award vests and the shares are issued. The entity routinely repurchases shares within a few weeks after employee termination. Therefore, the award is liability-classified until the shares have vested and are issued for six months.

EXAMPLE 3-13: CALL OPTION UPON EMPLOYEE TERMINATION — REPURCHASE PRICE AT OTHER THAN FAIR VALUE

FACTS

On July 1, 20X1, an entity grants a group of employees 10,000 restricted shares with graded vesting over two years (50% of the awards vest annually). The terms of the award agreement include a provision that allows the entity to repurchase any vested and issued shares upon an employee's termination for any reason at a price calculated based on a formula that has resulted in a value that is higher than the fair value of the shares over the past few years. The entity does not have a history of exercising the call option. Also, several employees have left the entity since the entity's formation.

CONCLUSION

The award is classified as equity.

ANALYSIS

- **Step 1:** Is the repurchase price at fair value upon repurchase?
  - No. The repurchase price is determined based on a formula rather than fair value. Proceed to Step 2.
- **Step 2:** Is it probable that the contingent event will occur (making the call exercisable)?
  - Yes. Because the repurchase price is not at fair value on repurchase date, the entity must assess whether the contingent event is probable to occur throughout the repurchase period. In this case, the call option has no expiration date. That is, the entity can exercise the call option at any point after the employee's termination. An employee's termination is certain to occur at some point in the future. Therefore, the contingent event is probable to occur. Accordingly, the entity treats the award as a noncontingent call option at non-fair value (see Section 3.2.2.3).
- Evaluation as a noncontingent call option:
  - **Step 1:** The repurchase price is based on a formula rather than fair value. Proceed to Step 2.
  - **Step 2:** The entity does not have a history of exercising the call option. Also, the repurchase price has been higher than the fair value of the shares over the past few years, and continues to be higher than the fair value of the shares at the end of the reporting period. For these reasons, it is not probable the entity will exercise the call option. Therefore, the award with the contingent call option is equity-classified.

3.2.3 Stock Options or Similar Instruments Settled in Cash or Other Assets

FASB REFERENCES

ASC 718-10-25-9, ASC 718-10-25-11 through 25-12, and ASC 718-10-25-15

Entities may settle stock options and similar instruments by transferring cash or other assets. In some cases, cash settlement is contractually required by the award's terms (see Section 3.2.3.1); in others, cash settlement is required only upon the occurrence of an event (see Section 3.2.3.2). Further, the award's terms may allow either the grantor or grantee the option to settle the awards in cash or shares (see Section 3.2.3.3).

Some stock options and similar instruments are classified as liabilities if the underlying shares are classified as liabilities. For example, if a stock option's underlying shares have repurchase features that result in classifying the underlying shares as a liability either under ASC 480 (see Section 3.2.1) or ASC 718-10-25-9 (see Section 3.2.2), the stock option may also be classified as a liability.

3.2.3.1 Required Cash Settlement

Cash settlement may be required under the contractual terms of a share-based payment award. One example of such an arrangement is a cash-settled SAR for which a grantor has an obligation to pay a grantee either on demand or at a specified date an amount of cash or other assets equivalent to the increase in the entity's share price from a specified level (the intrinsic value at settlement).

Other common examples of those arrangements include phantom shares and cash-settled performance units. Phantom shares are subject to ASC 718 because they are generally indexed to the value of the entity's shares. A cash-settled performance unit is an instrument used to measure and reward the performance of an individual or a group within an entity. It is a form of incentive compensation tied to specific financial goals or targets whose value is determined based on achieving those goals or targets and on the entity's stock price. Both phantom shares and cash-settled performance units are typically classified as liabilities under ASC 718 because they are settled in cash.

If the award's terms require settlement by transferring cash or other assets, the award must be classified as a liability.

3.2.3.2 Contingent Cash Settlement

FASB REFERENCES

ASC 480-10-S99-3A, ASC 718-10-25-8, ASC 718-10-25-11, ASC 718-10-35-15, and ASC 718-10-S99-1

Cash settlement can sometimes occur only upon a specified event (for example, an IPO or change in control). In that case, an entity determines whether the event is within the grantee's control. If the event is within the grantee's control, the entity assumes the event has already occurred, resulting in the award being classified as a liability. If the cash settlement feature becomes exercisable upon an event that is **not** within the grantee's control but the **grantee** can choose the method of settlement (see Section 3.2.3.3) (or the entity is required to settle in cash or other assets (see Section 3.2.3.1)), the award results in liability classification if it is probable the event will occur (see BDO Insight in Section 3.2.2.2). The probability assessment is generally performed on an individual grantee basis. If the cash settlement feature becomes exercisable upon an event that is **not** within the grantee's control and the **grantor** can choose the method of settlement (see Section 3.2.3.3), the award results in equity classification unless the substantive terms of the award indicate otherwise (see Section 3.2.6).

SEC registrants must also consider the requirements of ASC 480-10-S99-3A, which require the presentation of awards subject to cash settlement upon an event that is not solely within the entity's control as temporary or mezzanine equity (see Section 3.3).

Example 3-14 illustrates the application of the classification guidance in ASC 718 for an award that will be settled in cash upon the occurrence of an event.

EXAMPLE 3-14: SETTLEMENT IN CASH — CONTINGENT EVENT

FACTS

On January 1, 20X1, an entity grants 45,000 stock options to its new CFO. The award vests at the end of three years, at which point the CFO can require the entity to net cash settle the options but only upon a change in control.

CONCLUSION

The award is classified as equity. If the entity is an SEC registrant, it must evaluate whether temporary equity classification is required. Non-SEC registrants may apply the temporary equity classification guidance as a policy election (see Section 3.3).

ANALYSIS

Cash settlement is triggered only upon a change in control. A change in control is not within the grantee's control and is not considered probable to occur until it is consummated. Therefore, the award is equity-classified.

If the entity is an SEC registrant, it must evaluate whether temporary equity classification is required. Non-SEC registrants may choose to apply the temporary equity guidance as a policy election (see Section 3.3).

3.2.3.3 Optional Cash Settlement

FASB REFERENCES

ASC 718-10-25-15

Cash settlement for share-based payment awards may not be automatic (that is, it can occur upon election by either the grantee or grantor, in which case the accounting consequences may differ). If the **grantee** can choose to receive cash and can force the entity to pay in cash, the award is classified as **liability**. If the **entity** chooses the form of settlement (cash or stock), there is a presumption the entity will settle in stock. In that case, the award is classified as **equity** as long as the entity has enough authorized shares (see Section 3.2.6.2), there is no history of cash settlement (see Section 3.2.6.1), and no other features of the award result in liability classification (see Section 3.2). If the entity cannot avoid the obligation to transfer cash or other assets — for example, because grantees can compel the entity to settle the award in cash or other assets — the award must be classified as a liability.

Example 3-15 illustrates the application of the classification guidance in ASC 718 for an award that provides the grantee an optional cash settlement.

EXAMPLE 3-15: SETTLEMENT IN CASH — GRANTEE'S ELECTION

FACTS

Assume the same facts as in Example 3-14, except that the CFO can choose to settle the vested award in cash or in shares of the entity's common stock.

CONCLUSION

The award is classified as a liability.

ANALYSIS

The award provides the CFO the choice of requiring the entity to settle the stock options in either cash or shares of the entity's common stock. The choice of settlement is not contingent on the occurrence of an event. Once the award vests (based on passage of time), the CFO can choose the settlement method. Therefore, the award is classified as a liability.

Example 3-16 illustrates the application of the classification guidance in ASC 718 to an award that provides the grantor an optional cash settlement.

EXAMPLE 3-16: SETTLEMENT IN CASH — GRANTOR'S ELECTION

FACTS

Assume the same facts as in Example 3-14, except that the entity can choose to settle the award in cash or in shares of its common stock.

CONCLUSION

The award is classified as equity.

ANALYSIS

Unlike in Example 3-15, the award provides the entity the choice of settling the stock options in either cash or shares of its common stock. If the entity can choose the form of settlement, there is a presumption that the entity will settle in stock. Therefore, the award is classified as equity as long as the entity has enough authorized shares (see Section 3.2.6.2), there is no history of cash settlement (see Section 3.2.6.1), and no other features of the instrument result in liability classification (see Section 3.2).

3.2.4 Net Settlement

Share-based payment awards may be net settled either in cash or shares. For example, some awards can be net-cash settled through a broker-assisted cashless exercise (see Section 3.2.4.1) or to meet a statutory tax withholding requirement (see Section 3.2.4.3). Some awards can be net-share settled upon the grantor's (or grantee's) election to exercise the award on a cashless basis (see Section 3.2.4.2).

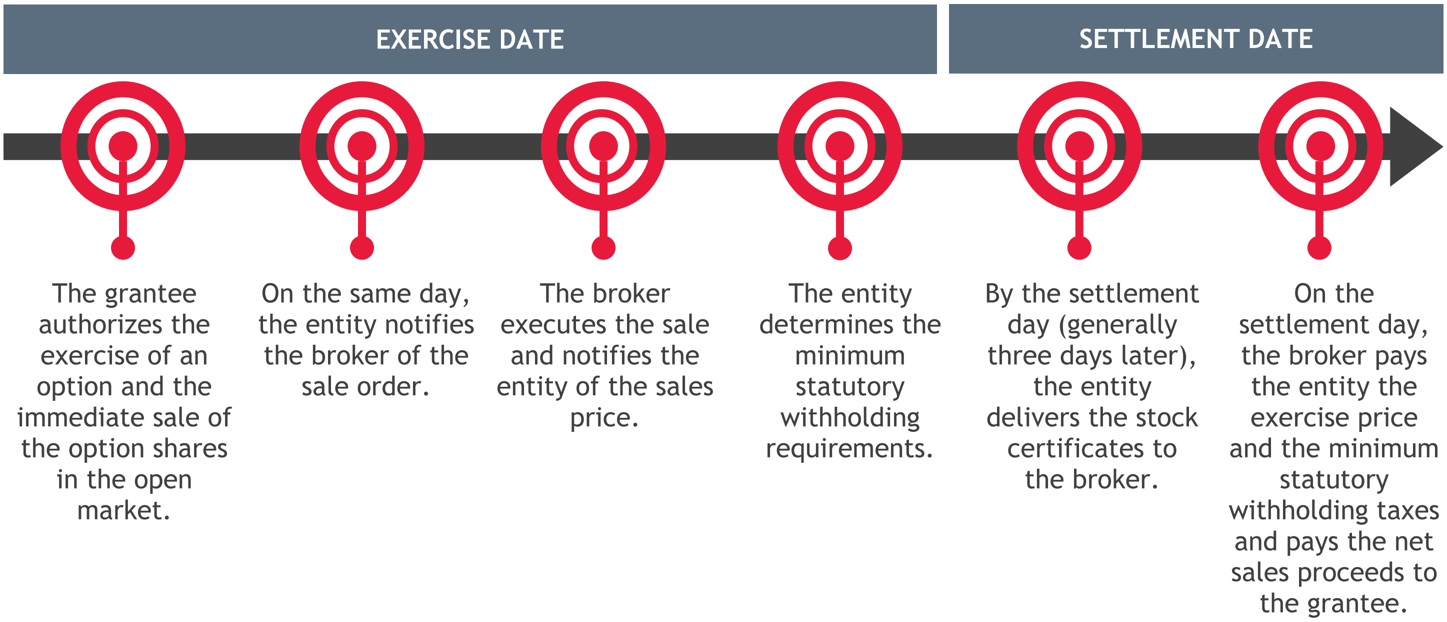
3.2.4.1 Broker-Assisted Cashless Exercise

FASB REFERENCES

ASC 718-10-20: Broker-Assisted Cashless Exercise and ASC 718-10-25-16 through 25-17

ASC 718 defines a broker-assisted cashless exercise as the simultaneous exercise by a grantee of a share option and sale of the shares through a broker. A portion of the proceeds acquired upon sale of the shares received upon exercise of the option is then remitted to the grantor to cover the exercise price and any tax withholding obligations. Then, the broker remits the net proceeds to the grantee and delivers the cash proceeds from selling the remaining shares to the grantee's account. In that scenario, the entity has not settled the awards in cash. Instead, it has delivered shares to settle the award, and the employee has sold those shares in the market and remitted cash back to the entity to settle the tax liability.

The diagram below illustrates that process.



A broker-assisted cashless exercise does not result in liability classification if **both** of the following criteria are met:

- The cashless exercise requires a valid exercise of the share options
- The grantee is the legal owner of the shares subject to the option (even though the grantee has not paid the exercise price before the sale of the shares subject to the option).

Also, if the broker is a related party of the entity that issued the awards, it would have to sell the shares in the public market within a normal settlement period (typically three days in the U.S.) and meet the two criteria above to avoid liability classification of the award.

3.2.4.2 Net-Share Settlement

Often, share-based payment awards are net-share settled, which means the grantee does not have to pay cash for the instrument's exercise price. In that case, no cash is exchanged, and the grantor delivers shares with a fair value equal to the instrument's intrinsic value to the grantee. Such transactions are commonly referred to as "cashless exercises." Net-share settlement provisions typically do not preclude equity classification of the award, assuming no other features of the instrument result in liability classification (see Section 3.2).

EXAMPLE 3-17: NET-SHARE SETTLEMENT TO SATISFY AN EXERCISE PRICE

FACTS

On January 1, 20X1, an entity grants its new CFO an award of 10,000 options to purchase common shares for an exercise price of $5 per option, which vests in equal annual installments over two years. The awards allow a cashless exercise whereby the entity delivers common shares based on the intrinsic value of the stock option upon exercise by the CFO (that is, there is no cash exchange between the entity and CFO).

On February 1, 20X3, the CFO decides to exercise the fully vested stock options. The share price of common stock on February 1, 20X3, is $15 per share. Instead of paying the exercise price of $5 per option, the CFO chooses net-share settlement to exercise the stock options. In other words, the CFO chooses cashless exercise.

CONCLUSION

The award is classified as equity.

ANALYSIS

Total net-share settlement = 6,666 shares of common stock ([$15 price per common share -$5 exercise price per option] * 10,000 stock options) / share price of $15). The cashless exercise feature does not preclude equity classification of the awards, assuming no other features of the stock option result in liability classification (see Section 3.2).

3.2.4.3 Statutory Tax Withholding Requirement

FASB REFERENCES

ASC 718-10-25-18 through 25-19A

If an employer withholds payment due to employees to meet statutory withholding requirements resulting from the exercise of stock options or vesting of restricted shares for awards that allow net settlement, liability classification is not required if **both** the following criteria are met:

- The employer has a statutory obligation to withhold taxes on the employee's behalf.
- The amount withheld does not exceed the maximum statutory tax rates in the employee's applicable jurisdictions. The maximum statutory rates are based on the applicable rates of the relevant tax authorities (federal, state, and local) and include the employee's share of payroll or similar taxes as provided in tax law, regulations or the authority's administrative practices. Further, they cannot exceed the highest statutory rate in the applicable jurisdiction, even if that rate exceeds the highest rate that may apply to the grantee. That assessment is performed jurisdiction by jurisdiction rather than using a blended rate across jurisdictions for all employees.

If those criteria are **not** met, the entire award, not just the amount withheld for tax purposes, is classified as a liability.

BDO INSIGHTS — STATUTORY TAX WITHHOLDING

The exception to liability accounting for statutory withholding does not apply to grantees for which the entity has no statutory obligation to withhold taxes. For example, amounts withheld to satisfy the tax obligation for nonemployee members of an entity's board of directors results in liability classification of the entire award. Although nonemployee directors are considered employees for other aspects of ASC 718, they are not considered employees under the IRS's statutory withholding requirements.

BDO INSIGHTS — FRACTIONAL SHARES

If an entity is unable to issue fractional shares (that is, it must withhold whole-number increments of shares from employees), it has the option to compensate the value of a fractional share in cash directly to the employee. We believe that rounding up the number of shares to fulfill the entity's statutory tax withholding obligation (up to the maximum statutory tax rate in the employee's relevant jurisdiction(s)) does not violate the principle in ASC 718-10-25-18 as long as the cash settlement for the fractional share is de minimis to the employee.

However, it is important for the entity to assess the facts and circumstances of each arrangement to determine whether it has created a liability and whether cash settlement for fractional shares remains insignificant to its employees. For example, an arrangement may be liability-classified if multiple exercises in small increments occur and the per-share price of the entity is exceptionally high, making the payment for a fractional share significant.

3.2.5 Indexation to Factors Other Than Market, Performance, or Service Condition

FASB REFERENCES

ASC 718-10-25-13 and ASC 718-10-55-65

In addition to share price, a share-based payment award may be indexed to a factor other than a service, performance, or market condition (see Section 4.2). Examples are an award whose exercise price is linked to fluctuations in the gross domestic product or a commodity, such as oil. Those awards are liability-classified because they are considered dual indexed, such that the grantee absorbs risks that are not based on the reporting entity's stock. In other words, the risk and benefit of holding such an award is based on something in addition to share ownership.

EXAMPLE 3-18: AWARD INDEXED TO A FACTOR OTHER THAN MARKET, PERFORMANCE, OR SERVICE CONDITION

FACTS

An entity grants an employee stock options with an exercise price equal to the market price of the entity's shares on the grant date. However, the exercise price is subject to annual adjustments based on changes in the consumer price index (CPI) until the employee exercises the stock options. On the grant date, the market price of the entity's shares is $100 per share and the CPI is at 100. The exercise price for the employee's stock options would be $100.

Over the next three years, the CPI fluctuates as follows: 102, 105, and 106.

CONCLUSION

The award is classified as liability.

ANALYSIS

Because the exercise price is adjusted annually based on the CPI, the exercise price for each year is calculated as:

- Year 1: $100 * (102/100) = $102
- Year 2: $102 * (105/102) = $105
- Year 3: $105 * (106/105) = $106

Because the exercise price varies with inflation (a factor that is not a market, performance, or service condition), the award is liability-classified.

BDO INSIGHTS —'OTHER' CONDITION VERSUS A PERFORMANCE OR MARKET CONDITION

A share-based payment award may be indexed to a factor in addition to the entity's share price. In that case, the award is considered dual indexed and must be classified as a liability unless the additional factor is a service, performance, or market condition (see Section 4.2). Therefore, it is important to determine whether the other factor qualifies as a service, performance, or market condition. That analysis can be complex when the award is based on the entity's share price performance or financial performance relative to an index or another peer entity (or group of peer entities). For example, consider an award that includes a performance condition that is based on the entity's EPS growth rate relative to a specified group of peer entities. We believe the award is classified as equity as long as the nature of the performance condition (that is, EPS) is the **same** for the entity and its peer entities. Said differently, if the award includes a performance condition that is based on the entity's EPS growth rate relative to the group of peer entities' pretax income growth rate, the award would be classified as a liability because the nature of the performance condition is not the same.

Determining whether a condition is indexed to a factor that is not a service, performance, or market condition requires the application of professional judgment based on the facts and circumstances.

3.2.5.1 Awards Denominated in Foreign Currency

FASB REFERENCES

ASC 718-10-25-14 through 25-14A

Share-based payment awards that are denominated in a foreign currency contain a factor other than a service, performance, or market condition because they are dual indexed to the entity's share price and the foreign currency, resulting in liability classification. However, such awards with a fixed exercise price denominated in a foreign currency can be classified as equity if they are **both**:

- Granted to employees or nonemployees of an entity's foreign operations
- The foreign currency is either the foreign operation's functional currency or the employee's payroll currency.

That exception also applies to awards with an exercise price denominated in the currency of a market where many of the entity's shares are traded, regardless of the entity's functional or payroll currency.

EXAMPLE 3-19: AWARD SETTLED IN A FOREIGN CURRENCY

FACTS

A U.S. entity (parent) owns a subsidiary in Japan. The parent grants share-based payment awards to its employees in Japan, with exercise prices denominated in Japanese yen. The subsidiary's financial statements are prepared using yen as the functional currency.

CONCLUSION

The award is classified as equity.

ANALYSIS

Because the exercise price and functional currency of the subsidiary are both yen and the awards are granted to employees of the parent's Japanese subsidiary, the awards meet the foreign currency exception under ASC 718-10-25-14 through 25-14A. As long as no other features of the awards require liability classification (see Section 3.2), the awards are equity-classified.

3.2.6 Substantive Terms of the Award

FASB REFERENCES

ASC 718-10-25-15

The accounting for a share-based payment award must reflect the substance of the award. The award's written terms usually provide the most reliable evidence of the award's substantive terms. However, there may be times when the substantive terms of the award differ from what is written in the award agreement. For example, an entity's past practice of cash settlement when it has the option to settle the award in cash or shares may indicate the award is in substance a liability (see Section 3.2.6.1), overcoming the presumption the entity will settle in stock (see Section 3.2.3.3). Conversely, an entity that grants a tandem award (see Section 3.2.6.3) under which the grantee has the option to receive an equity instrument or cash generally results in the award being liability-classified. Further, an award will be liability-classified when the issuing entity does not have the ability to deliver shares (see Section 3.2.6.2).

3.2.6.1 History of Cash Settlement

FASB REFERENCES

ASC 718-10-25-15

An entity's past practice of cash settlement may indicate that the award is in substance a liability. For example, consider a scenario in which an employee is granted restricted shares of an entity. The written terms of the award indicate that the award can be settled in cash or shares at the entity's option. Even though the entity has the option to settle the award in cash or shares (in which case there is a presumption that the entity will settle in stock (see Section 3.2.3.3)), the award would require liability classification if the entity has a history of settling awards in cash.

BDO INSIGHTS — DETERMINING WHETHER AN ENTITY HAS A HISTORY OF SETTLING AWARDS IN CASH

ASC 718 includes a general presumption that if an entity has the choice of settling a share-based payment award in cash or shares, the entity will settle the award in stock. However, the entity's past practice may override that share settlement presumption. For example, consider a scenario in which, because of hardship, an entity has settled awards in cash for two separate employees over the past three years. The entity has share-settled all other awards, including when the grantee has requested cash settlement but did not provide evidence of a valid need. In that case, we believe there likely is no history of cash settlement. In contrast, if the two employees requested cash settlement without a valid need and were the only employees to request cash settlement, we believe there is likely a history of cash settlement.

Determining whether an entity has a history of settling awards in cash requires the application of professional judgment based on the facts and circumstances. To facilitate that assessment, an entity should consider the following factors, among other facts and circumstances:

- The number of times the awards have been cash-settled
- The percentage of awards settled in cash versus shares.

3.2.6.2 Insufficient Authorized Shares

FASB REFERENCES

ASC 718-10-25-15(a) and ASC 815-40-35-12

If an award will be settled in shares, an entity considers whether it is able to deliver those shares. In other words, an entity must have enough authorized and unissued shares to settle the awards. In making that determination, ASC 718 clarifies that a requirement to deliver registered shares does not on its own result in liability classification of the award when assessing the entity's ability to deliver shares. Also, an entity must consider whether it has the ability to settle the award on a net basis (for example, based on a cashless exercise). Further, an entity must consider **all** outstanding instruments (including instruments outside the scope of ASC 718) when assessing whether it has enough authorized and unissued shares.

BDO INSIGHTS — ESTABLISHING A SEQUENCING POLICY

ASC 718 does not provide guidance on the allocation of authorized and unissued shares when multiple instruments are outstanding (including instruments outside the scope of ASC 718). We believe an entity must adopt a sequencing policy based on the guidance in ASC 815-40-35-12. Such policy must be systematic, rational, and consistently applied. See BDO Insights in Section 4.6.2.2 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments, for further discussion on the sequencing policy.

EXAMPLE 3-20: INSUFFICIENT AUTHORIZED AND UNISSUED SHARES

FACTS

- An entity has 200,000 authorized and unissued shares for its stock option plan.
- On January 1, 20X1, the entity grants to its employees one million at-the-money stock options exercisable for shares of common stock (the first award).
- The plan allows for settlement of the stock options in two ways at the entity's election: gross settlement (employee receives shares of common stock in exchange for cash payment for the exercise of stock options) and net-share settlement (cashless exercise (see Section 3.2.4.2)).
- The entity intends to settle the stock options through net-share settlement.
- As of January 1, 20X1, and December 31, 20X1, there are sufficient authorized and unissued shares to net-share settle the stock options.
- On November 15, 20X2, the entity grants an additional 800,000 stock options to new employees (the second award). The entity has adopted a sequencing policy to allocate the available shares by the instruments' issuance dates from earliest to latest. Based on this policy, the entity does not have sufficient authorized and unissued shares to net-share settle the second award.
- As of December 31, 20X2 (year-end date), the entity does not authorize more shares to cover the second award.

CONCLUSION

As of January 1, 20X1, December 31, 20X1, November 15, 20X2, and December 31, 20X2, the stock options in the first award are equity-classified because the entity intends to net-share settle the award and has sufficient authorized and unissued shares to do so.

As of November 15, 20X2, and December 31, 20X2, the stock options in the second award for which there are insufficient authorized and unissued shares is liability-classified.

ANALYSIS

The entity intends to settle the stock options through net-share settlement. While it does not have sufficient authorized and unissued shares to settle the stock options under gross settlement, the entity has sufficient authorized and unissued shares to net-share settle the stock options in the first award on the grant date and as of December 31, 20X1. However, the entity does not have sufficient authorized and unissued shares to net-share settle all stock options granted on November 15, 20X2. Because the entity adopted a sequencing policy to allocate the available shares by the instruments' issuance dates from earliest to latest, there are sufficient authorized and unissued shares to settle the first award as of November 15, 20X2 and December 31, 20X2.

On the other hand, the number of shares needed to net-share settle the stock options in the second award is insufficient. Therefore, the number of stock options issued in the second award for which there are insufficient authorized and unissued shares is classified as a liability. The entity continues to classify those stock options as a liability as of December 31, 20X2, because it still has not authorized additional shares to cover the second award.

3.2.6.3 Tandem Awards

FASB REFERENCES

ASC 718-10-20: Tandem Award, ASC 718-10-25-15, and ASC 718-10-55-116 through 55-130

Tandem awards consist of two or more components in which exercise of one part cancels the other(s). The components typically include settlement of the award in an equity instrument or cash. Further, the form of settlement is at the option of the grantee (see Section 3.2.3.3), so tandem awards are generally classified as a liability.

Example 3-21 outlines the accounting for a tandem award in which the grantees have a choice of stock options or cash-settled SARs.

EXAMPLE 3-21: SHARE OPTION OR CASH-SETTLED STOCK APPRECIATION RIGHTS (QUOTED FROM ASC 718-10-55-117 THROUGH 55-119)

ASC 718-10-55-117

Entity T grants to its employees an award of 900,000 share options or 900,000 cash-settled stock appreciation rights on January 1, 20X5. The award vests on December 31, 20X7, and has a contractual life of 10 years. If an employee exercises the stock appreciation rights, the related share options are cancelled. Conversely, if an employee exercises the share options, the related stock appreciation rights are cancelled.

ASC 718-10-55-118

The tandem award results in Entity T's incurring a liability because the employees can demand settlement in cash. If Entity T could choose whether to settle the award in cash or by issuing stock, the award would be an equity instrument unless Entity T's predominant past practice is to settle most awards in cash or to settle awards in cash whenever requested to do so by the employee, indicating that Entity T has incurred a substantive liability as indicated in paragraph 718-10-25-15. In this Case, however, Entity T incurs a liability to pay cash, which it will recognize over the requisite service period. The amount of the liability will be adjusted each year to reflect changes in its fair value. If employees choose to exercise the share options rather than the stock appreciation rights, the liability is settled by issuing stock.

ASC 718-10-55-119

The fair value of the stock appreciation rights at the grant date is $12,066,454, as computed in Example 1 (see paragraph 718-30-55-1 [BDO Example 4-34]), because the value of the stock appreciation rights and the value of the share options are equal. Accordingly, at the end of 20X5, when the assumed fair value per stock appreciation right is $10, the amount of the liability is $8,214,060 (821,406 cash-settled stock appreciation rights expected to vest × $10). One-third of that amount, $2,738,020, is recognized as compensation cost for 20X5. At the end of each year during the vesting period, the liability is remeasured to its fair value for all stock appreciation rights expected to vest. After the vesting period, the liability for all outstanding vested awards is remeasured through the date of settlement.

Tandem awards can include components that have different values after the grant date, depending on movements in the price of the entity's stock. Example 3-22 illustrates this concept.

EXAMPLE 3-22: PHANTOM SHARES OR SHARE OPTIONS (QUOTED FROM ASC 718-10-55-121 THROUGH 55-130)

ASC 718-10-55-121

Entity T grants to its chief executive officer an immediately vested award consisting of the following two parts:

a. 1,000 phantom share units (units) whose value is always equal to the value of 1,000 shares of Entity T's common stock
b. Share options on 3,000 shares of Entity T's stock with an exercise price of $30 per share.

ASC 718-10-55-122

At the grant date, Entity T's share price is $30 per share. The chief executive officer may choose whether to exercise the share options or to cash in the units at any time during the next five years. Exercise of all of the share options cancels all of the units, and cashing in all of the units cancels all of the share options. The cash value of the units will be paid to the chief executive officer at the end of five years if the share option component of the tandem award is not exercised before then.

ASC 718-10-55-123

With a 3-to-1 ratio of share options to units, exercise of 3 share options will produce a higher gain than receipt of cash equal to the value of 1 share of stock if the share price appreciates from the grant date by more than 50 percent. Below that point, one unit is more valuable than the gain on three share options. To illustrate that relationship, the results if the share price increases 50 percent to $45 are as follows.

	Units		*Exercise of Options*	
Market value	*$ 45,000*	*($45 x 1,000)*	*$ 135,000*	*($45 x 3,000)*
Purchase price	*—*		*90,000*	*($30 x 3,000)*
Net cash value	***$ 45,000***		***$ 45,000***	

ASC 718-10-55-124

If the price of Entity T's common stock increases to $45 per share from its price of $30 at the grant date, each part of the tandem grant will produce the same net cash payment (ignoring transaction costs) to the chief executive officer. If the price increases to $44, the value of 1 share of stock exceeds the gain on exercising 3 share options, which would be $42 [3 × ($44-$30)]. But if the price increases to $46, the gain on exercising 3 share options, $48 [3 × ($46-$30)], exceeds the value of 1 share of stock.

ASC 718-10-55-125

At the grant date, the chief executive officer could take $30,000 cash for the units and forfeit the share options. Therefore, the total value of the award at the grant date must exceed $30,000 because at share prices above $45, the chief executive officer receives a higher amount than would the holder of 1 share of stock. To exercise the 3,000 options, the chief executive officer must forfeit the equivalent of 1,000 shares of stock, in addition to paying the total exercise price of $90,000 (3,000 × $30). In effect, the chief executive officer receives only 2,000 shares of Entity T stock upon exercise. That is the same as if the share option component of the tandem award consisted of share options to purchase 2,000 shares of stock for $45 per share.

ASC 718-10-55-126

The cash payment obligation associated with the units qualifies the award as a liability of Entity T. The maximum amount of that liability, which is indexed to the price of Entity T's common stock, is $45,000 because at share prices above $45, the chief executive officer will exercise the share options.

ASC 718-10-55-127

In measuring compensation cost, the award may be thought of as a combination —not tandem—grant of both of the following:

a. 1,000 units with a value at grant of $30,000.
b. 2,000 options with a strike price of $45 per share.

ASC 718-10-55-128

Compensation cost is measured based on the combined value of the two parts.

ASC 718-10-55-129

The fair value per share option with an exercise price of $45 is assumed to be $10. Therefore, the total value of the award at the grant date is as follows.

	Amount
Units (1,000 x $30)	*$ 30,000*
Share options (2,000 x $10)	*20,000*
Value of award	*$ 50,000*

ASC 718-10-55-130

Therefore, compensation cost recognized at the date of grant (the award is immediately vested) would be $30,000 with a corresponding credit to a share-based compensation liability of $30,000. However, because the share option component is the substantive equivalent of 2,000 deep out-of-the-money options, it contains a derived service period (assumed to be 2 years). Hence, compensation cost for the share option component of $20,000 would be recognized over the requisite service period. The share option component would not be remeasured because it is not a liability. That total amount of both components (or $50,000) is more than either of the components by itself, but less than the total amount if both components (1,000 units and 3,000 share options with an exercise price of $30) were exercisable. Because granting the units creates a liability, changes in the liability that result from increases or decreases in the price of Entity T's share price would be recognized each period until exercise, except that the amount of the liability would not exceed $45,000.

3.3 TEMPORARY EQUITY (MEZZANINE) CLASSIFICATION

FASB REFERENCES

ASC 480-10-S99-3A, ASC 718-10-S99-1, and ASC 815-40-25

If a share-based payment award is not classified as a liability under ASC 718, SEC registrants and non-SEC registrants whose separate financial statements are filed with the SEC (such as for acquired or to be acquired businesses under Regulation S-X Rule 3-05[4], significant unconsolidated subsidiaries under Regulation S-X Rule 3-09, and subsidiary guarantors under Regulation S-X Rule 3-10) must consider whether the award is classified outside permanent equity (known as temporary or mezzanine equity) under ASC 480-10-S99-3A (see Chapter 5 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments), as discussed in SAB Topic 14.E, Questions 1 and 2, excerpted below.

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

E. FASB ASC Topic 718, Compensation—Stock Compensation, and Certain Redeemable Financial Instruments

Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer. [77] *FASB ASC Topic 718 provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as liabilities; however, some redeemable instruments will qualify for equity classification.* [78] *SEC Accounting Series Release No. 268, Presentation in Financial Statements of*

[4] S-X Rule 8-04 for smaller reporting companies.

"Redeemable Preferred Stocks," [79] *("ASR 268") and related guidance[80] address the classification and measurement of certain redeemable equity instruments.*

Facts: *Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder's option, but only after six months from the date of share issuance (as defined in FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of FASB ASC Topic 718. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e.g., redemption at the option of the holder) that are outside the control of the issuer.*

Question 1: *While the instruments are subject to FASB ASC Topic 718, is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under FASB ASC Topic 718?*

Interpretive Response: *Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements that are not classified as liabilities under FASB ASC Topic 718 result in the need to present certain amounts outside of permanent equity (also referred to as being presented in "temporary equity") in accordance with ASR 268 and related guidance.* [81]

When an instrument ceases to be subject to FASB ASC Topic 718 and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

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* [82] *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 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* [83] *value of the option should be presented as temporary equity at that date.*

---

[77] The terminology "outside the control of the issuer" is used to refer to any of the three redemption conditions described in Rule 5-02.27 of Regulation S-X that would require classification outside permanent equity. That rule 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.

[78] FASB ASC paragraphs 718-10-25-6 through 718-10-25-19A.

[79] ASR 268, July 27, 1979, Rule 5-02.27 of Regulation S-X.

[80] Related guidance includes EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities*, included in the FASB ASC in paragraph 480-10-S99-3A.

[81] Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which FASB ASC Section 815-40-25, *Derivatives and Hedging — Contracts in Entity's Own Equity — Recognition*, would otherwise require the assumption of net cash settlement. …

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

[83] The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

An award is classified as temporary or mezzanine equity if it is redeemable outside the entity's control for cash or other assets. For example, awards that are subject to redemption or repurchase at the holder's option, such as awards that allow the grantee to put the award to the entity at the current fair value six months after vesting, are classified as temporary or mezzanine equity by an SEC registrant (see Section 3.2.2). Similarly, awards that are redeemable upon the occurrence of an event (for example, a change in control) that is outside the entity's control are classified as temporary or mezzanine equity (see Section 3.2.3.2).

An entity initially recognizes a share-based payment award classified as temporary or mezzanine equity at its redemption amount. For instance:

- A stock option granted at-the-money that will be redeemed at its intrinsic value has an initial redemption amount of zero.
- A stock option granted in-the-money that will be redeemed at its intrinsic value has an initial redemption amount of the difference between the market value of the underlying share and the option's exercise price.
- A stock option that will be redeemed at fair value has an initial redemption amount at fair value.
- A stock option for which the underlying shares will be redeemed at fair value has an initial redemption amount at its intrinsic value; the underlying shares have a redemption amount at fair value after the option is exercised.

An award's redemption amount is remeasured at each reporting date based on the proportional requisite service period to date until the award is settled or reclassified to permanent equity. Changes in the redemption amount are recognized as adjustments to additional paid-in capital (APIC) rather than as compensation cost.

ASC 480-10-S99 also provides guidance on determining the amount reported in temporary or mezzanine equity for an award that is not currently redeemable because a contingency has not been met and it is not probable the instrument will become redeemable. In this case, no subsequent adjustment to the initial redemption amount is required. For instance, consider a stock option redeemable upon a change in control. If the stock option is in-the-money on grant date, its initial redemption amount (the in-the-money amount) is recognized in temporary equity as the option vests over the requisite service period. However, that initial redemption amount recognized in temporary equity is not subsequently adjusted because a change in control is not currently probable, so the option is not probable of becoming redeemable.

The probability of a contingent event occurring must be reassessed each reporting period. If the contingent event becomes probable, modification accounting applies, and the award is reclassified to a liability (see Section 5.4.1). ASC 480-10-S99 also provides guidance on reclassifying an instrument from permanent equity to temporary or mezzanine equity (see Section 5.9 of BDO's Blueprint, [Issuer's Accounting for Complex Financial Instruments]).

The tables below illustrate the accounting for temporary or mezzanine equity awards under different fact patterns.

	EXAMPLE 1: RESTRICTED SHARES PUTTABLE BEGINNING SIX MONTHS AFTER VESTING DATE
FACTS	▶ The fair value is $20,000 on January 1, 20X3 (grant date). ▶ Grantee has the right to put the shares at fair value after holding them for at least six months after vesting. ▶ The shares cliff vest in two years (December 31, 20X4). ▶ The fair value is $25,000 and $30,000 on December 31, 20X3 and 20X4, respectively.
INITIAL ACCOUNTING	▶ The restricted shares are not classified as liabilities under ASC 718 because the grantee bears the risks and rewards of equity ownership for a reasonable period after vesting (the grantee can redeem the shares at fair value beginning six months after vesting date). See Section 3.2.2.1. ▶ Because redemption is at the option of the holder, the restricted shares are classified as temporary equity. However, on the grant date, no redemption amount is recognized as temporary equity because the award is unvested.
SUBSEQUENT ACCOUNTING	▶ The entity recognizes compensation cost as the award vests for each of the Years 1 and 2 based on its grant-date fair value: Debit Compensation Cost $10,000 Credit Temporary Equity $10,000 To recognize compensation cost based on grant-date fair value ($20,000 grant-date fair value / 2 years = $10,000). ▶ The entity remeasures the award as it vests at redemption amount as of December 31, 20X3: Debit APIC $2,500 Credit Temporary Equity $2,500 To remeasure the awards at fair value as of December 31, 20X3 ($25,000 * 50% for 1 of 2 years of service rendered, less $10,000). ▶ The entity remeasures the fully vested award at redemption amount at December 31, 20X4: Debit APIC $7,500 Credit Temporary Equity $7,500 To remeasure the awards at fair value as of December 31, 20X4 ($30,000 - $22,500 temporary equity balance as of prior year).

EXAMPLE 2: STOCK OPTIONS REDEEMABLE UPON A CHANGE IN CONTROL — INTRINSIC VALUE ON GRANT DATE

FACTS

- The exercise price of $5,000 is less than the market value of the underlying shares of $7,000 on the grant date (in-the-money options).
- A cash settlement feature permits the employee to put the option to the entity at intrinsic value upon a change in control.
- A change in control is not probable at grant date or at the end of Years 1 or 2.
- The options cliff vest in two years.
- The grant-date fair value of options is $6,000.
- A change in control occurs three months after the options fully vest.
- The intrinsic value upon a change in control is $10,000.

INITIAL ACCOUNTING

- The options are not classified as liabilities under ASC 718 because their cash settlement depends on a change in control, which is not probable and neither the entity nor employee solely controls. See Section 3.2.3.2.
- Because redemption is contingent on an event (a change in control) that is not in the control of the grantee and is not probable, the award is classified as temporary equity.
- On the grant date, no initial redemption amount is recognized as temporary equity because the option is unvested. However, the initial redemption amount is subsequently recognized as the options vest over the requisite service period of two years. See "Subsequent Accounting." [5]

SUBSEQUENT ACCOUNTING

- The entity recognizes compensation cost as the award vests for each of the Years 1 and 2 based on its grant-date fair value.

Debit	Compensation Cost	$3,000	
Credit	APIC		$3,000

To recognize compensation cost ($6,000 grant-date fair value / 2 years = $3,000)

- Because the option has an intrinsic value on grant date ($2,000), that amount is recognized as temporary equity as the award vests. The entity records the following journal entry at the end of each Year 1 and 2.

Debit	APIC	$1,000	
Credit	Temporary Equity		$1,000

To reclassify the intrinsic value ($2,000 * 1 / 2 years) to temporary equity.

- When the change in control occurs (three months after the options fully vest), modification accounting applies (that is, incremental compensation cost is recognized, and the award is reclassified from equity to a liability (see Section 5.4.1)).

Debit	Temporary Equity	$2,000	
Debit	APIC	4,000	
Debit	Compensation Cost	4,000	
Credit	Share-based liability		$10,000

To recognize (1) share-based liability at intrinsic value when the change in control occurs and (2) compensation cost for the excess of the liability over the compensation cost previously recognized ($10,000 - $6,000 = $4,000)

---

[5] If the stock options are at-the-money on grant date, the initial redemption amount is zero, and there would be no redemption amount to be subsequently adjust in temporary equity until the change in control becomes probable.

3.4 ADDITIONAL CLASSIFICATION CONSIDERATIONS FOR NONPUBLIC ENTITIES

ASC 718 applies to share-based payment awards granted by entities (including nonpublic entities) in exchange for goods or services. However, ASC 718 includes special provisions for nonpublic entities (as defined in U.S. GAAP (see Section 2.4.3)) to ease compliance with the classification guidance for share-based payment transactions:

- **Mandatorily redeemable financial instruments** — ASC 480 specifically excludes from its scope mandatorily redeemable financial instruments issued by nonpublic entities that are not SEC registrants or controlled by SEC registrants and are either:
  - Not redeemable for a fixed amount or an amount determined by reference to an interest rate index, currency index, or another external index (for example, the instrument is redeemable at fair value)
  - Not redeemable at a fixed date (for example, redeemable upon the holder's death) (see Section 3.4.1).
- **Book value plans** — For nonpublic entities, share-based payment awards granted under a book value plan as described in Section 3.4.2 are not precluded from equity classification (assuming no other features in the awards result in liability classification).

3.4.1 Scope Exception for Mandatorily Redeemable Financial Instruments

FASB REFERENCES

ASC 718-10-25-8 and ASC 480-10-15-7A

In determining the classification of share-based payment awards under ASC 480, nonpublic entities must consider the scope exception related to ASC 480. The exception applies to some mandatorily redeemable financial instruments issued by nonpublic entities that are not SEC registrants (see Section 2.2.4 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments). For example, an award that must be redeemed upon an employee's termination of service or death at fair value on the redemption date is considered mandatorily redeemable under ASC 480 because such events are certain to occur. However, the scope exception for nonpublic entities would result in equity classification if all other requirements for equity classification in ASC 480 and ASC 718 are met.

3.4.2 Book Value Plans

FASB REFERENCES

ASC 718-10-25-9 and ASC 718-10-55-131 through 55-133

Nonpublic entities sometimes grant share-based payment awards under a book value plan that generally uses the entity's book value as the formula to determine the shares' purchase price. Typically, under a book value plan, employees must sell the shares back to the entity after termination at a price determined by the same formula.

The accounting for book value plans varies depending on factors such as whether the plan is compensatory or noncompensatory, and whether there are any repurchase features.

A book value plan is considered noncompensatory if the employee pays the same formula price as other shareholders of the same class of stock and receives the same formula price upon repurchase. For instance, if employees are required to sell any shares back to the entity upon retirement or other termination, the plan is not compensatory if the amount to be paid in the original sale and subsequent repurchase are calculated using the same formula price. In such cases, the formula price essentially establishes the fair value of the shares. If, however, the employee purchases shares at less than the formula price, the difference is considered compensatory. In other words, there is no compensation cost if the same formula price is used for all transactions in the same class of shares (or in substantially similar classes of shares).

However, the entity must still evaluate any repurchase features under ASC 718-10-25-9 to determine whether those features would cause the shares to be classified as liabilities. In other words, the grantee must be subject to the risks and rewards of share ownership for a reasonable period. If the repurchase price is measured at fair value and the repurchase feature can be exercised only after the share has been vested for six months, liability classification is not required (see Section 3.2.2).

A book value plan usually involves the issuance of shares, not stock options. However, if an entity with a book value plan issues options, compensation cost is recorded unless the employees pay an amount that is essentially equivalent to the options’ fair value (based on the formula price for the shares and the terms of the option). That is because the option gives the employee the right to buy the shares at a fixed price that may be lower than the formula price at the time of exercise, which represents an economic benefit for the employee.

Example 3-23 shows how to apply the guidance for book value plans.

EXAMPLE 3-23: BOOK VALUE PLANS FOR EMPLOYEES
(QUOTED FROM ASC 718-10-55-131 THROUGH 55-133)

ASC 718-10-55-131

A nonpublic entity that is not [an 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 share prices, such shares would be classified as liabilities pursuant to this Topic.

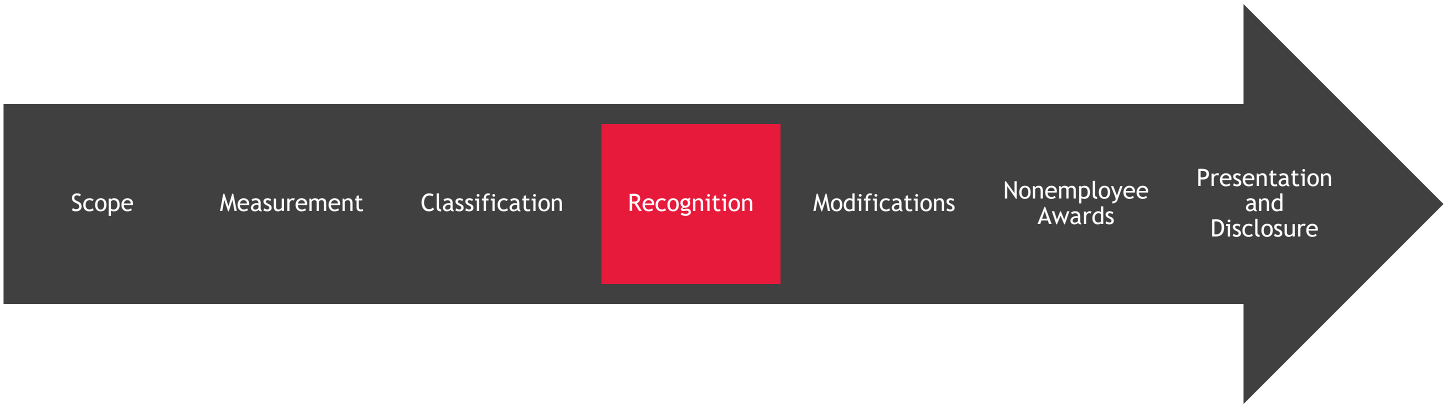
ASC 718-10-55-132

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.

Chapter 4 — Recognition



4.1 OVERVIEW

ASC 718 requires entities to recognize the services received in a share-based payment transaction as those services are received from the grantee. In other words, the value of a share-based payment award is generally recognized as compensation cost in the period when an entity consumes the services (or an employee provides the services) (see Sections 4.3 and 4.4) with the corresponding increase as equity or liability, depending on whether the award meets any of the liability criteria in ASC 718-10-25-6 through 25-19A (see Section 3.2). If an award is not classified as a liability under ASC 718, SEC registrants must consider whether the award is classified outside permanent equity (temporary or mezzanine equity) (see Section 3.3).

Grantees often must fulfill specific requirements to earn (or vest in) share-based payment awards, referred to as “vesting conditions.” Vesting conditions affect the timing and pattern of compensation cost and therefore are important when accounting for share-based payment awards (see Section 4.2).

Instead of services, entities may obtain goods in a share-based payment transaction. Further, in some cases, other U.S. GAAP may require capitalization of the compensation cost. For example, an entity may capitalize the cost of issuing a share-based payment award to acquire a good as inventory and later recognize it as cost of goods sold when the inventory is sold (see Section 4.9).

This chapter also discusses the following topics related to share-based payment arrangements:

CRITERIA	GUIDANCE
Clawback and noncompete provisions	Section 4.5
Financings to grantees in the form of recourse or nonrecourse notes	Section 4.6
Dividend-protected awards	Section 4.7
“Last man standing” arrangements	Section 4.8

4.2 VESTING CONDITIONS

FASB REFERENCES

ASC 718-10-20: Market Condition, Performance Condition, Service Condition, and Vest and ASC 718-10-55-65

Grantees typically must fulfill specific requirements to earn (or vest in) share-based payment awards, referred to as "vesting conditions." ASC 718 discusses two types of vesting conditions: service conditions (see Section 4.2.1) and performance conditions (see Section 4.2.3). Those vesting conditions affect the timing and pattern of compensation cost and therefore are important when accounting for share-based payment awards.

Unlike a service or performance condition, a market condition is **not** considered a vesting condition for purposes of recognizing compensation cost. In other words, compensation cost for an award with a market condition is recognized **regardless** of whether a market condition is satisfied. However, a market condition affects the fair value determination of a share-based payment award; therefore, it affects measurement of an award (see Section 4.2.2).

The table below provides definitions and examples of service, market, and performance conditions under ASC 718, as well as each condition's effect on compensation cost.

CONDITION	ASC 718 DEFINITION	EFFECT ON COMPENSATION	EXAMPLES
Service Condition	*"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."* (Emphasis added)	▶ Vesting condition is not considered in the grant-date fair value. ▶ Compensation cost is recognized if it is probable that the grantee will vest in the award and is generally recognized as the service condition is fulfilled.	▶ An award that vests if the grantee provides four years of service. ▶ An award that vests immediately upon a grantee's death, disability, or termination without cause.
Market Condition	*"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)… For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose."* (Emphasis added)	▶ Market condition is considered in the grant-date fair value. ▶ Compensation cost is recognized over the derived service period, regardless of whether the market condition is met.	▶ Award whose vesting is linked to the performance of the entity's stock or total shareholder return relative to a market index of peer entities. ▶ Award that vests when the entity achieves a stated market capitalization. ▶ Award that becomes exercisable when the underlying share price exceeds a specified amount. ▶ Award that vests upon achieving a specified internal rate of return (IRR) for a shareholder.

CONDITION	ASC 718 DEFINITION	EFFECT ON COMPENSATION	EXAMPLES
 Performance Condition	*"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 an explicitly or implicitly specified period.* *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)."* (Emphasis added)	▶ Vesting condition is not considered in the grant-date fair value. ▶ Compensation cost is generally recognized as service is rendered. ▶ Compensation cost is recognized only if it is probable that the performance condition will be satisfied.	▶ Award that vests upon attainment of regulatory approval by the entity. ▶ Award that vests if the entity completes a liquidity event, such as a change in control, IPO, or other financing event. ▶ Award that vests if the entity's sales increase by a specified percentage. ▶ Award that vests upon achievement by the entity of a defined EPS or EBITDA target.

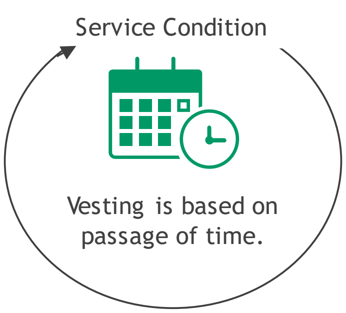
Service, performance, and market conditions can affect a share-based payment award beyond just vesting or exercisability, including its exercise price, contractual term, and quantity. When vesting conditions affect factors other than vesting or exercisability, entities need to determine the fair value of each potential outcome at the grant date and recognize compensation cost based on the actual performance outcomes (see Section 4.2.4).

Further, share-based payment awards may include repurchase features such as call options and put options. Such repurchase features may in substance function as vesting conditions (see Section 4.2.6).

4.2.1 Service Condition

FASB REFERENCES

ASC 718-10-20: Requisite Service Period and Service Condition, ASC 718-10-30-12, and ASC 718-10-55-87 through 55-88



A service condition requires an employee to remain employed for a specified period of time or for a nonemployee to deliver goods or services in order to earn (vest in) the share-based payment award. ASC 718 defines the period of time when an employee must provide service in exchange for the award as the "requisite service period." For nonemployees, it is simply referred to as a "vesting period" (see Section 6.5). A requisite service period may be explicit, implicit, or derived, depending on the terms of the award. Compensation cost for an award with only a service condition is recognized over the requisite service period.

Acceleration of vesting in the event of a grantee's death, disability or termination without cause is also a service condition. However, those types of service conditions do not affect the requisite service period until the triggering event (death, disability, or termination without cause) becomes probable. For example, if an award vests after four years of service or immediately upon the grantee's death, the requisite service period is initially four years and would be adjusted only in the event of the grantee's death within that period.

Share-based payment awards may cliff vest or vest on a graded schedule. Awards that fully vest upon completion of the requisite service period are known as cliff vesting awards, whereas awards that vest in increments (or tranches) over the requisite service period are known as graded-vesting awards. The vesting terms affect the recognition pattern of the award's compensation cost (that is, the award's expense attribution) (see Section 4.3).

BDO INSIGHTS — NONSUBSTANTIVE SERVICE CONDITION

In some instances, a service condition might not be substantive. If an award's service condition is not substantive, compensation cost is fully recognized on the grant date. For example, share-based payment awards may be granted to employees who are eligible for retirement as of the grant date. If the award's terms allow the employee to retain nonvested awards upon retirement, the awards are considered fully vested on the grant date even if they include an explicit service condition. In that scenario, the awards include a nonsubstantive service condition because the employees are not required to provide service after becoming eligible for retirement to retain the awards. Example 4-1 illustrates this concept. Determining whether a service condition is substantive requires judgment based on the facts and circumstances.

EXAMPLE 4-1: ESTIMATING THE EMPLOYEE'S REQUISITE SERVICE PERIOD (QUOTED FROM ASC 718-10-55-87 THROUGH 55-88)

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.

4.2.1.1 Types of Requisite Service Periods

FASB REFERENCES

ASC 718-10-20: Explicit Service Period and Implicit Service Period, ASC 718-10-30-25 through 30-26, ASC 718-10-35-5, and ASC 718-10-55-67 through 55-70

As discussed in Section 4.2.1, a requisite service period can be explicitly or implicitly stated in the terms of the award. The table below defines an explicit and implicit service period and provides examples of each.

Explicit Service Period	▶ The period stated in the terms of a share-based payment award during which the employee must provide continuous service to earn the award. • For example, an award that states that it vests after five years of continuous service has an explicit service period of five years.
Implicit Service Period	▶ The period that may be inferred from an analysis of an award's terms and other relevant facts and circumstances when not explicitly stated. • For example, the grantor must determine an implicit service period for an award that vests when a performance target is met as long as the employee remains employed until such time. If it is probable that the performance target will be met in two years, the implicit service period is two years (see Section 4.2.3).

Also, the requisite service period for an award with a market condition and no explicit service period is its derived service period (see Section 4.2.2).

An entity estimates the requisite service period at the grant date (or at the service inception date, if it precedes the grant date (see Section 4.3.2)) and recognizes compensation cost over that period. The initial estimate and any subsequent adjustment to that estimate is made based on an entity's analysis of the award's terms, including:

- Vesting and exercisability conditions, except for nonsubstantive conditions
- Explicit, implicit, and derived service periods
- Probability of performance or service conditions being met
- Other facts and circumstances, including the entity's past practices.

An award may have one or more explicit, implicit, or derived service periods (for example, if an award includes multiple vesting conditions (see Section 4.2.5)); however, it can have only one requisite service period for accounting purposes unless it is accounted for as multiple awards (for example, an award with a graded vesting schedule (see Section 4.3.1)). Service, market, and performance conditions typically have the following types of service periods.

	Service Condition	Market Condition	Performance Condition
Explicit service period	YES	YES	YES
Implicit service period			YES
Derived service period		YES	

If an award includes no market, performance, or service conditions, **all** the compensation cost must be recognized when the award is granted.

4.2.1.2 Forfeitures

FASB REFERENCES

ASC 718-10-35-3

The cumulative amount of compensation cost recognized by the end of a requisite service period is based on the number of awards for which the requisite service has been rendered. Said differently, compensation cost is recognized only for awards that vest, and any compensation cost previously recognized related to the awards for which the requisite service is not rendered is reversed. For example, consider an award with a service condition specifying the award vests in full after two years. If the grantee stops providing services before completing the two-year service requisite service period, any previously recognized compensation cost is reversed on the date the grantee no longer provides services. ASC 718 describes that concept as a forfeiture.

ASC 718 provides two policy elections for accounting for forfeitures related to employee share-based payment awards:

ESTIMATE FORFEITURES

An entity can elect to estimate forfeitures when awards are granted (and update the estimate if new information suggests actual forfeitures will differ from previous estimates). Changes in the estimated number of awards affecting both current and prior periods are recognized in the period of the change, resulting in adjustments to compensation cost (see Section 4.2.1.2.1).

ACCOUNT FOR FORFEITURES AS INCURRED

An entity can elect to account for forfeitures when they occur. Initially, compensation cost is recognized for all awards, ignoring forfeiture expectations. Forfeitures are recognized in the period when they happen. If a forfeiture occurs after period end but before the financial statements are issued, the reversal for known forfeitures is not accelerated (see Section 4.2.1.2.2).

The accounting policy election for forfeitures must be applied to **all** share-based payment awards issued to employees (that is, it is an entity-wide policy election). Regardless of its policy election to either estimate forfeitures or account for forfeitures as incurred, an entity must determine whether some or all of the awards are probable of vesting upon a modification (see Chapter 5).

ASC 718 also requires accounting for forfeitures related to share-based payment awards issued to nonemployees, including awards issued to customers (see Section 6.5.1.1).

4.2.1.2.1 Estimating Forfeitures

FASB REFERENCES

ASC 718-20-55-4 through 55-4A and ASC 718-20-55-5 through 55-25

Entities that estimate forfeitures recognize compensation cost based on the estimated number of share-based payment awards expected to ultimately vest over the requisite service period. For example, if an entity estimates that 10 of 100 employees will forfeit unvested awards (a forfeiture rate of 10%), and total compensation cost is $100,000, then compensation cost of $90,000 (after factoring in the 10% forfeiture rate) is recognized over the requisite service period. If one employee leaves and forfeits the award, the entity must estimate how many of the remaining 99 employees will forfeit their awards. If the employee's forfeiture was part of the original estimate of 10 employees and the entity does not believe that any more forfeitures will occur beyond the original estimate of 10 employees, the entity would adjust its forfeiture estimate to 9% (9 of 99 employees). However, if the employee's termination was not originally expected and the entity continues to expect 10 of the remaining 99 employees will forfeit unvested awards, the entity would maintain its original forfeiture rate of 10% (10 of 99 employees).

If an award includes a performance condition, an entity must first assess the probability of achieving the performance condition. If the performance condition is probable of achievement, the entity estimates forfeitures. However, if the performance condition is not probable of achievement, the entity does not recognize compensation cost for the award and therefore does not estimate forfeitures (see Section 4.2.3).

COMPENSATION COST MUST AT LEAST EQUAL GRANT-DATE FAIR VALUE AT VESTING DATE

Compensation cost recognized as of any date must at least equal the grant-date fair value of the vested portion of the award on that date. If not, entities must true-up compensation cost for share-based payment awards at the vesting date so that compensation cost at least equals the grant-date fair value of the awards. In particular, entities should pay close attention to awards with service conditions that have graded vesting schedules (see Section 4.3.1) when it has elected to estimate forfeitures.

For example, an entity grants 50,000 awards to its employees at a total grant-date fair value of $500,000. The awards vest over four years based on a graded schedule with 25% vesting at the end of each year of service. The entity elects to recognize compensation cost using the straight-line method (see Section 4.3.1). The entity elects to estimate forfeitures and determines a 10% forfeiture rate. Accordingly, the entity recognizes annual compensation cost of $112,500 ($500,000 * 90% / 4 years). At the end of Year 1, there were no actual forfeitures, and the entity continues to estimate a forfeiture rate of 10% for the remaining unvested awards. Compensation cost as of the end of Year 1 must at least equal the grant-date fair value of the vested portion of the award as of the end of Year 1 of $125,000 ($500,000 / 4 years). As a result, the entity must recognize additional compensation cost of $12,500 as of Year 1 to reflect that all the first 25% tranche of the graded vesting schedule vested with no forfeitures.

In deriving an estimated forfeiture rate for employees, the following sources could be considered:

- Historical rates of forfeiture for awards with similar terms
- Historical rates of employee turnover (before vesting)
- The award’s intrinsic value on the grant date
- The volatility of the entity’s share price
- The length of the vesting period
- The number and value of awards granted to individual employees
- The nature and terms of the award’s vesting condition(s)
- The employee’s characteristics, such as whether the employee is a member of executive management of the entity
- A large population of relatively homogenous employee grants
- Other relevant terms and conditions of the award that may affect forfeiture behavior.

BDO INSIGHTS — ESTIMATING FORFEITURES BASED ON INFORMATION FROM PEER ENTITIES

An entity may not have sufficient historical information to estimate forfeitures; for example, if the entity is newly formed. In that case, an entity can use forfeiture rates from peer entities until it has sufficient information to estimate its own forfeiture rates. That is consistent with ASC 718-10-55-25 on deriving option-pricing assumptions (see Section 2.3.2.3.3). We believe judgment is required when determining which peer entities are appropriate.

Further, an entity must reassess its estimated forfeiture rate throughout its employees’ requisite service periods and adjust the rate as needed. Any resulting adjustment is accounted for as a change in estimate and therefore recognized as a cumulative-effect adjustment (see Example 4-2).

Example 4-2 illustrates how to determine compensation cost when changes occur in the estimated number of forfeitures during an employee’s requisite service period.

EXAMPLE 4-2 (ADAPTED FROM ASC 718-20-55-4 THROUGH 55-24, CASE A): STOCK OPTIONS WITH CLIFF VESTING AND FORFEITURES ESTIMATED IN INITIAL ACCRUALS OF COMPENSATION COST

FACTS

- On January 1, 20X5, an entity grants 900,000 at-the-money employee stock options with a grant-date fair value of $14.69 per option. All stock options vest at the end of three years (cliff vesting), which is an explicit (and requisite) service period of three years.
- The entity's accounting policy is to estimate the number of forfeitures expected to occur.
- The entity has experienced historical turnover rates of approximately 3% per year for employees at the grantees' level, and it expects that rate to continue over the requisite service period of the awards.
- On January 1, 20X6, management decides that the forfeiture rate will likely increase through 20X7 and changes its estimated forfeiture rate for the entire award to 6% per year.

CONCLUSION

Compensation cost in Year 1 is calculated based on an estimated forfeiture rate of 3% per year. The change in estimated forfeiture rate as of December 31, 20X6, is accounted as a cumulative effect adjustment.

ANALYSIS

The entity's accounting policy is to estimate the number of forfeitures expected to occur. The entity initially determined that the estimated forfeiture rate is 3% per year. Therefore, the number of stock options expected to vest is estimated at the grant date to be 821,406 (900,000 * $.97^{\wedge 3}$). Thus, the compensation cost to be recognized over the requisite service period at January 1, 20X5, is $12,066,454 (821,406 * $14.69), and the compensation cost to be recognized during each year of the three-year vesting period is $4,022,151 ($12,066,454 / 3).

The journal entry to recognize compensation cost for 20X5 is:

Debit	Compensation cost	$ 4,022,151	
Credit	APIC		$ 4,022,151

To recognize compensation cost.

On December 31, 20X6, management's estimated employee forfeiture rate increases from 3% to 6% per year. The revised number of stock options expected to vest is now 747,526 (900,000 * $.94^{\wedge 3}$). Accordingly, the revised cumulative compensation cost to be recognized by the end of 20X7 is $10,981,157 (747,526 * $14.69). The cumulative adjustment to reflect the effect of adjusting the forfeiture rate is the difference between two-thirds of the revised cost of the award and the cost already recognized for 20X5 and 20X6. The computations at December 31, 20X6, to adjust for new forfeiture rate are:

Revised total compensation cost	$	10,981,157
Revised cumulative cost as of December 31, 20X6 ($10,981,157 * 2/3)	$	7,320,771
Cost already recognized in 20X5 and 20X6 ($4,022,151 * 2)		8,044,302
Adjustment to cost at December 31, 20X6	$	(723,531)

The journal entry for 20X6 is:

Debit	APIC	$ 723,531	
Credit	Compensation cost		$ 723,531

To adjust previously recognized compensation cost and equity to reflect a higher estimated forfeiture rate.

The journal entry for 20X7 is:

Debit	APIC	$ 3,660,386	
Credit	Compensation cost		$ 3,660,386

To recognize compensation cost of $3,660,386 ($10,981,157 / 3).

As of December 31, 20X7, the entity would examine its actual forfeitures and make any necessary adjustments to reflect cumulative compensation cost for the number of shares that actually vested.

4.2.1.2.2 Accounting for Forfeitures as Incurred

FASB REFERENCES

ASC 718-20-55-4 through 4A, ASC 718-20-55-5 through 55-9, and ASC 718-20-55-34A through 55-34G

An entity that elects the policy to account for forfeitures as they occur recognizes compensation cost, assuming the service condition will be completed. If the service condition is not completed and the award is forfeited, previously recognized compensation cost for the unvested award is reversed in the period the award is forfeited. That election applies only to the service condition of an award. If an award also includes a performance condition, an entity must continually assess the probability of achieving the performance condition at each reporting period (see Section 4.2.3). Also, if an award includes a market condition that is not satisfied, resulting in forfeiture of the award, compensation cost is not reversed if the service condition is met (see Section 4.2.2).

Example 4-3 illustrates the calculation of compensation cost when forfeitures are recognized as incurred.

EXAMPLE 4-3 (ADAPTED FROM ASC 718-20-55-34A THROUGH 55-34G, CASE A): STOCK OPTIONS WITH CLIFF VESTING AND FORFEITURES RECOGNIZED WHEN THEY OCCUR

FACTS

- Assume the same facts as in Example 4-2, except that the entity accounts for forfeitures when they occur.
- In 20X5, 20X6, and 20X7, stock option forfeitures are 45,000, 47,344, and 60,130, respectively.

CONCLUSION

Compensation cost for Years 1, 2, and 3 is initially recognized, assuming all awards vest. Previously recognized compensation cost related to awards forfeited in each of the years is reversed.

ANALYSIS

The entity accounts for forfeitures when they occur. Consequently, compensation cost previously recognized for an employee stock option is reversed in the period when forfeiture occurs. Previously recognized compensation cost is not reversed if an employee stock option for which the requisite service has been rendered expires unexercised.

At January 1, 20X5, the compensation cost to be recognized over the requisite service period is $13,221,000 (900,000 * $14.69), and the compensation cost to be recognized (excluding the effect of forfeitures) during each year of the three-year vesting period is $4,407,000 ($13,221,000 / 3).

The journal entry for 20X5 to recognize compensation cost is:

Debit	Compensation cost	$ 4,407,000	
Credit	APIC		$ 4,407,000

To recognize compensation cost excluding the effect of forfeitures for 20X5.

During 20X5, 45,000 stock options are forfeited; accordingly, the entity remeasures compensation cost to reflect forfeitures when they occur and recognizes compensation cost for 855,000 (900,000 - 45,000) stock options (net of forfeitures) at $12,559,950 (855,000 * $14.69) over the three-year vesting period, or $4,186,650 each year ($12,559,950 / 3). Therefore, the entity reverses compensation cost of $220,350 (45,000 stock options * $14.69 / 3) to account for forfeitures during 20X5. The journal entry to recognize the effect of forfeitures during 20X5 is:

Debit	APIC	$ 220,350	
Credit	Compensation cost		$ 220,350

To recognize the effect of forfeitures on compensation cost when they occur for 20X5.

As of January 1, 20X6, the entity determines the compensation cost to recognize during 20X6. The journal entry for 20X6 to recognize compensation cost (excluding the effect of forfeitures in 20X6) is:

Debit	Compensation cost	$ 4,186,650	
Credit	APIC		$ 4,186,650

To recognize compensation cost excluding the effect of awards that forfeited during 20X6.

The entity would follow the same approach in 20X7 that it applied in 20X6.

4.2.2 Market Condition

FASB REFERENCES

ASC 718-10-20: Derived Service Period and Market Condition, ASC 718-10-30-14, ASC 718-10-35-4, and ASC 718-10-55-71

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

- A specified price of the entity's shares: for example, an award that is exercisable when the entity's share price exceeds $50 per share.
- A specified amount of intrinsic value indexed solely to the entity's share: for example, a stock option that is exercisable when its intrinsic value (the difference between the entity's share price and the stock option's exercise price) is at least $5 per stock option.
- A specified price of the entity's shares in terms of a similar (or index of similar) equity security (securities): for example, an award that is exercisable when the entity achieves a return on its stock that at least equals the average three-year return of the S&P 500.
- A specified return on the entity's share price based on invested capital, such as IRR or multiple on invested capital (MOIC): for example, an award earned by the grantee when the entity's annual compounded IRR is at least 20% per year.
- A specified threshold of the entity's stock price in comparison to a peer group of entities' average stock price: for example, an award that vests when the 30-day average stock price of an entity's stock exceeds that of peer entity A.

Unlike a service or performance condition, a market condition is **not** considered a vesting condition for purposes of recognizing compensation cost. In other words, compensation cost for an award with a market condition is recognized **regardless** of whether a market condition is satisfied. Instead, the fair value of the award incorporates the likelihood of achieving market condition. As a result, entities will typically need to use a more sophisticated valuation model, such as a lattice model, to value awards with market conditions (see Section 2.3.1.2).

An award with a market condition may also include an explicit service period; if it does not, the grantor must estimate the service period. The period over which an award with a market condition is recognized is called a "derived service period." A derived service period is inferred from the application of valuation methods used to estimate the fair value of an award with a market condition. For example, assume the fair value of an award with a market condition is estimated using a Monte Carlo simulation, which simulates multiple share-price paths over time (see Section 2.3.1.2). Some paths show an increase in share price, while others show a decrease. The median path, where 50% of paths take more time and 50% take less time to meet the market condition, is selected. The derived service period is then calculated as the time from the service inception date (usually the grant date) to the first occurrence of the market condition on the median path.

If an award has a market condition with a derived service period **and** does not have an explicit service period…

…the derived service period becomes the requisite service period for recognizing the compensation cost.

The requisite service period is **not** revised **unless** the market condition is met before the end of the derived service period. For example, consider a scenario in which an entity issues to an employee an award with a market condition. The award does not include a service or performance condition. Therefore, the derived service period, which is calculated as three years, is the requisite service period. If, after the grant date, facts change such that the market condition is not probable of being met within the three-year period, the requisite service period is not adjusted. Compensation cost continues to be recognized over the three-year period, and cumulative compensation cost recognized to-date is not reversed despite the market condition no longer being probable of achievement during the requisite service period. Conversely, if the market condition is achieved before the end of the three-year period, the grantor accelerates recognition so that the remaining compensation cost is fully recognized on the date the market condition is met.

The accounting considerations for an award that is solely based on a market condition are summarized below.

Initial recognition

Compensation cost is recognized over the requisite service period regardless of whether a market condition is satisfied as long as the grantee continues to provide service to the entity.

Subsequent recognition

Previously recognized compensation cost is:

Reversed **only** if the grantee does not provide goods or services to the entity (that is, employee is terminated).

Not reversed if the grantee continues to provide goods or services to the entity, even if the market condition is not met.

Example 4-4 illustrates this concept.

EXAMPLE 4-4: AWARD SUBJECT TO A MARKET CONDITION

FACTS

An entity grants its CFO 25,000 stock options at a grant-date fair value of $2 per stock option. The exercise price of the stock options is $5 per stock option, and the contractual term is 10 years. The options can be exercised only if the entity's share price reaches at least $10 per share for 15 consecutive trading days (the market condition). The entity's accounting policy is to account for forfeitures as they occur.

Further, assume the following scenarios:

- Scenario 1: CFO is employed through the end of the five-year derived service period. Market condition is not met at any point during the derived service period.
- Scenario 2: Market condition is met in Year 4, and CFO remains employed.
- Scenario 3: CFO terminates employment in Year 5 before the end of the derived service period and before the market condition is met.

CONCLUSION

For Scenario 1, compensation cost is recognized over the derived service period because the CFO continues to provide service throughout the period, regardless of whether the market condition is met.

For Scenario 2, compensation cost is recognized each year over the derived service period. In Year 4, the remaining compensation cost is fully recognized when the market condition is met.

For Scenario 3, any previously recognized compensation cost is reversed in Year 5 because the CFO terminates employment before completing the derived service period and before the market condition is met.

ANALYSIS

The award does not specify an explicit service period. Therefore, the entity determines a derived service period using a path-dependent pricing model. It uses the lattice model and projects that the market condition will be met over five years (the derived service period). As a result, compensation cost will be recognized during that five-year derived service period unless the CFO terminates employment with the entity during that time, in which case previously recognized compensation cost is reversed.

Compensation cost recognized for each of the three scenarios is listed in the table below.

Total compensation cost of award	25,000 * $2 = $50,000
Annual compensation cost	$50,000 / 5 years = $10,000

	SCENARIO 1	SCENARIO 2	SCENARIO 3
Year 1	$ 10,000	$ 10,000	$ 10,000
Year 2	10,000	10,000	10,000
Year 3	10,000	10,000	10,000
Year 4	10,000	20,000	10,000
Year 5	10,000	—	(40,000)
Total compensation cost	$ 50,000	$ 50,000	$ —

4.2.3 Performance Condition

FASB REFERENCES

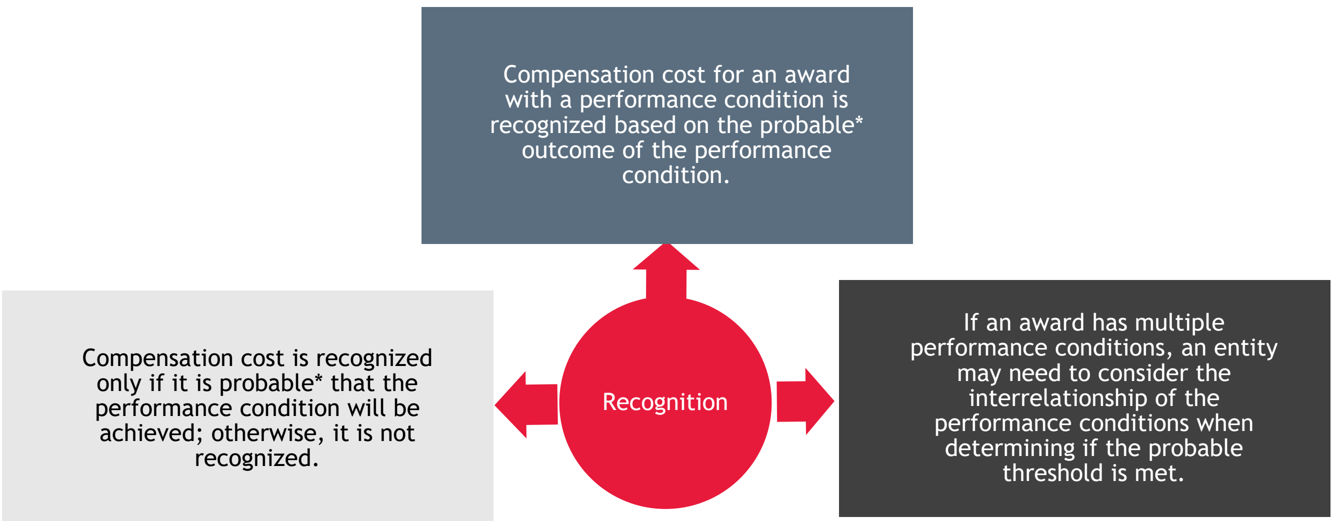
ASC 718-10-20: Explicit Service Period, Implicit Service Period, Performance Condition, and Probable, ASC 718-10-25-20 and ASC 718-10-55-69 through 55-70

A performance condition affects the vesting, exercisability, exercise price, or other factors used in the determination of the fair value of a share-based payment award and relates to **both**:

- Providing service or delivering goods for an explicitly or implicitly specified period
- Achieving a specified performance target related to the grantor's operations (or activities) or the grantee's performance.

Unlike a market condition (see Section 4.2.2), a performance condition is not directly factored into the award's fair value or measurement.

The accounting for awards with performance conditions is summarized below.



* ASC 718 defines the term "probable" as "likely to occur." For further discussion on the probable threshold, refer to BDO Insights in Section 3.2.2.2.

As discussed in Section 4.2.1.1, compensation cost is recognized in the period in which the employee provides the services (that is, over the requisite service period). In awards with a performance condition, the requisite service period can be explicit or implicit. An explicit service period is directly stated in an award's terms. For example, if an award vests upon achievement of a specific sales target by an entity over the next two years, the explicit service period is two years. An implicit service period is not explicitly stated in an award's terms but is inferred from an analysis of those terms and other facts and circumstances. For example, if an award vests upon achievement of a specific sales target without a stated period, but the entity estimates that the sales target will be achieved in four years based on financial projections, the implicit service period is four years. Accordingly, compensation cost for an award with a performance condition that is probable of being achieved is generally recognized ratably over the explicit or implicit service period.

EXAMPLE 4-5: PERFORMANCE AWARD WITH EXPLICIT SERVICE PERIOD

FACTS

On January 1, 20X4, an entity grants its CFO 100,000 at-the-money stock options with a grant-date fair value of $10 per stock option. The stock options will vest if the entity achieves a 25% increase in cumulative net revenues over the next four fiscal years. Further, the CFO will forfeit the stock options upon termination with the entity during the four-year period. The entity elects to account for forfeitures as incurred.

CONCLUSION

The stock options contain a performance condition and an explicit service period.

ANALYSIS

The stock options will vest if (1) the CFO provides service for an explicit period (four years) and (2) the entity achieves a specified performance target (25% increase in cumulative net revenues) during the explicit service period. Therefore, the stock options contain a performance condition. If the performance condition is probable of being achieved, compensation cost is recognized ratably over the explicit service period of four years. If the performance condition is not probable of being achieved, compensation cost is not recognized. Further, if the CFO leaves the entity before the performance condition is achieved during the four-year period, any compensation cost recognized to date is reversed on the termination date.

EXAMPLE 4-6: PERFORMANCE AWARD WITH IMPLICIT SERVICE PERIOD

FACTS

Assume the same facts as in Example 4-5, except the stock options' terms are silent on the period in which the specified performance target (25% increase in cumulative net revenues) must be achieved. The entity's financial projections indicate that cumulative net revenues will have increased by 25% at the end of Year 3.

CONCLUSION

The stock options contain a performance condition and an implicit service period of three years.

ANALYSIS

Unlike in Example 4-5, the award does not specify an explicit service period. Instead, an implicit service period is estimated based on the stock options' terms and other facts and circumstances. The entity's financial projections indicate that cumulative net revenue will have increased by 25% at the end of Year 3. Therefore, the stock options have a performance condition because they will vest if (1) the CFO provides service for the implicit period of three years and (2) the entity achieves a specified performance target of a 25% increase in cumulative net revenues.

The following sections address common performance conditions associated with share-based payment awards:

TOPIC	GUIDANCE
Performance conditions based on liquidity events	Section 4.2.3.1
Performance conditions based on regulatory approval	Section 4.2.3.2
Performance conditions satisfied after requisite service period	Section 4.2.3.3
Performance conditions with carryback and carryforward provisions	Section 4.2.3.4
Implied performance condition	Section 4.2.3.5
Change in estimate of probability of a performance condition	Section 4.2.3.6

4.2.3.1 Performance Conditions Based on Liquidity Events

FASB REFERENCES

ASC 805-20-55-50 through 55-51

Some awards vest only upon the occurrence of liquidity events such as a change in control or IPO. The occurrence or nonoccurrence of a liquidity event represents a performance condition. Compensation cost for awards that include performance conditions is recognized only when such conditions become probable.

BDO INSIGHTS — PROBABLE THRESHOLD FOR SOME LIQUIDITY EVENTS

As discussed in the BDO Insights in Section 3.2.2.2, we believe the term "probable" generally means at least 75% likely to occur. In practice, however, liquidity events are not considered probable until they actually occur. ASC 805-20-55-51 states "*…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.*" While that guidance applies specifically to business combinations, we believe it should be applied by analogy to other liquidity events that are not solely in the grantor's control, such as an IPO.

An exception to the probability assessment on liquidity events relates to a sale of a portion of an entity's business (for example, a business unit or subsidiary) to a third party. In other words, a sale of a portion of an entity's business may be probable before it actually occurs. In that case, we believe an entity should consider the held-for-sale criteria in ASC 360, *Property, Plant, and Equipment,* when determining whether such a sale is probable. Determining whether a sale of a portion of an entity's business is probable requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 4-7: AWARD VESTS ONLY UPON A CHANGE IN CONTROL

FACTS

On January 1, 20X4, an entity grants its CEO 5,000 stock options. The stock options will vest upon a change in control, which is defined as a sale of more than 50% of the entity's shares to a third party. No other vesting conditions are included in the terms of the stock option agreement.

On July 1, 20X7, the entity signs a letter of intent to sell 60% of its shares to an unrelated investor within the next 12 months. On that date, the entity assesses the likelihood of the change in control occurring to be 90%.

The change in control closes December 31, 20X7.

CONCLUSION

The change in control is not considered probable until it closes on December 31, 20X7.

ANALYSIS

We believe a change in control is not probable until it actually occurs. As a result, compensation cost for the stock options is not recognized until the completion of the change in control on December 31, 20X7.

4.2.3.2 Performance Conditions Based on Regulatory Approval

FASB REFERENCES

ASC 718-10-20: Performance Condition and Probable

Obtaining regulatory approval to market a specified product is a type of performance condition. In the pharmaceutical industry, for example, an award may vest when regulatory approval for a new drug is obtained. Entities must assess whether a performance condition based on the attainment of a regulatory approval is probable. If obtaining a regulatory approval is probable, compensation cost for the award is recognized.

ASSESSING THE PROBABILITY OF REGULATORY APPROVAL REQUIRES JUDGMENT

Entities must evaluate whether obtaining regulatory approval is probable to determine when to recognize compensation cost. As part of that assessment, entities should consider the type of regulatory approval and the regulator's history of approving or denying similar proposals. For example, we believe it is rare for an entity to conclude that the U.S. Food and Drug Administration's approval of a drug candidate is probable before the approval date. Reaching a conclusion about whether a regulatory approval is probable requires the application of professional judgment based on the facts and circumstances.

4.2.3.3 Performance Conditions Satisfied After Requisite Service Period

FASB REFERENCES

ASC 718-10-30-28 and ASC 718-10-55-87 through 55-88

As discussed in Section 4.2.1.1, the requisite service period is the period over which compensation cost is recognized. Generally, the service period is commensurate with the achievement of a performance condition. For example, if an entity grants awards that will vest upon achievement of a specified EBITDA target, and the entity determines the specified EBITDA target will be met in three years, the implicit service period for the award is three years.

However, in some cases, the service period is **not** commensurate with the achievement of the performance condition. In other words, the grantee is entitled to earn the award regardless of whether it continues to provide goods or services until the date the performance condition is achieved. In those instances, if the performance condition is probable of being met, compensation cost is recognized over the requisite service period (that is, only the period the grantee must provide service). If the performance condition is not achieved, compensation cost recognized to date is reversed. On the other hand, if compensation cost was not recognized because the performance condition was not probable of being met while the grantee was providing service and the performance condition is later achieved, compensation cost is immediately recognized on the date the performance condition is met (or becomes probable of being met) even if the grantee is no longer providing goods or services at that point.

An example of an award with a service period that is not commensurate with the achievement of a performance condition is an award granted to an employee who is eligible for retirement and that allows a performance condition to be achieved after the employee's retirement. Example 4-8 illustrates this concept.

EXAMPLE 4-8: PERFORMANCE CONDITION SATISFIED AFTER REQUISITE SERVICE PERIOD

FACTS

An entity grants retirement-eligible employees 10,000 stock options at a grant-date fair value of $15 per stock option. The stock options will vest and become exercisable if the entity's cumulative revenues exceed $6 million over the next four annual reporting periods. If the employees choose to retire, they can retain the stock options for the remaining contractual life. However, the stock options will become exercisable only once the cumulative revenue target is achieved.

CONCLUSION

The explicit service period of four years is considered nonsubstantive because the employees can retire and retain their awards. Therefore, compensation cost of $150,000 is recognized immediately on the grant date because the entity concludes it is probable that the performance target will be met.

ANALYSIS

The stock options contain a performance condition (the entity reporting cumulative revenues in excess of $6 million) and an explicit service period of four years. In that scenario, the explicit service period of four years is considered nonsubstantive because employees can keep their stock options even if they choose to retire immediately after receiving them (see BDO Insights in Section 4.2.1). However, for the stock options to become legally vested and exercisable, the entity must achieve cumulative revenues exceeding $6 million over the next four annual reporting periods.

Based on its internal forecasts, the entity believes it is probable that it will achieve cumulative revenues in excess of $6 million over the next four annual reporting periods. Therefore, it recognizes compensation cost of $150,000 ($15 grant-date fair value per stock option * 10,000 stock options) immediately on the grant date.

4.2.3.4 Performance Conditions With Carryback and Carryforward Provisions

FASB REFERENCES

ASC 718-10-20: Performance Condition, Probable, and Requisite Service Period

Entities sometimes issue share-based payment awards that contain performance conditions with carryback and carryforward provisions.

	Carryback provisions	Allow for the performance metrics of a **future period to be applied retroactively to a prior period**. For example, if an entity misses its performance target in Year 1 but exceeds it in Year 2, the excess performance in Year 2 can be carried back to Year 1 to meet the Year 1 performance condition.
	Carryforward provisions	Allow for the performance metrics of a **prior period to be applied to a future period**. For example, if an entity exceeds its performance target in Year 1, the excess performance can be carried forward to Year 2 to help meet the performance condition for that year.

Carryback and carryforward provisions affect the requisite service period of an award. In other words, the provisions affect the period over which compensation cost must be recognized. Example 4-9 illustrates this concept for share-based payment awards that include performance conditions with carryback and carryforward provisions.

EXAMPLE 4-9: PERFORMANCE AWARDS WITH CARRYBACK AND CARRYFORWARD PROVISIONS

FACTS

On January 1, 20X4, an entity issues restricted stock to specific members of management. The restricted stock vests in two tranches on December 31, 20X4, and December 31, 20X5, contingent upon the entity meeting annual free cash flow (FCF) targets. On January 1, 20X4, the grantees are informed of the specific annual FCF targets for each of the two years. All other conditions for establishing a grant date are also met on January 1, 20X4. Further:

- The ability to vest by meeting the FCF target in Year 2 remains unaffected if the FCF target is not met in Year 1.
- Any excess FCF amount achieved in Year 1 can be carried forward to Year 2 (that is, there is a carryforward provision).
- Any excess FCF amount achieved in Year 2 can be carried back to Year 1 if the FCF target was not met (that is, there is a carryback provision).

CONCLUSION

The implicit service period for each tranche is based on the most probable outcome after considering the carryback and carryforward provisions.

ANALYSIS

Both tranches have the same grant date and service inception date of January 1, 20X4. The entity must assess the most probable outcome for each tranche, considering projections and other relevant data, including any excess FCF from one annual period that affects the other annual period. Compensation cost for each tranche is recognized over the implicit service period based on the estimated outcome. The entity must regularly review and update the implicit service period for each tranche, adjusting the service period if expectations change (see Section 4.3.4).

BDO INSIGHTS — AWARDS WITH CARRYBACK AND CARRYFORWARD PROVISIONS

Example 4-9 demonstrates a simple award with carryback and carryforward provisions. Other awards with more complex fact patterns may require the application of professional judgment based on the facts and circumstances.

4.2.3.5 Implied Performance Condition

FASB REFERENCES

ASC 718-10-25-3 and ASC 718-10-55-61

ASC 718 requires an entity to consider all rights and obligations of an award regardless of legal structure. In some cases, an award's agreement terms do not explicitly identify a performance condition, but a performance condition is implied based on other terms and conditions, resulting in an implied performance condition. Diversity in practice has emerged in determining whether an implied performance condition exists, and significant judgment is required.

BDO INSIGHTS — MARKET CONDITION AND AN IMPLIED PERFORMANCE CONDITION

Some awards vest upon the achievement of a target IRR or MOIC, both of which are market conditions. Also, some awards include **both** a market condition and a performance condition that must be satisfied for the awards to vest. For example, an award vests upon a liquidity event (such as a change in control or IPO) in which the proceeds from the event result in an IRR of at least 30%. In that case, the award contains an explicit performance condition and an explicit market condition.

In other instances, an award may include an explicit market condition only. While there is no explicit performance condition included in the award's terms, the explicit market condition can plausibly be achieved only upon the entity receiving sufficient proceeds from a liquidity event or through sufficient distributions to shareholders. Therefore, the award may also include an **implied** performance condition.

In determining whether there is both a market condition and an implied performance condition, we believe an entity must exercise professional judgment based on facts and circumstances.

EXAMPLE 4-10: PROFITS INTERESTS — MOIC MAY RESULT IN AN IMPLIED PERFORMANCE CONDITION

FACTS

An LLC issues Class B profits interests as an incentive to members of management. The profits interests have been determined to be in the scope of ASC 718 (see Section 1.2.1). The award vests as follows:

- 50% vest upon common unit investors achieving a 2.5x return on Class A shares.
- 50% vest upon common unit investors achieving a 4.0x return on Class A shares.

CONCLUSION

The profits interest contains a market condition and may also contain an implied performance condition.

ANALYSIS

The award vests upon achieving MOIC levels. Although a MOIC is generally considered a market condition, in some circumstances, it may be appropriate to consider whether the award also contains an implied performance condition. Because the award vests solely based upon the achievement of MOIC conditions, the LLC must consider the probability of achieving either MOIC level in the normal course of business or through a significant transaction, such as a change in control.

If the LLC concludes it is highly improbable that any of the required MOIC levels can be achieved without a change in control, an implied performance condition (a change in control that results in achieving an MOIC threshold) may exist. If the award includes an implied performance condition, the LLC would not recognize compensation cost until the performance condition is probable of being met (which would likely be when the change in control occurs).

Conversely, if there is no implied performance condition, compensation cost is recognized over the derived service period, which is the period from the grant date until the date the LLC is expected to achieve the market condition.

The LLC must exercise professional judgment based on facts and circumstances.

BDO INSIGHTS — DIVERSITY IN ACCOUNTING FOR HURDLE RATES OF PROFITS INTEREST AWARDS

Profits interests typically include a threshold that must be attained before profits interest holders can receive distributions, often called a “hurdle rate.” Entities may assert that a distribution is highly unlikely to be made until the occurrence of an exit event or other liquidity event even though distributions can contractually and legally be made at the board’s discretion at any time.

Some believe the hurdle rate results in the profits interests containing an implied performance condition because the rate is likely to be achieved only upon the occurrence of an exit event. Under that approach, compensation cost is not recognized because the implied performance condition (the exit event) is not probable. We believe a hurdle rate often does **not** represent an implied performance condition. However, some awards may include a hurdle rate that is so high that it can plausibly be achieved only upon the entity receiving sufficient proceeds from a liquidity event or other transaction. Therefore, all facts and circumstances must be considered.

EXAMPLE 4-11: PROFITS INTERESTS — DISTRIBUTION HURDLE MAY RESULT IN AN IMPLIED PERFORMANCE CONDITION

FACTS

- An LLC issues profits interests as an incentive to members of management. The profits interests have been determined to be in the scope of ASC 718 (see Section 1.2.1) and vest at the end of three years.
- The award contains a distribution threshold of $20 per common unit that represents approximately 10 times the current estimated value of the LLC.
- The profits interest units start participating pro rata with the common unit holders in any further distributions once common units have received distributions of at least $20 per unit.

CONCLUSION

The profits interest contains a service condition and may also contain an implied performance condition.

ANALYSIS

Profits interests typically include a threshold that must be attained before profits interest holders can receive distributions (sometimes referred to as the hurdle rate). Entities may assert that a distribution is highly unlikely to be made until the occurrence of an exit event or other liquidity event even though distributions can contractually and legally be made at the board’s discretion at any time once the distribution threshold is achieved.

The LLC might consider the probability of achieving the distribution hurdle in the normal course of business or upon a significant transaction, such as a change in control. In some circumstances, a distribution hurdle may be sufficiently high such that it represents an implied performance condition because it is highly unlikely the hurdle will be achieved absent a significant transaction. However, the LLC must also consider that the award contains an explicit service vesting condition.

The LLC must exercise professional judgment based on facts and circumstances.

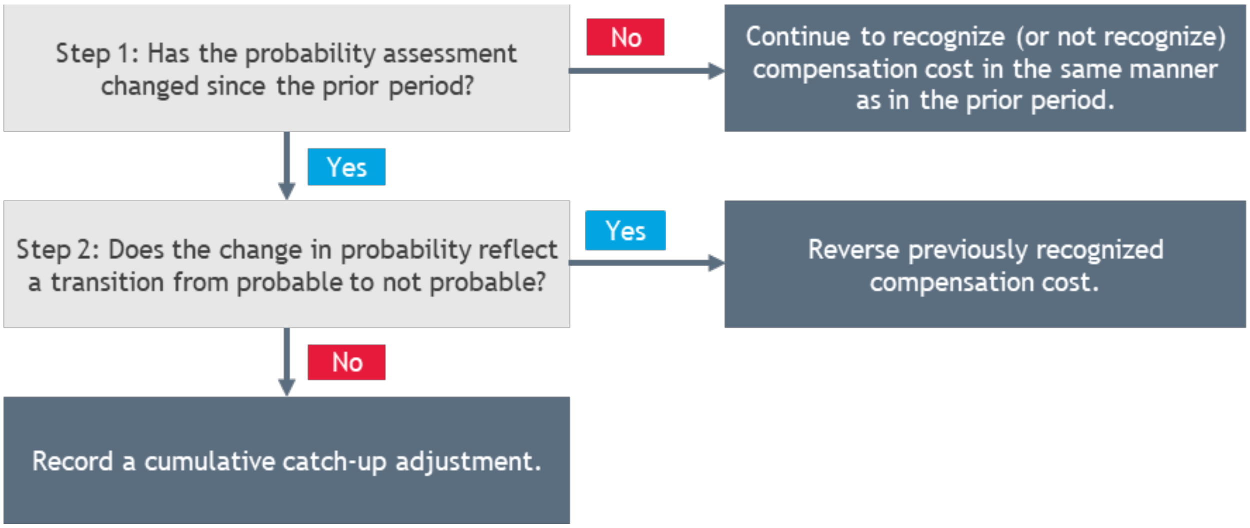
4.2.3.6 Change in Probability of a Performance Condition

FASB REFERENCES

ASC 718-10-55-76 through 55-79

At each reporting date, entities must reassess whether a performance condition is probable of achievement. If an entity initially determined that a performance condition was not probable of achievement but facts and circumstances change such that the condition later becomes probable of achievement, the entity recognizes a cumulative catch-up adjustment in the period of the change as if the new assessment of probability had been applied since the service inception date. Conversely, if an entity initially determined that a performance condition was probable of achievement but later determines that it is no longer probable of achievement, the entity reverses compensation cost recognized to date in the period of the change.

The flowchart below illustrates this concept.



EXAMPLE 4-12: CHANGE IN PROBABILITY OF A PERFORMANCE CONDITION

FACTS

Assume the same facts as in Example 4-5. On July 1, 20X5, the entity loses a key customer to a competitor. Therefore, it is no longer probable that a 25% increase in cumulative net revenues (the performance condition) will be achieved by December 31, 20X7. Compensation cost recognized as of July 1, 20X5, is $375,000 ($1,000,000 grant-date fair value * 37.5% for service rendered from January 1, 20X4, through July 1, 20X5).

CONCLUSION

The entity reverses the $375,000 compensation cost previously recognized.

ANALYSIS

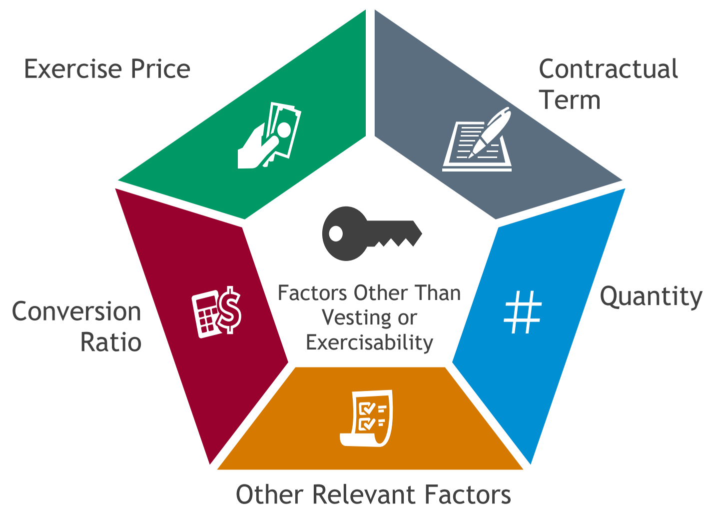
- **Step 1:** Has the probability assessment changed since the prior period?
  - Yes. Because of the loss of a key customer on July 1, 20X5, it is no longer probable that the entity will achieve the 25% increase in cumulative net revenues required for the stock options to vest. Proceed to Step 2.
- **Step 2:** Does the change in probability reflect a transition from probable to not probable?
  - Yes. As of July 1, 20X5, the reassessment indicates that attaining the performance condition is no longer probable. Therefore, the entity must reverse the $375,000 in compensation cost previously recognized to reflect the updated assessment that the performance condition is not expected to be met by the end of the requisite service period on December 31, 20X7. Unless the probability of achieving the performance condition changes again, no further compensation cost will be recognized for the stock options.

4.2.4 Conditions That Affect Factors Other Than Vesting or Exercisability

FASB REFERENCES

ASC 718-10-30-15, ASC 718-10-55-64, and ASC 718-20-55-35 through 55-46

Service, performance, and market conditions can affect factors other than the vesting or exercisability of a share-based payment award. For example, if a performance condition is met, an award's exercise price may be adjusted or the number of awards may change. Factors beyond vesting or exercisability that could be affected by vesting conditions include an award's exercise price, contractual term, quantity, and conversion ratio, as illustrated below.



Performance conditions that affect factors other than vesting or exercisability of an award are considered when determining the amount of compensation cost to recognize. A fair value is determined for each potential outcome at the grant date, and the final compensation cost is recognized based on the actual outcome of the performance condition.

When performance or service conditions affect factors other than vesting, such as exercise price or number of awards, a grant-date fair value is calculated for each possible outcome at the grant date.

Example: An award has varying exercise prices based on different sales thresholds, in which case each outcome would have a distinct grant-date fair value.

Probability assessments must be updated regularly; any changes are recorded as a cumulative catch-up adjustment (see Section 4.2.3.6). If none of the outcomes are deemed probable, no compensation cost is recognized until an outcome becomes probable. The final compensation cost is based on the grant-date fair value of the **actual** outcome.

Entities that grant awards with market conditions that affect factors other than vesting or exercisability incorporate all potential outcomes into the grant-date fair value, which is then recognized over the requisite service or vesting period. That is different than for awards with service or performance conditions whereby separate grant-date fair values are determined for each possible outcome.

Example 4-13 illustrates how multiple performance conditions affect the number of awards earned and thus compensation cost recognized.

EXAMPLE 4-13: AWARD IN WHICH THE NUMBER OF OPTIONS TO BE EARNED VARIES (QUOTED FROM EXAMPLE 2, ASC 718-20-55-36 THROUGH 55-40)

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 [BDO Example 4-2]…. The grant-date fair value per share option is $14.69. While the vesting conditions in this Example and in [BDO Example 4-2]…. 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.

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 ×$.97^{3}$) 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 ×$.94^{3}$). 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			
	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*

Example 4-14 illustrates how a performance condition affects the exercise price of an award.

EXAMPLE 4-14: SHARE OPTION AWARD UNDER WHICH THE EXERCISE PRICE VARIES (QUOTED FROM EXAMPLE 3, ASC 718-20-55-42 THROUGH 55-46)

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. …

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. …*

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.*

4.2.5 Multiple Conditions

FASB REFERENCES

ASC 718-10-25-20 through 25-21, ASC 718-10-55-60 through 55-63, ASC 718-10-55-72 through 55-79, ASC 718-10-55-102 through 55-106, and ASC 718-20-55-62 through 55-67

A share-based payment award may contain multiple conditions (service, performance, or market conditions) upon whose satisfaction the grantee is entitled to the award. If a share-based payment award contains multiple vesting conditions, compensation cost is recognized depending on whether **all** conditions or **any single** condition must be met.

Awards containing a mix of market, performance, or service conditions may also have multiple service periods. However, there can be only one requisite service period for accounting purposes. To accurately determine the requisite service period, an entity must analyze all conditions for vesting and exercisability; all explicit, implicit, and derived service periods; and the probability of meeting service or performance conditions.

The effects of multiple conditions (service, performance, and market conditions) on an award's requisite service period are described in the table below.

	IF BOTH SERVICE AND PERFORMANCE CONDITIONS ARE PROBABLE	IF ONE OF THE SERVICE OR PERFORMANCE CONDITIONS IS NOT PROBABLE
SERVICE OR PERFORMANCE CONDITION	▶ The requisite service period is the shorter of the explicit or implicit service period. ▶ Any condition can be met; thus, the shorter period is used.	▶ The vesting condition (service or performance condition) that is not probable is ignored in determining the requisite service period. Therefore, the requisite service period is based on the service period related to the vesting condition that is probable
SERVICE AND PERFORMANCE CONDITION	▶ The requisite service period is the **longer** of the explicit or implicit service period. ▶ Multiple conditions must be met; thus, the longer period is used.	▶ Compensation cost is not recognized until **both** the service and performance conditions are probable.
MARKET OR SERVICE/ PERFORMANCE CONDITION	▶ The requisite service period is the **shortest** of the explicit, implicit, or derived service period. ▶ Any condition can be met; thus, the shortest period is used.	▶ The derived service period is the requisite service period because the service or performance condition is excluded from the assessment of the requisite service period. However, if an entity elects to recognize forfeitures when they occur and there are only service and market conditions (that is, there is no performance condition), the requisite service period is the **shorter** of the explicit or derived service period.
MARKET AND SERVICE/ PERFORMANCE CONDITION	▶ The requisite service period is the **longest** of the explicit, implicit, or derived service period. ▶ Multiple conditions must be met; thus, the longest period is used.	▶ Compensation cost is not recognized until the service or performance condition is probable. However, if an entity elects to recognize forfeitures when they occur and there are only service and market conditions (that is, there is no performance condition), the requisite service period is the **longer** of the explicit or derived service period.

The circumstances under which an entity reverses previously accrued compensation cost when the award terms include multiple vesting conditions are described below.

- Service or Performance Condition
- Market or Service/Performance Condition

An entity reverses accrued compensation cost if it expects an employee to forfeit the award (if it elected to estimate forfeitures) or when the forfeiture actually occurs (if it elected to account for forfeitures as incurred) before the service **or** performance conditions are met.

- Service and Performance Condition
- Market and Service/Performance Condition

An entity reverses accrued compensation cost if it expects an employee to forfeit the award (if it elected to estimate forfeitures) or when the forfeiture actually occurs (if it elected to account for forfeitures as incurred) before the service **and** performance condition are met.

Examples 4-15 and 4-16 illustrate how to determine the requisite service period when an award has multiple conditions and only **one** of the conditions must be met for the employee to vest in or exercise the award.

EXAMPLE 4-15: AWARDS THAT VEST WHEN EITHER A SERVICE OR PERFORMANCE CONDITION IS MET

FACTS

An entity grants restricted stock to an employee. The award will vest either after completion of four years of continuous service or once revenues exceed $10 million, whichever occurs first. The entity expects the revenue targets to be achieved at the five-year anniversary of granting the award. The entity recognizes forfeitures as they occur.

CONCLUSION

The requisite service period is four years, which is the shorter of the explicit and implicit service periods.

ANALYSIS

The award includes both a service condition (vesting at the end of the fourth year of service) and a performance condition (vesting upon the entity exceeding $50 million in revenues). The service condition includes an explicit service period of four years, and the performance condition has an implicit service period of five years. The award vests when **either** condition is met. Further, both the service and performance conditions are probable of being met. Therefore, the requisite service period is the **shorter** of the two service periods, which is four years.

If the award vests before the end of the requisite service period (that is, because the entity achieves the revenue target before completing four years of service), the entity immediately recognizes any unrecognized compensation cost on the date the performance condition is met.

EXAMPLE 4-16: AWARDS THAT VEST WHEN EITHER A SERVICE OR MARKET CONDITION IS MET

FACTS

An entity grants stock options to an employee. The options will vest after completion of five years of continuous service or once the entity's market capitalization exceeds $2 million, whichever occurs first. The entity expects to achieve its market capitalization target three years after granting the award. The entity recognizes forfeitures as they occur.

CONCLUSION

The requisite service period is three years, which is the shorter of the explicit and derived service periods.

ANALYSIS

The stock options include both a service condition (vesting at the end of the fifth year of service) and a market condition (vesting if the entity's market capitalization exceeds $2 million). The service condition includes an explicit service period of five years, and the market condition has a derived service period of three years. The award vests when **either** condition is met. Therefore, the requisite service period is the **shorter** of the two service periods, which is three years.

If the market capitalization target is attained before the derived service period of three years, the entity immediately recognizes any unrecognized compensation cost on the date the market condition is met. Conversely, if the market capitalization target is never achieved, but the employee continues employment for at least three years, compensation cost is still recorded. In other words, compensation cost continues to be recognized over the three-year requisite service period, and cumulative compensation cost recognized to-date is not reversed despite the market capitalization target not being achieved at the end of the three-year derived service period (see Section 4.2.2).

Examples 4-17 and 4-18 illustrate how to determine the requisite service period when an award includes multiple conditions and **all** the conditions must be met for the employee to vest in or exercise the award.

EXAMPLE 4-17: AWARDS THAT VEST WHEN BOTH A SERVICE AND PERFORMANCE CONDITION MUST BE MET

FACTS

Assume the same facts as in Example 4-15, except the award will vest after completion of four years of continuous service by the employee **and** once the entity's revenues exceed $10 million. Also, the entity does not believe it is probable that it will achieve the revenue target.

CONCLUSION

The entity concludes no compensation cost is recognized because the performance condition is not probable of being achieved. If the performance condition were probable of being achieved, for example in five years, the requisite service period would be five years.

ANALYSIS

If the vesting of an award depends on both a service condition and a performance condition, the entity must initially determine which outcomes are probable. The service condition is expected to be met based on the entity's policy election to recognize forfeitures as they occur. However, the performance condition is not expected to be met. Consequently, no compensation cost is recognized.

Conversely, when an award vests upon satisfying **both** a service condition and a performance condition, **and** it is probable that the performance condition will be achieved, the entity would recognize compensation cost over the **longer** of the explicit or implicit service period. The explicit service period would be four years, whereas the implicit service period would be five years. Accordingly, compensation cost would be recognized over five years.

EXAMPLE 4-18: AWARDS THAT VEST WHEN BOTH A SERVICE AND MARKET CONDITION MUST BE MET

FACTS

Assume the same facts as in Example 4-16, except the award vests only upon meeting both the market **and** service conditions.

CONCLUSION

The entity records compensation cost over five years.

ANALYSIS

The stock options include both a service condition (vesting at the end of the fifth year of service) and a market condition (vesting if the entity's market capitalization exceeds $2 million). The service condition has an explicit service period of five years, and the market condition has a derived service period of three years. The award vests when **both** conditions are met. Therefore, the requisite service period is the **longer** of the two service periods, which is five years.

If the entity does not achieve the market capitalization target within the expected three years, it continues to recognize the compensation cost over the five-year period. That is because the derived service period is revised only if the market condition is met earlier than expected (see Sections 4.2.2 and 4.3.4).

As discussed in Section 1.2.1, entities may issue profits interest awards that are in the scope of ASC 718. Often, profits interest awards may include multiple vesting conditions, as illustrated in Example 4-19.

EXAMPLE 4-19: PROFITS INTERESTS — ACCELERATED VESTING UPON A CHANGE IN CONTROL

FACTS

An LLC issues Class B profits interests that are in the scope of ASC 718 as an incentive to management. The Class B profits interests vest annually over four-years based on employee service. The LLC accounts for forfeitures as they occur. If a change in control happens before the end of the service period, any unvested profits interests immediately vest in full.

CONCLUSION

The profits interest contains an explicit service condition and an explicit performance condition (change in control).

ANALYSIS

If an award has multiple vesting conditions and vests if **any** condition is satisfied, the employee's requisite service period is the shortest explicit or implicit service period. Performance conditions must be assessed for probability of achievement. If it is not probable that a performance condition will be achieved, that condition is ignored in estimating the employee's requisite service period.

A change in control event is a performance condition that is generally not deemed probable until it occurs, as discussed in Section 4.2.3.1. Therefore, in this case, compensation cost is recognized over the requisite service period based on the explicit service condition because the performance condition is not probable until it occurs. If a change in control occurs, any unrecognized compensation expense would be accelerated and recognized then.

Example 4-20 illustrates an award with performance and market conditions that must be met for the employee to vest in or exercise the award.

EXAMPLE 4-20: SHARE UNIT WITH PERFORMANCE AND MARKET CONDITIONS (QUOTED FROM EXAMPLE 6, ASC 718-20-55-62 THROUGH 55-67)

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. … 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.

Debit	*Compensation cost*	*$12,000,000*	
Credit	*Additional paid-in-capital*		*$ 12,000,000*

To recognize compensation cost. …

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. …

4.2.6 Repurchase Features That Function as Vesting Provisions

FASB REFERENCES

ASC 718-10-55-31(a)

Share-based payment awards may contain terms that resemble repurchase features but in substance function as vesting provisions. Repurchase features that function as vesting provisions are often seen in stock option plans that allow employees to early exercise their stock options before the employees render service to the entity. That early exercise results in the employee remitting cash equal to the options' exercise price in exchange for the options' underlying shares to obtain a favorable tax position.[6] However, early exercise does not mean the employee has earned (or vested in) the stock options. Rather, the employee effectively received restricted shares with a repurchase feature that allows the entity to take back the shares if the employee does not fulfill the requisite service period. The repurchase price is typically **either**:

- The stock option's exercise price
- The lesser of the stock option's exercise price or the fair value of the shares on the repurchase date.

ASC 718-10-55-31(a) states that "*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.*"

Example 4-21 illustrates how repurchase features effectively serve as vesting provisions.

EXAMPLE 4-21: REPURCHASE FEATURES AS VESTING PROVISIONS

FACTS

An entity grants an executive 500 fully vested stock options with an exercise price equal to the market value of the underlying stock. The executive immediately exercises the options. The shares are subject to a repurchase feature that gives the entity the right to repurchase them at the exercise price if the executive terminates employment within three years for any reason other than death or disability.

CONCLUSION

The repurchase feature is an in-substance vesting provision.

[6] Under U.S. tax law, early exercise of nonvested stock options generally results in deemed ownership of the shares. The holding period for those shares starts on the exercise date and, if held for the required time, any increase in value upon sale of those shares is taxed at the lower capital gains rate.

ANALYSIS

The repurchase feature is an in-substance vesting provision because the entity can exercise the repurchase feature if the executive leaves within three years. In other words, the award does not vest if the executive does not remain employed with the entity for at least three years. The fact that the awards are fully vested on the grant date is not substantive. Therefore, compensation cost for the awards is recognized over a requisite service period of three years.

When a repurchase feature is considered a vesting provision, any payment the entity receives for the exercise price is generally recognized as a deposit liability. If the employee does not vest in the award and the entity exercises its call option, the award has not vested, and the entity returns the exercise price it recognized as a deposit liability. If, however, the entity does not exercise its call option, a Type III improbable-to-probable modification occurs because the stock options were not expected to vest (that is, the entity was presumed to exercise its call option) but is now expected to vest (that is, the entity has not exercised its call option) (see Section 5.3.3).

4.3 EXPENSE ATTRIBUTION

FASB REFERENCES

ASC 718-10-20: Requisite Service Period and ASC 718-10-35-2

ASC 718 requires compensation cost for a share-based payment award issued to an employee to be recognized over the requisite service period, which is the period over which an employee is required to provide service in exchange for the award. A requisite service period begins on the service inception date, which is generally the grant date but can sometimes precede the grant date. Conversely, a grant date can precede the service inception date. Also, a requisite service period can be explicitly or implicitly stated in an award's terms and applies only to awards issued to employees (see Section 4.2.1.1). Compensation cost for share-based payment awards issued to nonemployees is recognized in the same period and in the same manner as if the entity paid cash for the goods or services from the nonemployees (see Section 6.5).

While a requisite service period determines the period over which compensation cost is recognized, it does not dictate the **pattern** of compensation cost (commonly referred to as "expense attribution"). Rather, the pattern of compensation cost for awards varies depending on the awards' vesting mechanism (cliff vesting versus graded vesting).

The following sections address matters related to a requisite service period for share-based payment awards:

TOPIC	GUIDANCE
Cliff vesting versus graded vesting	Section 4.3.1
Service inception date precedes grant date	Section 4.3.2
Grant date precedes service inception date	Section 4.3.3
Change in requisite service period	Section 4.3.4

4.3.1 Cliff Vesting Versus Graded Vesting

FASB REFERENCES

ASC 718-10-35-8

Share-based payment awards may cliff vest or vest on a graded schedule. How an award vests affects the recognition pattern of the award's compensation cost (that is, the award's expense attribution).

Cliff vesting awards fully vest upon completing the requisite service period.

In cliff vesting, employees fully own their share-based payment awards after a specific waiting period (the cliff). Compensation cost for cliff vesting awards is recognized evenly throughout the employee's requisite service period.

EXAMPLE 4-22: EXPENSE ATTRIBUTION FOR A CLIFF VESTING AWARD

FACTS

An entity grants its chief operating officer (COO) 10,000 options with a grant-date fair value of $10, which cliff vest at the end of five years.

CONCLUSION

Compensation cost is recognized evenly over the requisite service period of five years.

ANALYSIS

Total compensation cost of award	10,000 * $10 = $100,000
Annual compensation cost	$100,000 / 5 years = $20,000

If the COO leaves the entity before completing the five-year requisite service period, any previously recognized compensation cost is reversed. For example, if the COO is terminated at the beginning of Year 4, cumulative compensation cost of $60,000 would be reversed on the termination date.

Graded-vesting awards vest in increments (or tranches) over the requisite service period.

In graded vesting, employees gain ownership of their share-based payment awards at intervals over the vesting period. Awards that have a graded vesting schedule are accounted for as **either:**

- Multiple awards with each tranche treated as a separate award (accelerated or graded method)
- A single award (straight-line method).

Accelerated method	An entity recognizes compensation cost over the requisite service period for each separately vesting tranche as though each tranche of the award is in substance a separate award. This method results in compensation cost recognized on an accelerated basis.
Straight-line method	An entity recognizes compensation cost for the entire award on a straight-line basis over the requisite service period, which corresponds to the last separately vesting tranche of the award. This method results in compensation cost recognized evenly over the requisite service period.

An entity can make an accounting policy election to recognize compensation cost using either the accelerated method or the straight-line method for employee awards subject to graded vesting when vesting of the awards is **solely** based on a service condition. However, an entity is prohibited from using the straight-line method for awards with a performance and/or market condition. For example, if a graded-vesting award is subject to a performance condition that is probable of achievement, compensation cost for each award tranche must be recognized over the period from the service inception date to the vesting date separately for each tranche.

BDO INSIGHTS — APPLICATION OF STRAIGHT-LINE METHOD AND ACCELERATED METHOD

We believe:

An entity's policy decision to account for employee awards using either the accelerated method or straight-line method must be applied consistently to all employee awards subject to graded vesting and should be disclosed if significant.	Consistently applied
If an entity changes its policy decision, it must justify that the change in policy is preferable in accordance with ASC 250. Because ASC 718 does not specify which attribution method is preferable, an entity should make the assessment based on the facts and circumstances.	Justifiable change

Regardless of the policy election to recognize compensation cost using either an accelerated method or straight-line method, cumulative compensation cost recognized as of any given date must **at least equal** the grant-date fair value of the award's vested portion on that date. In other words, if an entity elects the straight-line method, and cumulative compensation cost recognized to date is lower than the grant-date fair value of the award's vested portion on that date, the entity must recognize more compensation cost to meet or exceed the grant-date fair value of the vested amount (the "floor" concept). If an entity estimates forfeitures but the actual forfeitures are lower than the estimate, compensation cost is adjusted to at least equal the grant-date fair value of the vested portion of the award.

The policy election **does not** apply to nonemployee awards because compensation cost for such awards is recognized as if the entity had paid cash for the goods or services, which generally results in a pattern of recognition that is consistent with the accelerated method (see Section 6.5).

Examples 4-23 through 4-26 demonstrate how compensation cost is attributed using either the accelerated or straight-line method for awards with graded vesting.

EXAMPLE 4-23: ACCELERATED METHOD FOR AN AWARD WITH GRADED VESTING

FACTS

An entity grants each of its 200 employees 100 stock options at a grant-date fair value of $10 per stock option. The stock options contain only a service condition and vest over three years based on the following graded schedule:

- Tranche 1 / Year 1: 25%
- Tranche 2 / Year 2: 25%
- Tranche 3 / Year 3: 50%

The entity elects to account for all employee awards using the accelerated method and to estimate forfeitures, as follows:

- Year 1: No employees are expected to depart.
- Year 2: Six employees are expected to depart.
- Year 3: Ten additional employees are expected to depart.

CONCLUSION

Compensation cost is recognized on an accelerated basis, treating each tranche as a separate award.

ANALYSIS

The table below summarizes compensation cost for each tranche, taking into account the estimated forfeitures.

	COMPENSATION CALCULATION	TOTAL COST
Tranche 1	200 * 100 * 25% * $10	$ 50,000
Tranche 2	194 * 100 * 25% * $10	48,500
Tranche 3	184 * 100 * 50% * $10	92,000
Total compensation cost		$ 190,500

The table below summarizes compensation cost for the three years of service based on the accelerated method.

	YEAR 1	YEAR 2	YEAR 3	TOTAL COST
Tranche 1 ($50,000 * 1/1)	$ 50,000	$	$ _	$ 50,000
Tranche 2 ($48,500 * 1/2)	24,250	24,250	_	48,500
Tranche 3 ($92,000 * 1/3)	30,667	30,667	30,666	92,000
Total compensation cost	$ 104,917	$ 54,917	$ 30,666	$ 190,500

The amount of cumulative expense recognized as of each period equals the value of vested awards. Therefore, no adjustment to the amount of expense recognized is needed.

EXAMPLE 4-24: STRAIGHT-LINE METHOD FOR AN AWARD WITH GRADED VESTING

FACTS

Assume the same facts as in Example 4-23, except that the entity elected to account for all employee awards using the straight-line method.

CONCLUSION

Compensation cost is recognized on a straight-line basis, treating the entire award as a single award.

ANALYSIS

Under the straight-line method, the entity recognizes compensation cost for each of the three years of service as follows:

Year 1 ($190,500/3)	$ 63,500
Year 2 ($190,500/3)	63,500
Year 3 ($190,500/3)	63,500
Total	$ 190,500

The amount of cumulative expense recognized as of each period equals or exceeds the value of vested awards. Therefore, no adjustment to the amount of expense recognized is needed.

EXAMPLE 4-25: ACCELERATED METHOD FOR A FRONT-LOADED AWARD WITH GRADED VESTING

FACTS

Assume the same facts as in Example 4-23, except that the stock options vest in diminishing increments: 50% in Year 1 and 25% each in Year 2 and Year 3.

CONCLUSION

Compensation cost is recognized on an accelerated basis, treating each tranche as a separate award.

ANALYSIS

The table below summarizes compensation cost for each tranche, taking into account the estimated forfeitures.:

	COMPENSATION CALCULATION	TOTAL COST
Tranche 1	200 * 100 * 50% * $10	$ 100,000
Tranche 2	194 * 100 * 25% * $10	48,500
Tranche 3	184 * 100 * 25% * $10	46,000
Total compensation cost		$ 194,500

The table below summarizes compensation cost for the three years of service based on the accelerated method.

	YEAR 1	YEAR 2	YEAR 3	TOTAL COST
Tranche 1 (100,000 * 1/1)	$ 100,000	$ —	$ —	$ 100,000
Tranche 2 (48,500 * 1/2)	24,250	24,250	—	48,500
Tranche 3 (46,000 * 1/3)	15,333	15,333	15,334	46,000
Total compensation cost	$ 139,583	$ 39,583	$ 15,334	$ 194,500

The amount of cumulative expense recognized as of each period equals the value of vested awards. Therefore, no adjustment to the amount of expense recognized is needed.

EXAMPLE 4-26: APPLYING THE FLOOR CONCEPT TO AN AWARD WITH GRADED VESTING

FACTS

Assume the same facts as in Example 4-25, except that the entity elected to account for all employee awards using the straight-line method.

CONCLUSION

Because the straight-line basis of compensation cost results in recognition of an amount that is lower than the legally vested portion of the first two tranches of stock options, the entity must recognize additional compensation cost to meet or exceed the vested amount.

ANALYSIS

Consistent with Example 4-25, compensation cost for each tranche, considering the estimated forfeitures, is summarized as:

	COMPENSATION CALCULATION	TOTAL COST	CUMULATIVE COMPENSATION COST
Tranche 1	200 * 100 * 50% * $10	$ 100,000	$ 100,000
Tranche 2	194 * 100 * 25% * $10	48,500	$ 148,500
Tranche 3	184 * 100 * 25% * $10	46,000	$ 194,500
Total compensation cost		$ 194,500	

Under the straight-line method, the entity recognizes compensation cost for the three years of service as follows:

	ANNUAL COMPENSATION COST	CUMULATIVE COMPENSATION COST
Year 1 ($194,500/3)	$ 64,833	$ 64,833
Year 2 ($194,500/3)	64,833	$ 129,666
Year 3 ($194,500/3)	64,834	$ 194,500
Total	$ 194,500	

Comparison of cumulative compensation cost under the straight-line method to the floor amount:

	CUMULATIVE COMPENSATION COST COMPARISON	ADDITIONAL COMPENSATION COST
Year 1	$64,833 < $100,000	$35,167 ($100,000 - $64,833)
Year 2	$129,666 < $148,500	$18,834 ($148,500 - $129,666)
Year 3	$194,500 = $194,500	$0 ($194,500 – $194,500)

Because cumulative compensation cost in Years 1 and 2 is lower than the grant-date fair value of the award's vested portion for those periods, additional compensation cost must be recognized in those periods. A final true-up in Year 3 will be required so that total compensation cost recognized is $194,500.

4.3.2 Service Inception Date Precedes Grant Date

FASB REFERENCES

ASC 718-10-20: Service Inception Date, ASC 718-10-35-6, ASC 718-10-35-8, ASC 718-10-55-94, and ASC 718-10-55-108 through 55-115

The service inception date is the date at which the employee's requisite service period begins. While the service inception date is usually the grant date, it may precede the grant date in some circumstances.

When does the service inception date precede the grant date?

ASC 718-10-55-108 states that the service inception date precedes the grant date if **all** the following criteria are met:

- An award is authorized (see Section 4.3.2.1).
- Service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached (see Section 2.2.2).
- **Either** of the following conditions applies:
  - The award's terms do not include a substantive future requisite service condition at the grant date.
  - The award has a market or performance condition that, if not satisfied during the service period before the grant date and after the inception of the award, results in the forfeiture of the award.

When the service inception date precedes the grant date, an employee has already commenced providing service to earn the award. Therefore, an entity typically begins recognizing compensation cost before the grant date.

If the service inception date precedes the grant date, compensation cost is remeasured based on the award's estimated fair value at the end of each reporting period until the grant date and accrued based on the proportionate amount of service rendered as of the reporting period. For equity-classified awards, fair value of the award becomes fixed on the grant date (that is, cumulative compensation cost is adjusted to reflect the award's fair value on the grant date). For liability-classified awards, the award's fair value continues to be remeasured each reporting period until settlement (see Section 4.4).

Example 4-27 illustrates the accounting for an award whose service inception date precedes the grant date.

EXAMPLE 4-27: SERVICE INCEPTION DATE PRECEDES THE GRANT DATE

FACTS

On January 1, 20X4, an entity announces that each of its key executives will be granted 2,000 equity-classified stock options in two years subject to continuous service and a 15% increase in revenue as of December 31, 20X4. The options' exercise price will be based on the share price one year from the date of the announcement. As of the announcement date, the achievement of the performance condition (15% increase in revenue during 20X4) is considered probable, and all necessary approvals have been obtained.

CONCLUSION

The service inception date precedes the grant date. Therefore, compensation cost is remeasured based on the award's estimated fair value at the end of each reporting period until the grant date and accrued based on the proportionate amount of service rendered as of the reporting period.

ANALYSIS

In determining whether the service inception date precedes the grant date, the entity considers the criteria in ASC 718-10-55-108:

- An award is authorized — All necessary approvals for the stock options have been obtained on the announcement date, so this criterion applies.
- Service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached — The service inception date is the announcement date (January 1, 20X4) because that is the date the requisite service period begins for the key executives. The grant date has not been established because a mutual understanding of the key terms and conditions of the stock options (the exercise price) are not reached (see Section 2.2.2.2). The exercise price is determined one year from the announcement date (January 1, 20X5), so this criterion applies.
- Either of the following applies:
  - The award's terms do not include a substantive future requisite service condition at the grant date — To vest in the stock options, the key executives must provide service for two years (January 1, 20X4, through December 31, 20X5). However, the grant date is January 1, 20X5. Therefore, the stock options' terms include a substantive future requisite service period on the grant date. In other words, the key executives must provide service for an additional year after the grant date (January 1, 20X5, through December 31, 20X5). So, this criterion does not apply.
  - The award has a market or performance condition that, if not satisfied during the service period before the grant date and after the inception of the award, results in the forfeiture of the award — In addition to the requisite service period of two years, the entity must achieve a performance condition for the stock options to vest. In other words, the entity must increase its revenue by 15% during the one-year period following the award's announcement date. If this performance condition is not met, the stock options are forfeited. Therefore, this criterion applies.

All criteria in ASC 718-10-55-108 are met, so the service inception date precedes the grant date. Further, the achievement of the performance condition is probable. As such, from the service inception date until the grant date (January 1, 20X4, to January 1, 20X5), the stock options are remeasured at their fair value at the end of each reporting period using the assumptions existing on those dates. Also, compensation cost for the stock options is accrued based on the proportionate amount of service rendered as of the reporting period. Assuming the performance condition is achieved on December 31, 20X4, once the grant date is established on January 1, 20X5, the equity-classified stock options are no longer remeasured at each reporting period. Instead, remaining unrecognized compensation cost based on that grant-date fair value is recognized over the remaining service period (January 1, 20X5, to January 1, 20X6).

Example 4-28 illustrates service inception date that does **not** precede the grant date.

EXAMPLE 4-28: SERVICE INCEPTION DATE DOES NOT PRECEDE THE GRANT DATE

FACTS

On March 1, 20X4, an entity's compensation committee approves stock options for some key executives. As of the approval date, the fair value of the awards is $500,000. The stock options are equity-classified and will vest evenly over four years, with 25% vesting each year, starting January 1, 20X4 (all executives were providing service as of January 1, 20X4). There are no performance conditions or market conditions that need to be met for the awards to vest. The entity elects a policy to recognize compensation cost using the straight-line attribution approach.

CONCLUSION

The requirements to establish a service inception date before the grant date have not been met; therefore, no compensation cost is recognized before March 1, 20X4. The entity records compensation cost prospectively beginning on the grant date.

ANALYSIS

In determining whether the service inception date precedes the grant date, XYZ considers the criteria in ASC 718-10-55-108:

- An award is authorized — All necessary approvals for the stock options have been obtained on the announcement date, so this criterion applies.
- Service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached — Although vesting starts on January 1, 20X4, service inception cannot occur until all necessary approvals have been obtained on March 1, 20X4. Mutual understanding of the key terms and conditions is also achieved on March 1, 20X4, thereby establishing the grant date. Therefore, this criterion applies.
- Either of the following applies:
  - The award's terms do not include a substantive future requisite service condition at the grant date — To vest in the stock options, the key executives must provide service for three years and 10 months (March 1, 20X4, through December 31, 20X7). Therefore, the stock options' terms include a substantive future requisite service period on the grant date, and this criterion does not apply.
  - The award has a market or performance condition that, if not satisfied during the service period before the grant date and after the inception of the award, results in the forfeiture of the award — The awards vest solely based on providing the requisite service, with no additional performance or market conditions. Therefore, this criterion does not apply.

Not all criteria are met, so the service inception date does not precede the grant date. Compensation cost is recognized over the requisite service period. Although vesting starts on January 1, 20X4, a period before the grant date cannot be included in the requisite service period if future service is required for vesting. Therefore, the entity does not record a catch-up journal entry on March 1, 20X4. This is consistent with the definition of requisite service period, which states that if an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. However, the entity must consider the floor concept in ASC 718-10-35-8.

By December 31, 20X4, when the first portion of options vest, the entity must have recognized at least $125,000 ($500,000 * 25%) of compensation. To meet this requirement, the entity recognizes $125,000 of compensation cost evenly from March 1, 20X4, through December 31, 20X4. The remaining $375,000 of compensation cost would be recognized from January 1, 20X5, through the final vesting date.

4.3.2.1 Award Authorization

FASB REFERENCES

ASC 718-10-55-108(a)

One criterion for the service inception date to precede the grant date is for the award to be authorized. While the assessment of that criterion may be straightforward for some awards, it can be complex for others, such as awards with performance conditions. For example, consider a scenario in which an entity implements an annual bonus program for its employees that combines cash and shares and is contingent on the entity achieving specific performance or market metrics for a given year. While the program is approved by all necessary parties, the compensation amount is not determined and communicated to the employees until shortly after the annual performance period.

BDO INSIGHTS — NARROW AND BROAD VIEWS WHEN DETERMINING AWARD AUTHORIZATION

In determining whether an award is authorized under ASC 718-10-55-108(a), we believe entities can apply either the narrow or broad view, as explained below:

NARROW VIEW

An award is authorized when **all** approval requirements are fulfilled, including:

- The approval of the award by the compensation committee or board of directors.
- The award's key terms and conditions (for example, the number of awards to be issued) are finalized.

Under this view, an entity evaluates whether an award is authorized for purposes of determining whether the service inception date precedes the grant date in the same manner as determining whether a grant date is established. Therefore, the service inception date is generally the same as the grant date.

BROAD VIEW

Under this view, the award's key terms and conditions do not have to be finalized to meet the award authorization criterion. In other words, the precise details of the award (for example, the number of awards to be issued to each recipient) do not have to be approved and finalized by the compensation committee or board of directors to meet the award authorization criterion. Instead, an entity considers all relevant factors related to its policies and procedures for granting awards, including:

- The approval of an overall compensation plan or strategy, which includes share-based payment awards, by the board of directors or compensation committee.
- The extent to which employees understand the compensation plan or strategy, including an awareness that achieving specific metrics or goals results in the grant of awards.
- Whether the compensation plan or strategy outlines the process for allocating the awards to employees, including the number or value of awards based on specific metrics or goals, either through authorized policy or established practices.
- The substance of the approval process by the board of directors or compensation committee after the performance period, including the nature and degree of discretion the board or committee has on approving the award's terms relative to the initial authorization.

The factors above are not exhaustive. An entity must exercise professional judgment based on the facts and circumstances. We believe entities must establish an accounting policy to use either the narrow or broad view of award authorization and must consistently apply that view to all awards, with appropriate disclosures.

AWARD AUTHORIZATION: DIFFERENCES IN DETERMINING SERVICE INCEPTION DATE VERSUS GRANT DATE

The considerations for determining whether an award is authorized under ASC 718-10-55-108(a) may not be the same as those required for establishing a grant date (see Section 2.2). For example, an award may be approved by the entity's appropriate governing body (compensation committee or board of directors) before finalizing its key terms and conditions. Therefore, the entity and grantee have not reached a mutual understanding of the award's key terms and conditions (see Section 2.2.2). Accordingly, a grant date is not established. However, under the broad view, the award is authorized under ASC 718-10-55-108(a).

4.3.2.2 Forfeiture of Award if Market or Performance Condition Is Not Satisfied

FASB REFERENCES

ASC 718-10-55-108(a), ASC 718-10-55-108(c)(2)

As discussed, the service inception date can precede the grant date if the award includes a market or performance condition that results in a forfeiture of the award if not satisfied during the service period before the grant date and after the inception of the arrangement.

A market or performance condition may not be well-defined. For example, the market or performance metric for all awards may be specified in the overall compensation plan or strategy but not defined for each individual employee's award.

BDO INSIGHTS — NARROW AND BROAD VIEWS WHEN DETERMINING WHETHER A MARKET OR PERFORMANCE CONDITION RESULTS IN AWARD FORFEITURE

As is the case with award authorization under ASC 718-10-55-108(a) (see BDO Insights in Section 4.3.2.1), an entity can elect a narrow or broad view when determining whether an unmet market or performance condition results in forfeiture of the award pursuant to ASC 718-10-55-108(c)(2):

Individual Award Agreements	**Narrow view:** Each employee's award terms must include a specified performance or market condition as defined in ASC 718.
General Policy	**Broad view:** The performance or market condition associated with the overall compensation plan or strategy must be sufficiently specific or defined, even if the allocation to each employee is not.

We believe an entity must establish an accounting policy to use either the narrow or broad view and must consistently apply that view when determining whether a market or performance condition results in forfeiture of the award.

Further, we believe an entity can elect different accounting policies for award authorization under ASC 718-10-55-108(a) and for evaluating whether a performance or market condition results in forfeiture of the award under ASC 718-10-55-108(c)(2). In other words, an entity can elect the broad view for award authorization, a narrow view for the performance or market condition, and vice versa.

4.3.3 Grant Date Precedes Service Inception Date

FASB REFERENCES

ASC 718-10-35-8, ASC 718-10-55-94, ASC 718-10-55-96, and ASC 718-10-55-110 through 55-115

In some circumstances, an award's grant date occurs **before** the award's service inception date. Example 4-29 illustrates such a scenario.

EXAMPLE 4-29: PERFORMANCE TARGETS ARE SET AT THE INCEPTION OF THE ARRANGEMENT AND MAY BE EARNED INDEPENDENTLY (QUOTED FROM EXAMPLE 3, CASE A, ASC 718-10-55-94)

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.

In contrast, Example 4-30 illustrates a scenario in which the service inception date is the **same** as the grant date.

EXAMPLE 4-30: PERFORMANCE TARGETS ARE SET AT THE ARRANGEMENT'S INCEPTION AND MAY NOT BE EARNED INDEPENDENTLY (QUOTED FROM EXAMPLE 3, CASE C, ASC 718-10-55-96)

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.

4.3.4 Change in Requisite Service Period

FASB REFERENCES
ASC 718-10-35-7 and ASC 718-10-55-76 through 55-79

Compensation cost is recognized over an employee's requisite service period, which is initially estimated based on the award's terms and conditions. An entity may revise its initial estimate of the employee's requisite service period for an equity-classified award, only in the circumstances described in the table below.

For liability-classified awards, the requisite service period is generally revised each reporting period when the awards are remeasured (see Section 4.4).

BASIS FOR INITIAL ESTIMATE OF THE REQUISITE SERVICE PERIOD	WHEN TO CHANGE THE REQUISITE SERVICE PERIOD
Performance or Service Condition	**Change** the requisite service period if new information suggests that **either** condition applies: ▶ It is probable that the performance condition will be achieved within a different time period. ▶ Another performance or service condition becomes probable.
Market and Performance or Service Conditions **(When the initial estimate of the requisite service period is based on the derived service period of the market condition.)**	**Do not change** the requisite service period **unless either** of the following conditions apply: ▶ The market condition is satisfied before the end of the derived service period. ▶ The requisite service period is no longer based on the achievement of the market condition.
Market Condition	**Do not change** the requisite service period **unless** the market condition is satisfied before the end of the initial estimate of the requisite service period.

When the initial estimate of the requisite service period changes, the accounting depends on the nature of the change.

Cumulative Effect Adjustment	▶ If either the quantity or grant-date fair value of an award changes because another performance or service condition becomes probable (for example, the newly probable performance condition affects exercise price), that change will be accounted for as a cumulative effect adjustment. ▶ The cumulative effect (catch-up) adjustment is recorded in the period of change and equals what would have been recognized had the new estimate been used since the service inception date.
Prospective Adjustment	▶ If the initial estimate of the requisite service 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 will be recognized prospectively over the revised requisite service period. Similarly, if it becomes probable that a performance condition will be achieved earlier or later than initially estimated, any unrecognized compensation cost at that date will be recognized prospectively over the revised requisite service period.

Examples 4-31 and 4-32 illustrate these concepts.

EXAMPLE 4-31: CHANGE IN REQUISITE SERVICE PERIOD — CUMULATIVE EFFECT ADJUSTMENT

FACTS

An entity grants awards whose number varies depending on the entity's cumulative revenue over three years.

- If the entity generates $5 million of cumulative revenue over three years, 1,000 awards will vest.
- If the entity generates $6 million of cumulative revenue over three years, 1,500 awards will vest.

The entity determines that the performance condition is probable of achievement and that the entity will make $5 million of cumulative revenue over the three-year period. The grant-date fair value of the award is $5 per award. As a result, the entity recognized cumulative compensation cost of $3,333 (1,000 awards * $5 per award * 2/3) through the end of Year 2.

On the first day of Year 3, the entity executes revenue contracts with two large customers. Therefore, it anticipates generating $6 million of cumulative revenue by the end of Year 3.

CONCLUSION

The change in estimate is accounted for as a cumulative effect adjustment recorded in the period of change and equals what would have been recognized had the new estimate been used since the service inception date.

ANALYSIS

At the beginning of Year 3, the entity determines that it will generate $6 million of cumulative revenue (instead of $5 million) by the end of Year 3. Therefore, 1,500 awards will vest instead of 1,000 awards initially estimated because of the new revenue contracts. That change in estimate is accounted for as a cumulative effect adjustment. Accordingly, the entity recognizes additional compensation cost of $1,667 [(1,500 awards * $5 per award * 2/3) - $3,333 compensation cost recognized to-date] at the beginning of Year 3. If the estimate does not change again before the end of Year 3, the entity recognizes the remaining compensation cost of $2,500 [($1,500 awards * $5 per award) - $5,000 compensation cost recognized after the cumulative effect adjustment] during Year 3.

EXAMPLE 4-32: CHANGE IN REQUISITE SERVICE PERIOD — PROSPECTIVE ADJUSTMENT

FACTS

An entity grants an award with a grant-date fair value of $12,000. The award vests upon the entity generating a specified amount of cumulative revenue by the end of five years (the performance condition). The entity determines that the performance condition is probable of achievement in three years (it has an implicit service period of three years).

At the beginning of Year 3, the entity had recognized compensation cost of $8,000 ($12,000 * 2/3). However, it lost a key customer in Year 3 and therefore no longer expects to meet the performance condition at the end of Year 3. Rather, it determines that the performance condition will now be achieved at the end of Year 4.

CONCLUSION

The change in estimate is accounted for prospectively. In other words, the remaining compensation cost is recognized over the remaining period of the revised requisite service period.

ANALYSIS

At the beginning of Year 3, the entity determines that although the performance condition is still probable of achievement, the performance condition will be achieved in four years instead of three years. That change in estimate is accounted for prospectively. Accordingly, the entity recognizes the remaining $4,000 ($12,000 grant-date fair value less $8,000 recognized to-date) over the remaining two years of the revised requisite service period ($2,000 each year).

Example 4-33 illustrates a change in requisite service period when the award includes a market condition.

EXAMPLE 4-33: CHANGE IN REQUISITE SERVICE PERIOD — MARKET CONDITION

FACTS

An entity grants executives 1,000 stock options that vest upon the entity's stock achieving and maintaining a price of $75 over 30 consecutive trading days. The executives must remain employed with the entity to vest in the award; otherwise, the stock options contain no other vesting conditions. The entity applies a lattice model and initially estimates that the market condition will be achieved in three years, which represents a derived service period. However, market conditions improve and the entity's stock price achieves the market condition two years after grant.

CONCLUSION

The entity initially recognizes the grant-date fair value of the award over three years, which is the derived service period. When the market condition is achieved in two years, the entity recognizes all remaining unrecognized compensation expense.

ANALYSIS

At grant date, the entity uses a lattice model to estimate the award's fair value and derived service because of the presence of a market condition. Because the award contains no other vesting conditions, the entity initially recognizes compensation cost over the derived service period of three years. The requisite service period for an award with a market condition is not revised unless the market condition is satisfied before the end of the derived service period. Because the market condition is satisfied in only two (not three) years, the entity immediately recognizes any unrecognized compensation cost because the executives do not have to provide any additional service to earn the award.

Alternatively, if the market condition is not achieved, but the executives render the three years of requisite service, compensation cost is not reversed.

4.4 ACCOUNTING FOR LIABILITY-CLASSIFIED AWARDS

FASB REFERENCES

ASC 718-10-20: Settlement of an Award, ASC 718-30-30-1, ASC 718-30-35-1 through 35-4, and ASC 718-30-55-1 through 55-11

At the grant date, the measurement objective for share-based payment awards that are classified as liabilities is the same as awards classified as equity. However, unlike equity-classified awards, where the measurement date is the grant date, the measurement date for liability-classified awards is the **settlement date**. In other words, liability-classified awards are remeasured at fair value (or, if elected, intrinsic value for nonpublic entities (see Section 2.4.2.2)) each reporting period until the occurrence of an action or event that irrevocably extinguishes the entity's obligation under the share-based payment award. Examples of settlements include:

- Forfeiture of shares or stock options caused by failure to satisfy a vesting condition
- An entity's repurchase of an instrument in exchange for assets or for a fully vested and transferable equity share or instrument.
- An entity's repurchase of a share.

The vesting of a liability-classified stock option or similar instrument is not a settlement if the entity is still obligated to issue liability-classified shares or transfer assets upon exercise of the stock option or similar instrument (see Section 3.2.3). Similarly, the vesting of a liability-classified stock award (for example, restricted shares) is not a settlement if the award includes repurchase features (see Section 3.2.2).

Changes in the fair (or intrinsic) value of a liability-classified award during the requisite service period for employees or vesting period for nonemployees is recognized as compensation cost over that period. The percentage of fair (or intrinsic) value accrued as compensation cost at each reporting period must correspond to the percentage of service rendered. Changes in the fair (or intrinsic) value after the requisite service or vesting period are recognized as compensation cost in the period of the change. Any difference between the settlement amount and fair value of a liability-classified award is adjusted as compensation cost in the settlement period. When an award is classified as liability, an entity must:

1. Measure the fair value of the award on the grant date.
2. Remeasure the fair value of the award each reporting period.
3. Calculate the change in fair value based on the portion of service rendered and recognize it as compensation cost in each reporting period.
4. Once the requisite service period is complete, continue to remeasure the fair value of the award (with changes in fair value recognized as compensation cost) until the award is settled.

Example 4-34 illustrates the accounting for a liability-classified award.

EXAMPLE 4-34 (ADAPTED FROM EXAMPLE 1, ASC 718-30-55-1 THROUGH 55-11): CASH-SETTLED SAR

FACTS

- On January 1, 20X5, an entity grants employees 900,000 SARs with a grant-date fair value of $14.69 per SAR. Also, the fair value of the SARs as of December 31, 20X5, 20X6, and 20X7, is:
  - December 31, 20X5: $10 per SAR
  - December 31, 20X6: $25 per SAR
  - December 31, 20X7: $20 per SAR
- The awards cliff vest at the end of three years of service (an explicit and requisite service period of three years).
- The entity makes an accounting policy election to estimate the number of forfeitures expected to occur and determines a forfeiture rate of 3% per year based on its experienced historical turnover rates. It expects that rate to continue over the awards' requisite service period.
- Each SAR entitles the employee to receive an amount in cash equal to the increase in value of one share of the entity's stock over $30.

CONCLUSION

SARs are classified as liabilities and must be initially measured at fair value on grant date and subsequently remeasured at fair value each reporting period through settlement date.

ANALYSIS

The entity estimates its forfeiture rate at 3% per year. Therefore, the number of SARs for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 (900,000 * .97^3). Thus, the fair value of the award as of January 1, 20X5, is $12,066,454 (821,406 * $14.69).

The SARs are classified as liabilities because they will be settled in cash. Awards classified as liabilities are initially recognized at fair value and remeasured at each reporting date through the date of settlement; consequently, compensation cost recognized during each year of the three-year vesting period (as well as post-vesting until settlement) will vary based on changes in the award's fair value. As of December 31, 20X5, the fair value is $10 per SAR; hence, the award's fair value is $8,214,060 (821,406 * $10). The share-based compensation liability as of December 31, 20X5, is $2,738,020 ($8,214,060 / 3) to account for the portion of the award related to the service rendered in 20X5 (one year of the three-year requisite service period).

The journal entry for 20X5 is:

Debit	Compensation cost	$ 2,738,020	
Credit	Share-based compensation liability		$ 2,738,020

To recognize a share-based compensation liability and associated compensation cost.

As of December 31, 20X6, the fair value is $25 per SAR; hence, the 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 service has been provided for two years of the three-year requisite service period. Compensation cost recognized for the award in 20X6 is $10,952,080 ($13,690,100 - $2,738,020). The entity records the following journal entry for 20X6:

Debit	Compensation cost	$ 10,952,080	
Credit	Share-based compensation liability		$ 10,952,080

To recognize a share-based compensation liability and associated compensation cost.

As of December 31, 20X7, the fair value is $20 per SAR; hence, the award's fair value is $16,428,120 (821,406 * $20), and the liability is $16,428,120 because the award is fully vested. Compensation cost recognized for the liability award in 20X7 is $2,738,020 ($16,428,120 - $13,690,100). The entity recognizes the following journal entry for 20X7:

Debit	Compensation cost	$ 2,738,020	
Credit	Share-based compensation liability		$ 2,738,020

To recognize a share-based compensation liability and associated compensation cost.

If the SAR is not settled upon vesting, the entity would continue to remeasure the award's fair value and recognize any changes in earnings as compensation cost until settlement.

For liability-classified awards, compensation cost is remeasured at each reporting period until settlement date. As a result, the grantor recognizes no cumulative compensation cost for an award that has no value on the settlement date (for example, a cash-settled SAR when the share price at settlement is less than the target price). That model differs from an equity-classified award whose grant date fair value is not revised. Compensation cost for such an award is not reversed as long as the vesting conditions are met, even if the award has little or no value at settlement or expiration.

4.5 CLAWBACK AND NONCOMPETE PROVISIONS

FASB REFERENCES

ASC 718-10-30-24, ASC 718-10-55-8 and 55-47, ASC 718-20-35-2 through 35-3, and ASC 718-20-55-84 through 55-92

A share-based payment arrangement may require a grantee to return vested awards or realized gains from the sale of vested awards in exchange for consideration that is less than the award's fair value (or no consideration) on the return date. This protective provision (which is meant to function as a noncompete tool, often known as a clawback feature) requires or allows the recovery of value from grantees upon specific contingent events, such as the following:

- **Material restatement**
- **Malfeasance**
- **Fraud**
- **Violation of non-solicitation agreement**

Clawback features are not considered in determining the grant-date fair value or in recognizing compensation cost. Rather, their effects are recognized **only** when the contingent event occurs, at which time the consideration received is recognized on the balance sheet with an offsetting entry to the income statement equal to the **lesser** of:

- The previously recognized compensation cost of the share-based payment award containing the clawback feature
- The fair value of the consideration received.

Any difference between the fair value of the consideration received and the amount recognized in the income statement is recorded as APIC.

Example 4-35 illustrates the accounting for a clawback feature.

EXAMPLE 4-35: SHARE AWARD WITH A CLAWBACK FEATURE (QUOTED FROM ASC 718-20-55-85 THROUGH 55-86)

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 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 consideration as a result of the clawback feature.

In rare cases, a noncompete provision requiring the return of vested shares or profits from the sale of those shares when the provision is triggered may function as a service condition. Determining whether a noncompete provision represents an in-substance service condition is a matter of judgment based on the facts and circumstances. Factors an entity considers when determining whether a noncompete provision is an in-substance service condition could include:

	The employee's rights under the arrangement; for example, the right to sell.
	The arrangement's nature and legal enforceability.
	The lack of an explicit service condition.
	Limitations on the employee's ability to work in the industry in any capacity.
	The expiration of any transferability or exercisability restriction mirroring the lapse of the arrangement.
	The nature of the entity's operations, industry, and employee relationships.
	The award's fair value relative to the employee's expected future annual total compensation.
	The entity's intent to enforce the arrangement and its past practice of enforcement.

Example 4-36 illustrates a noncompete provision functioning as an in-substance service condition.

EXAMPLE 4-36: SOME NONCOMPETE AGREEMENTS AND REQUISITE SERVICE FOR EMPLOYEE AWARDS (QUOTED FROM EXAMPLE 11 ASC 718-20-55-87 THROUGH 55-91)

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.

Some share-based payment awards include clauses that require grantees to exercise their vested stock options within a specific time period after termination, effectively shortening the contractual lives of those awards. If the awards are not exercised within the designated period, they expire. The obligation to relinquish vested awards because of non-exercise before their expiration **does not** qualify as a clawback feature. According to ASC 718-10-35-3, entities must not treat such provisions as clawback features nor reverse the recorded compensation cost for vested awards that are forfeited because they were not exercised before expiring.

4.5.1 SEC Clawback Rule

The SEC adopted **final rules** to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the clawback rules. Those rules require public entities to adopt policies that mandate the recovery of incentive-based compensation (for example, stock options, bonuses, and other performance-based awards) from current and former executive officers in the event of a material restatement of the entity's financial statements. Public entities must file their clawback policies as exhibits to their annual reports and disclose any actions taken under those policies.

Under the final rules, entities must recover excess incentive-based compensation awarded during the three years preceding the date on which the entity must prepare an accounting restatement. The amount subject to clawback equals the excess of what was paid to executive officers (as defined in the rules) over what would have been paid based on the restated results over the three-year look-back period. The clawback applies regardless of whether the executive was at fault for the restatement. See BDO's **Snapshot: SEC Clawback Rules** for more guidance on the rules.

As discussed in Section 4.5, a clawback is recognized **only** upon the occurrence of the contingent event and when consideration is received. Therefore, there is no accounting effect on the initial measurement and recognition of the award before the clawback event. When the material restatement triggering the clawback occurs and the consideration is received, the entity reverses compensation cost related to the original equity-classified award and recognizes the fair value of the consideration received in excess of that compensation cost as an increase to APIC. If the original award is classified as a liability, similar accounting applies; the final measurement of compensation cost is recognized in the entity's income statement with any excess recognized as an increase to APIC.

4.6 RECOURSE AND NONRECOURSE NOTES

FASB REFERENCES

ASC 718-10-25-3

ASC 718 states that the accounting for share-based payment transactions must reflect the grantee's rights and the entity's obligations, regardless of the transaction's structure. For instance, the exchange of equity shares for a nonrecourse note is in substance a grant of stock options and therefore must be accounted for as such.

Entities may provide financing to grantees to purchase shares or exercise stock options. The financing may be in the form of a recourse or nonrecourse note. A recourse note is generally collateralized by assets of the grantee beyond the awards themselves. In other words, in the event of default by the grantee, the entity (lender) can claim personal assets of the grantee (borrower) in addition to the shares. Conversely, a nonrecourse note is collateralized by the shares **only**, thereby limiting the entity's (lender's) claim to only the shares in case of default by the grantee. Public entities also need to consider regulatory restrictions, such as those imposed by the Sarbanes-Oxley Act of 2002, on providing notes to employees for purchasing shares or exercising options.

The distinction between recourse and nonrecourse loans is crucial in determining how to account for the transaction (see Sections 4.6.1 and 4.6.2).

NONRECOURSE: An entity's recourse is limited to the purchased shares and does not extend to the grantee's additional assets.

RECOURSE: An entity is granted the legal authority to seize the grantee's other assets (beyond the shares) if a default occurs.

Also, a grantee can purchase shares or exercise stock options in exchange for a portion of a recourse note and the remainder as a nonrecourse note, which can be used to obtain favorable U.S. tax treatment (see Section 4.6.3). Further, an entity may add features to, or change the terms of, a note, such as the interest rate (see Section 4.6.4).

4.6.1 Recourse Notes

FASB REFERENCES

ASC 210-10-S99-1, ASC 505-10-45-2, and ASC 718-10-25-3 through 25-4

A recourse note is an enforceable obligation that allows the lender (entity or employer) to seek repayment from the borrower's (grantee's) entire asset portfolio in the event of a default. The note can be secured or unsecured. A secured note indicates that specific borrower assets are earmarked as collateral for the lender, such as the shares acquired through the note or other specified assets of the grantee secured in escrow, whereas an unsecured note does not refer to specific assets. However, an unsecured note can still legally enable the lender to pursue all the borrower's assets in the event of a default. A note being secured does not necessarily equate to it being a full recourse note. For example, nonrecourse notes are typically secured by the related shares.

A note receivable is generally presented as a reduction of shareholders' equity rather than as an asset in accordance with ASC 505-10-45-2. While a nonpublic entity may present the note receivable as an asset in very limited circumstances, as discussed in ASC 210-10-S99-1, public entities must present the note receivable as a reduction of shareholders' equity. Also, the shares associated with the note are included in the calculations of earnings per share and dividends per share. Dividend payments on the shares are recorded against retained earnings.

An entity may allow a grantee to purchase shares or exercise stock options through a recourse note that carries either no interest or interest at a below-market rate. That results in a purchase or exercise price that is less than the fair value of the shares. In such cases, the purchase or exercise price is determined by discounting the principal and any interest at the current market rate to arrive at its present value, which is the fair value of the recourse note, in accordance with ASC 835-30, *Interest — Imputation of Interest*. The difference between the fair value of the shares and the present value of the note is recognized as compensation cost because an award's fair value includes the award's intrinsic value.

Example 4-37 illustrates the accounting for a recourse note with a below-market interest rate.

EXAMPLE 4-37: RECOURSE NOTE WITH A BELOW-MARKET INTEREST RATE

FACTS

An entity makes a $50,000 non-interest-bearing recourse note to its CEO in exchange for the CEO's purchase of the entity's shares. The recourse note is payable in four years. At the time of the transaction, the prevailing market interest rate is 7%.

CONCLUSION

The difference between the fair value of the shares and the present value of the note is recognized as compensation cost.

ANALYSIS

The entity effectively lowered the purchase price of the shares by making a non-interest-bearing recourse note to its CEO. The CEO acquired shares valued at $50,000, but because the entity made a four-year, non-interest-bearing note to the CEO when the market interest rate was 7%, the fair value of the consideration (purchase price) is $38,145. In other words, the present value of the note is $50,000 over four years, discounted at a 7% interest rate.

The difference of $11,855 between the fair value of the shares ($50,000) and the present value of the note ($38,145) is recognized as compensation cost over the note's four-year term.

A note may be legally structured as a recourse note but in substance may function as a nonrecourse note. That is sometimes the case when an entity receives a recourse note and does not intend to fully collect on the note if the shares are worth less than the note balance.

BDO INSIGHTS — IN-SUBSTANCE NONRECOURSE NOTE

An entity must evaluate a recourse note to determine if the note functions as a nonrecourse note. In doing so, we believe Issue 34 of EITF Issue 00-23, although superseded, remains relevant. That guidance suggests that a recourse note is accounted for as a nonrecourse note if the arrangement has **any** of the following features:

- The entity has a history of not demanding repayment of note amounts in excess of the shares' fair value.
- The grantee does not have sufficient assets or other means (beyond the shares) to justify the recourse nature of the loan.
- The entity has accepted a recourse note upon exercise and subsequently converts the note to a nonrecourse note.
- The entity has legal recourse to the grantee's other assets but does not intend to seek repayment beyond the shares issued.

Reaching a conclusion about whether a recourse note is in substance a nonrecourse note requires the application of professional judgment based on the facts and circumstances.

4.6.2 Nonrecourse Notes

FASB REFERENCES

ASC 718-10-25-3 through 25-4 and ASC 718-10-30-5

A nonrecourse note issued by a grantee to purchase shares or exercise stock options is collateralized by the shares only, thereby limiting the entity's (lender's) claim to only the shares in case of default by the grantee. When a grantee provides a nonrecourse note as consideration, that note is treated as a stock option for accounting purposes. If the value of shares pledged as collateral falls below the note's outstanding balance, the grantee can choose not to repay the outstanding note balance and instead return the shares. That ability puts the grantee in a position as if the stock option exercise or share purchase had never occurred.

When a nonrecourse note is exchanged for shares, its principal and interest are treated as the exercise price of a hypothetical stock option, eliminating the recognition of interest income. As the note accrues interest, the exercise price increases over time by the accruing interest amount, so the valuation model must factor that increasing exercise price into the value of the stock option. Also, given that the shares issued on a nonrecourse basis are treated as stock options, neither the note nor the shares are directly recorded. Instead, the fair value of the hypothetical stock options is recognized as compensation cost over the requisite service period or vesting period with a corresponding credit to APIC or liability, depending on the award's classification. All principal and interest payments are considered refundable deposits and recognized as a liability until the note is repaid, at which point the liability is reclassified as APIC. Nonrefundable payments (for example, nonrefundable interest payments) are recognized as APIC upon receipt. Moreover, the shares issued in exchange for the nonrecourse note are excluded from basic EPS calculations and instead considered in diluted EPS using the treasury stock method until the note is repaid (see Section 7.5).

The fair value of the hypothetical stock option is recognized as compensation cost over the requisite service period or the vesting period. That requisite service period or vesting period might not align with the note's term. For example, the terms of a nonrecourse note that matures in five years might provide the grantee the option to prepay the note. In that case, the note's maturity date serves as the hypothetical stock option's contractual term included as an input into the award's fair value determination, and the award's fair value is fully recognized as compensation cost at the grant date, not over the note's term. That is because the grantee can prepay the note at any time and is not required to deliver the goods or service over the entire five-year term of the note.

Additional considerations related to a nonrecourse note include:

Interest-Bearing Nonrecourse Note Linked to an External Index	An entity may enter a nonrecourse note with a grantee that carries a variable interest rate linked to an external index (like the Secured Overnight Financing Rate) throughout the note's term. As the exercise price adjusts based on an external index, the hypothetical stock option is tied to a factor that does not relate to a market, performance, or service condition. Therefore, the award is classified as a liability (see Section 3.2.5).
Dividends Paid on a Nonrecourse Note	An entity may pay dividends on shares acquired through a nonrecourse note. Because a nonrecourse note exchanged for shares is treated as a stock option, dividends paid on the shares while the note remains outstanding are deducted from retained earnings for equity-classified awards anticipated to vest. For equity-classified awards that are not anticipated to vest or ultimately do not vest, dividend payments are recorded as additional compensation cost (see Section 4.7).

BDO INSIGHTS — CASH LOAN THROUGH A NONRECOURSE NOTE

An entity may receive a nonrecourse cash note from a grantee in which the note is collateralized by the grantee's existing shares in the entity. ASC 718 does not address that type of transaction. However, we believe it is treated like a conversion of a recourse note to a nonrecourse note. In other words, the transaction is accounted for as a repurchase of shares from the grantee, followed by the issuance of a new award in the form of a stock option. The repurchase of shares is considered a treasury stock transaction, and any excess of the repurchase price over the shares' fair value is recognized as compensation cost. Because cash is issued in exchange for a nonrecourse note collateralized by shares, the repurchase price is the sum of the cash amount and the fair value of the option held by the grantee.

IF: Repurchase Price (Cash Loan + Fair Value of Option) > Fair Value of Shares Pledged or Collateralized → THEN: Recognize Compensation Cost

EXAMPLE 4-38: CASH LOAN THROUGH A NONRECOURSE NOTE

FACTS

- An entity loaned its COO $750,000 at a fixed annual interest rate that is at market. Additional loan terms are:
- Both the principal amount and any interest accrued on the loan must be repaid in full at the end of five years from issuance date of the loan (maturity date).
  - The loan is secured exclusively by 50,000 shares of the entity's common stock that the COO acquired by exercising stock options a year before.
  - The COO is required to retain ownership of the pledged shares of the entity's common stock until the loan's maturity date and is not allowed to sell or transfer the shares.
  - The loan offers no recourse against any other assets owned by the COO.
  - The COO can prepay the loan at any time before its maturity date.

- The fair value of pledged shares and the option to reacquire the shares is $1 million and $450,000, respectively. The option to reacquire the shares is equity-classified.

CONCLUSION

The repurchase is treated as a treasury stock transaction. The entity recognizes compensation cost for the difference if the repurchase price exceeds the fair value of the pledged shares.

ANALYSIS

The entity issued the COO a nonrecourse cash note collateralized solely by 50,000 shares of its common stock owned by the COO. The entity accounts for the loan as nonrecourse (that is, a repurchase of shares from the COO, followed by the issuance of a new award in the form of a stock option). Accordingly, the entity calculates the total repurchase price as the sum of the cash loan amount and the fair value of the option held by the COO:

Loan proceeds	$ 750,000
Fair value of option	450,000
Total repurchase price	$1,200,000

Because the total repurchase price exceeds the fair value of the pledged shares, the excess is recognized as compensation cost as:

Total repurchase price	$1,200,000
Fair value of pledged shares	(1,000,000)
Compensation cost	$ 200,000

As of the issuance date of the cash loan, the entity records the following journal entries:

Debit	Treasury stock	$1,000,000	
Debit	Compensation cost	200,000	
Credit	Cash		$750,000
Credit	APIC		450,000

To record the nonrecourse cash loan.

Compensation cost is fully recognized on the loan's issuance date because the loan provides the COO with a prepayment option whereby the COO is not required to provide service over the entire term of the loan.

4.6.3 Part Recourse Note and Part Nonrecourse Note

A grantee may purchase shares or exercise stock options partly in exchange for a recourse note and partly for a nonrecourse note to obtain favorable U.S. tax treatment.

If the respective notes are not aligned with a corresponding percentage of the underlying shares (that is, the respective notes are not each related to a pro-rata portion of the shares), then the exercise price for each share of stock is represented by both the nonrecourse notes and the recourse notes. In such a non-pro-rata structure, no portion of the award should be accounted for as exercised. That is, the inclusion of the nonrecourse note as part of the exercise price causes both notes to be accounted for together as nonrecourse, regardless of the relative percentages of the recourse and nonrecourse notes to the total exercise price.

4.6.4 Changes to Notes

An entity may add features to, or change the terms of, a note, such as the interest rate. Those additions or changes are generally accounted for as a modification (see Chapter 5).

If an entity forgives or extends a note or converts a recourse note to a nonrecourse note, the accounting is as follows:

FORGIVENESS	
An entity forgives a **recourse note**, including any accrued and unpaid interest. As a result, the grantee may not be required to return the collateralized shares.	Forgiveness of a recourse note is considered a modification under ASC 718, even if the shares initially issued in exchange for the recourse note were not subject to ASC 718. Therefore, on the date of forgiveness, the entity must recognize compensation cost for the forgiven recourse note and any accrued and unpaid interest offset by any recoveries. Also, forgiveness may require the entity to reassess whether there was an intention to forgive the recourse note at the time of its issuance and to evaluate if other existing recourse notes are in-substance nonrecourse notes.
An entity forgives a **nonrecourse note**, including any accrued and unpaid interest. As a result, the grantee may not be required to return the collateralized shares.	A nonrecourse note is accounted for as a grant of a stock option, whereby the principal and interest are treated as the hypothetical stock option's exercise price. Consequently, forgiving a nonrecourse note effectively reduces the hypothetical stock option's exercise price to zero. Therefore, at the time of forgiveness, an entity applies modification accounting and recognizes any additional compensation cost (see Chapter 5). If an entity forgives a nonrecourse note and requires the grantee to return the collateralized shares, the forgiveness is accounted for as a cancellation without the concurrent grant of a replacement award (see Section 5.7).

EXTENSION	
An entity extends the maturity date of a **recourse note.**	Extension of the maturity date of a recourse note is considered a modification (see Chapter 5). Accordingly, an entity must determine whether the extension provides added value to the grantee, requiring recognition of additional compensation cost. That may occur, for example, if the interest rate for the grantee is below the market rate at the time of extension. Further, an entity must assess whether the modification effectively converts the recourse note to a nonrecourse note. See BDO Insights in Section 4.6.1 for factors to consider when determining if a recourse note is in substance a nonrecourse note.

4.7 DIVIDEND-PROTECTED AWARDS

FASB REFERENCES

ASC 480-10-55-14, ASC 480-10-55-28, and ASC 718-10-55-45

A grantee may receive dividends or dividend equivalents related to a share-based payment award that is subject to vesting conditions. Those awards are commonly called “dividend-protected awards.”

The accounting for dividends on dividend-protected, equity-classified awards depends on the policy for forfeitures.

ESTIMATING FORFEITURES	ACCOUNTING FOR FORFEITURES AS INCURRED
▶ Dividends are factored into the grant-date fair value of the award. ▶ Dividends are recorded against retained earnings based on forfeiture estimates used to recognize compensation cost to the extent the award is expected to vest. ▶ Dividends are subsequently reclassified between retained earnings and compensation cost if there are changes in forfeiture estimates or if actual forfeitures differ from previous estimates.	▶ All forfeitable and nonforfeitable dividends are recorded against retained earnings. ▶ Nonforfeitable dividends are reclassified to compensation cost as forfeitures of the awards occur.

BDO INSIGHTS — EQUITY RESTRUCTURING MODIFICATIONS VERSUS DIVIDEND-PROTECTED AWARDS

As discussed in Section 5.5, the guidance in ASC 718 on equity restructurings refers to “large” and “non-recurring” dividends. Dividend distributions in an equity restructuring are generally significant in amount and infrequent. They may require modification accounting depending on the facts and circumstances.

We believe the guidance on dividend-protected awards is relevant when employees receive dividends regularly, such as annually, and award recipients are eligible for those dividends. Those distributions typically do not result in modification accounting but may require additional compensation cost recognition in some circumstances. Determining whether a dividend distribution is treated as a modified award as a result of an equity restructuring or a dividend-protected award requires the application of professional judgment based on the facts and circumstances.

The table below summarizes the effect of nonforfeitable and forfeitable dividends on equity-classified awards.

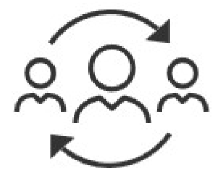
Nonforfeitable Dividends[7]	▶ Nonforfeitable dividends on awards that are expected to vest are recognized as charges to retained earnings. ▶ Nonforfeitable dividends on awards that are not expected to vest are recognized as additional compensation cost.
Forfeitable Dividends	▶ Forfeitable dividends are paid to the grantee only when the award vests, so they do not result in additional compensation cost.

[7] Unvested awards that have nonforfeitable rights to dividends are participating securities for computing earnings per share. See Section 7.5.

BDO INSIGHTS — DIVIDENDS PAID ON LIABILITY AWARDS

ASC 718 does not specifically address the appropriate treatment of dividend-protected liability-classified awards. Consistent with the guidance in ASC 480-10-55-14 and ASC 480-10-55-28 whereby dividends paid related to liability-classified equity contracts are recognized as expenses, we believe dividends paid on liability-classified awards must be accounted for as compensation cost.

4.8 "LAST MAN STANDING" ARRANGEMENTS



Share-based payment awards may be granted to a group of employees but subsequently can be reallocated to remaining employees if any employees terminate before vesting in the awards. Those arrangements are commonly referred to as "last man standing" arrangements. They can also occur when an acquirer offers share-based payment awards to specific shareholders of an acquiree who become employees of the combined entity. Those awards may be placed in a trust when the acquisition occurs and are earned by the shareholders if they provide continued service for a specified period of time. See BDO's Blueprint, Business Combinations Under ASC 805, for guidance on share-based payment awards issued in a business combination.

Awards forfeited by the terminated employee and then reallocated to the remaining employees in last man standing arrangements are treated as forfeitures followed by grants of new awards. Therefore, an entity accounts for the forfeiture based on its accounting policy for forfeitures, measures compensation cost based on the fair value of the new award on the reallocation date, and recognizes that cost over the requisite service period.

4.9 CAPITALIZATION OF SHARE-BASED COMPENSATION COST

FASB REFERENCES

ASC 718-10-25-2A and ASC 718-10-S99-1

ASC 718 provides guidance on the measurement, timing, and pattern of recognition related to compensation cost. However, it does not specify that all compensation cost must be expensed. In other words, while compensation cost is generally recognized as an expense in the income statement, it is sometimes capitalized as an asset in accordance with other U.S. GAAP. SAB Topic 14.I addresses this concept:

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

I. Capitalization of Compensation Cost Related to Share-Based Payment 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.* [85]

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 management's 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,[86] is effective.*

[85] FASB ASC paragraph 718-10-25-2A.

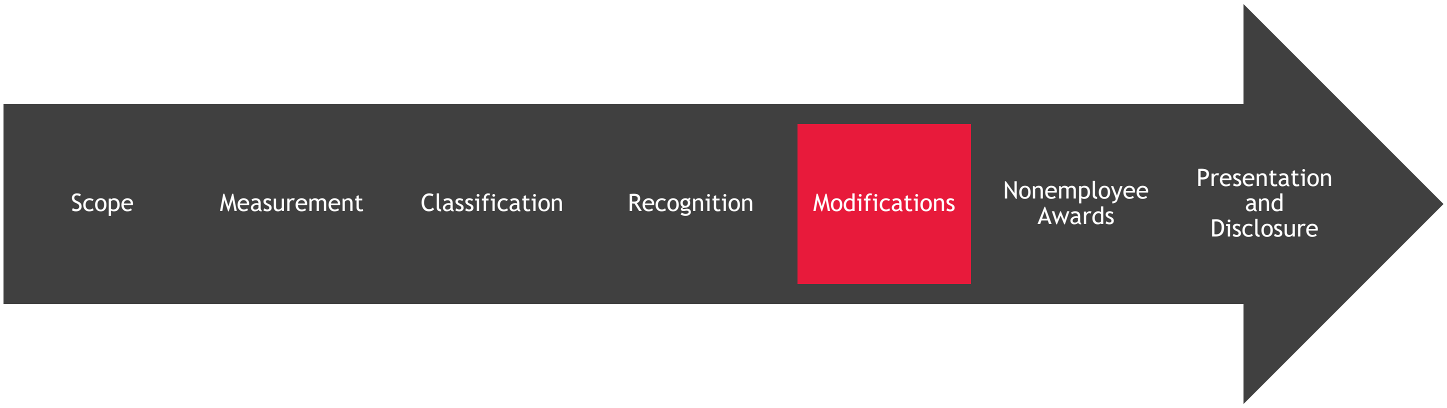
[86] Release No. 34-47986, June 5, 2003, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.

If share-based compensation cost is capitalized, it is then accounted for under other U.S. GAAP that requires capitalization.

The table below provides examples of assets in which share-based compensation cost can be capitalized.

	EXAMPLES OF CAPITALIZED COSTS
	ASC 330, *Inventory*
	Costs in the scope of ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*
	Capitalized software costs: ▶ Internal-use software in the scope of ASC 350-40 and ASC 360 ▶ Costs in the scope of ASC 985-20, *Software — Costs of Software to be Sold, Leased, or Marketed*
	ASC 360, *Property, Plant, and Equipment*

Chapter 5 — Modifications



5.1 OVERVIEW

Entities sometimes change the terms or conditions of an existing share-based payment award for a variety of reasons, for example:

BUSINESS REASONS	ECONOMIC REASONS	REGULATORY REASONS
▶ Change in control or IPO ▶ Grantee termination	▶ Reduction in exercise price stemming from a significant decline in the entity's share price	▶ Change in tax law

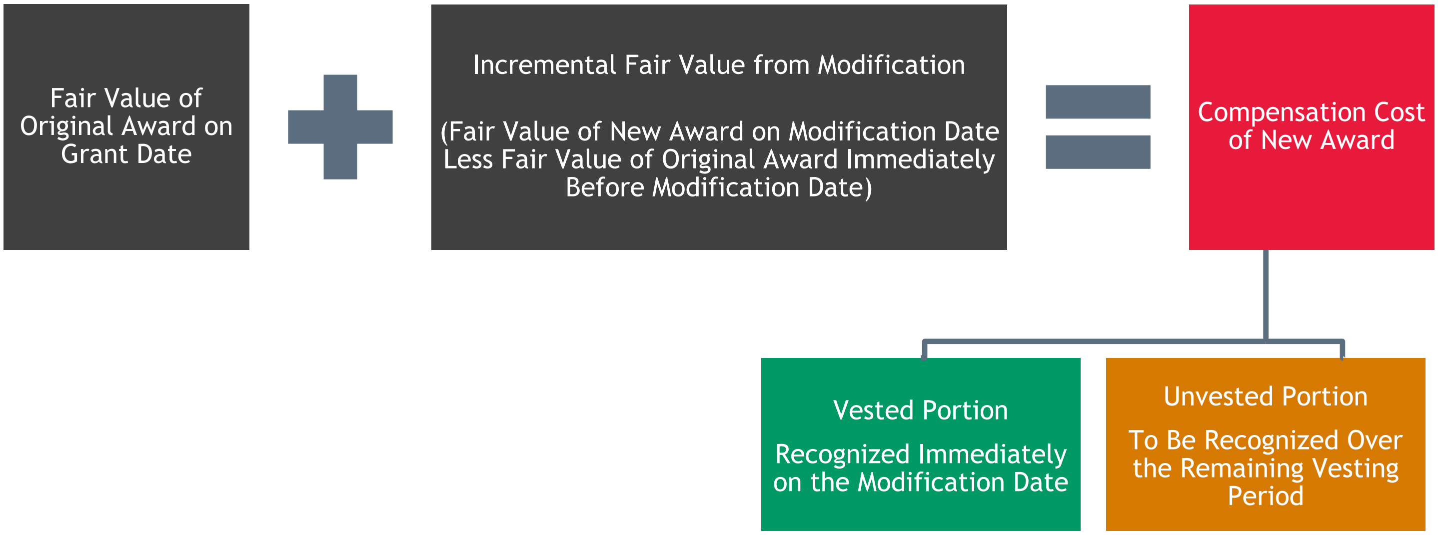
An entity must account for a modification of an equity-classified award's terms in accordance with ASC 718 unless the modification meets the scope exception in ASC 718-20-35-2A (see Section 5.2). Also, an entity may be required to apply modification accounting in some circumstances that do not include a legal change to the terms of an award. For example, establishing a history of settling an award in cash could result in a change in the award's classification from equity to liability. If an existing liability-classified share-based payment award is modified, an entity simply remeasures the fair value of the award using the modified terms at the modification date and each reporting period thereafter (see Example 5-2). The concept of compensation cost at least equaling the grant-date fair value of the original award does not apply to liability-classified awards. Because modifications of existing liability-classified awards are less complex than equity-classified awards, this Chapter focuses on modifications of existing equity-classified awards unless otherwise noted.

If an entity modifies an existing equity-classified share-based payment award and the scope exception in ASC 718-20-35-2A does not apply, the modification is treated as an exchange of the original award for a new award. In substance, the entity repurchases the original award by issuing a new award of equal or greater value. That results in additional compensation cost for any incremental value, which is recognized on the modification date (for vested awards) or over the remaining vesting period (for unvested awards).

The accounting for modifications applies to all share-based payment awards, including those issued to nonemployees (see Section 6.7). Further, changes to the terms or conditions of an award require specific disclosures (see Section 7.3). An entity must consider the effects of modifications on EPS (see Section 7.5) and income tax accounting.

ASC 718 does not explicitly provide guidance on the determination of the modification date. In practice, the same criteria for determining the grant date in Section 2.2 are used to establish the modification date.

Compensation cost for a modified equity-classified award is generally measured at the modification date as the **sum of** (i) the grant-date fair value of the original award and (ii) the incremental fair value of the award that results from the modification, as illustrated below:



EXAMPLE 5-1: MODIFICATION OF VESTED AND UNVESTED STOCK OPTIONS

FACTS

On January 1, 20X3, an entity grants 5,000 stock options to employees with a grant-date fair value of $10 each. The stock options vest over four years based on a graded schedule with 25% vesting at the end of each year of service. The entity elected an accounting policy to recognize compensation cost for the stock options on a straight-line basis over the requisite service period. The entity expects no forfeitures (that is, all stock options are probable of vesting).

As of December 31, 20X3, the entity recognized compensation cost of $12,500 (5,000 * $10 * 25%) for Year 1.

On January 1, 20X4, the entity modifies the terms of the award such that the fair value of the modified stock options is $15 each. Immediately before the modification, the fair value of the original award is $12 per stock option. No changes are made to the requisite service period of four years, and all options are still expected to vest.

CONCLUSION

Incremental compensation cost of $3,750 is recognized immediately on the modification date. The remaining $48,750 of compensation cost, which includes the incremental compensation cost and the original compensation cost, is recognized over the remaining requisite service period of three years.

ANALYSIS

- Fair Value of Original Award on Grant Date
  - The number of stock options granted multiplied by the grant date fair value of each option, or (5,000 * $10 = $50,000)
- Incremental Fair Value From Modification

	VALUE	CALCULATION
Fair value of modified stock options	$ 75,000	5,000 * $15
Less fair value of original stock options immediately before modification	60,000	5,000 * $12
Incremental fair value	$ 15,000	5,000 * $3

- Compensation Cost of New Award
  - The sum of the fair value of the original award on the grant date ($50,000) and the incremental fair value from the modification ($15,000) is the compensation cost of the new award ($65,000).
    - Vested Portion: As of the modification date, the new award's compensation cost for the first year of service is $16,250 ($65,000 * 25%). Therefore, the entity must recognize an additional $3,750 ($16,250 less $12,500 previously recognized) of compensation cost on the modification date representing the vested portion of the new award.
    - Unvested Portion: The remaining $48,750 ($65,000 * 75%) of compensation cost is recognized over the remaining requisite service period of three years.

BDO INSIGHTS — COMPENSATION COST OF A MODIFIED AWARD GENERALLY CANNOT BE LESS THAN THE GRANT-DATE FAIR VALUE OF THE ORIGINAL AWARD

Compensation cost for a modified equity-classified award must **at least equal** the grant-date fair value of the original award unless the performance or service condition of the original award is not expected to be satisfied on the modification date. Therefore, if the fair value of the modified award is less than the fair value of the original award on the modification date, compensation cost is not adjusted on the modification date such that the grant-date fair value is reduced. We believe modifications that result in the fair value of the new award being less than the fair value of the original award are rare because changes to the terms or conditions of an award typically are made either to provide incremental economic benefit to grantees or compensate grantees for an economic downturn of an entity's business.

EXAMPLE 5-2: LIABILITY TO LIABILITY MODIFICATION (CASH-SETTLED TO CASH-SETTLED STOCK APPRECIATION RIGHTS) (QUOTED FROM EXAMPLE 16, CASE D, ASC 718-20-55-139 THROUGH 55-143)

ASC 718-20-55-139

Entity T grants stock appreciation rights to its employees. The fair value of the award on January 1, 20X5, is $12,066,454 (821,406 × $14.69).

ASC 718-20-55-140

On December 31, 20X5, the fair value of each stock appreciation right is assumed to be $5; therefore, the fair value of the award is $4,107,030 (821,406 × $5). The share-based compensation liability at December 31, 20X5, is $1,369,010 ($4,107,030 ÷ 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 [entry] to recognize compensation cost for 20X5 [is] as follows.

Compensation cost	*$1,369,010*	
Share-based compensation liability		*$1,369,010…*

ASC 718-20-55-141

On January 1, 20X6, Entity T reprices the stock appreciation rights, giving each holder the right to receive an amount in cash equal to the increase in value of 1 share of Entity T stock over $10. The modification affects no other terms or conditions of the stock appreciation rights and does not change the number of stock *appreciation rights expected to vest. The fair value of each stock appreciation right based on its modified terms is $12. The incremental compensation cost is calculated [as follows]:*

Fair value of modified stock appreciation right award (821,406 x $12)	*$9,856,872*
Less: Fair value of original stock appreciation right (821,406 x $5)	*(4,107,030)*
Incremental value of modified stock appreciation right	*5,749,842*
Divide by three to reflect earned portion of the award	*÷ 3*
Compensation cost to be recognized	*$1,916,614*

ASC 718-20-55-142

Entity T also could determine the incremental value of the modified stock appreciation right award by multiplying the fair value of the modified stock appreciation right award by the portion of the award that is earned and subtracting the cumulative recognized compensation cost [($9,856,872 ÷ 3) - $1,369,010 = $1,916,614]. As a result, Entity T would record the following journal [entry] at the date of the modification.

Compensation cost	*$1,916,614*	
Share-based compensation liability		*$1,916,614. …*

ASC 718-20-55-143

Entity T would continue to remeasure the liability award at each reporting date until the award's settlement.

5.2 SCOPE

FASB REFERENCES

ASC 718-20-20: Award and ASC 718-20-35-2A

When an entity changes the terms or conditions of an existing share-based payment award, modification accounting applies unless **all** the following conditions are met:

- The fair value of the modified award is the same as the fair value of the original award immediately before the modification.
- The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the modification.
- The classification of the modified award is the same as the classification of the original award immediately before the modification.

In determining whether the fair values of the modified and original awards are the same, BC16 of ASU 2017-09, *Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting*, states:

> *The Board does not expect that an entity will need to estimate the value immediately before and after the modification in all cases. Rather, the entity might be able to determine whether the modification affects any of the inputs to the value estimation technique for the award. If the modification does not affect any of the inputs to the valuation technique for the award, then the entity is not required to estimate the value immediately before and after the modification.*

Accordingly, an entity is not always required to derive the fair value of the award before and after the modification to determine whether the condition in ASC 718-20-35-2A(a) is met.

BDO INSIGHTS — SIGNIFICANCE OF THE CHANGE IN AN AWARD'S FAIR VALUE

Whether the fair value of the modified award must be **exactly** the same as the fair value of the original award immediately before modification to qualify for the scope exception in ASC 718-20-35-2A(a) requires judgment. For example, after considering all facts and circumstances (including the entity's intent to preserve the value of the original award), an entity may conclude that an insignificant difference between the fair values of the modified and original awards does not preclude the modification from qualifying for the scope exception in ASC 718-20-35-2A(a).

The guidance in ASC 718-20-35-2A must be applied based on the definition of an award in ASC 718-20-20, which states "*references to an award also apply to a portion of an award*." In other words, the unit of account is based on the modified award, which may be a subset of all individual instruments in the original award.

EXAMPLE 5-3: UNIT OF ACCOUNT WHEN EVALUATING THE SCOPE EXCEPTION FOR MODIFICATION ACCOUNTING

FACTS

On January 1, 20X3, an entity grants to an employee 2,000 equity-classified stock options. On July 1, 20X3, the exercise price of a portion (1,500) of the stock options are reduced because of a significant decline in the entity's share price.

CONCLUSION

The unit of account for determining whether the scope exception in ASC 718-20-35-2A applies is 1,500 stock options.

ANALYSIS

While an award is typically defined as the total amount granted (here, 2,000 stock options), the unit of account in determining whether modification accounting applies is only the 1,500 stock options whose terms were changed. Because the other 500 stock options were not modified (that is, exercise price was not changed), modification accounting does not apply to those 500 stock options.

The table below lists examples of changes to a share-based payment award and whether such changes require modification accounting.

MODIFICATION ACCOUNTING REQUIRED	MODIFICATION ACCOUNTING NOT REQUIRED
▶ Repricing of stock options that results in a change in value of those stock options ▶ Changes in a service, market, or performance condition ▶ Changes in an award that result in a reclassification of the award (equity to liability or vice versa) ▶ Adding an involuntary termination provision in anticipation of a sale of a business unit that accelerates vesting of the award	▶ Changes that are administrative in nature, such as a change to the entity name, entity address, or compensation plan name ▶ Changes in an award's net settlement provisions related to tax withholdings that do not affect the classification of the award

Regardless of whether the scope exception in ASC 718-20-35-2A applies, entities must consider other aspects of the guidance in ASC 718, such as disclosure requirements.

5.3 MODIFICATIONS OF VESTING CONDITIONS

FASB REFERENCES

ASC 718-20-35-3A, ASC 718-20-55-107, ASC 718-20-55-111 through 55-119, and ASC 718-20-55-121

An existing share-based payment award may be modified by changing its vesting conditions. Such modifications are accounted for under the overall principle in ASC 718-20-35-3 that requires a modification to be treated as an exchange of the original award for a new award. Accordingly, modifications that change an award's vesting conditions affect the amount of compensation cost to be recognized based on whether the award is probable of vesting under its new terms. Therefore, assessing whether a modified award is probable of vesting is an important factor when accounting for modifications that change an award's vesting conditions.

ASC 718-20-55 classifies modifications into four types. The table below summarizes the accounting of each type of modification based on the principle in ASC 718-20-35-3.

TYPE OF MODIFICATION	DESCRIPTION	TREATMENT	REFERENCE
Type I — probable-to-probable	The original award and the modified award are both expected to vest. In other words, the modification does not change the expectation that the award will vest.	Compensation cost is recognized because the award is probable of vesting under both its original and modified terms. The amount of the new award's compensation cost is the sum of (i) the grant-date fair value of the original award and (ii) any incremental fair value that results from the modification.	Section 5.3.1
Type II — probable-to-improbable	The original award was expected to vest, but the modified award is not expected to vest. This type of modification is rare because grantees are typically not willing to accept a reduction in value unless they are compensated through other means.	No incremental compensation cost is recognized because the award is not probable of vesting under its modified terms. However, the grantor continues to recognize compensation cost for the original grant-date fair value if the award continues to be probable of vesting under its original terms.	Section 5.3.2

TYPE OF MODIFICATION	DESCRIPTION	TREATMENT	REFERENCE
Type III — improbable-to-probable	The original award was not expected to vest, but the modified award is expected to vest.	Compensation cost is recognized because the award is probable of vesting under its modified terms. Cumulative compensation cost for the original award based on its grant-date fair value is zero because the award was not expected to vest under its original terms. Instead, cumulative compensation cost is based on the fair value of the modified award (even if the value of the modified award is less than the grant-date fair value of the original award) and recognized over any remaining requisite service period.	Section 5.3.3
Type IV — improbable-to-improbable	Neither the original award nor the modified award is expected to vest. The modification does not change the expectation that the award will not vest.	No compensation cost is recognized because the award continues not to be probable of vesting under its modified terms. However, if the modified award becomes probable of vesting, compensation cost will be recognized based on the modified award's fair value.	Section 5.3.4

An entity that has an accounting policy to account for forfeitures as incurred (see Section 4.2.1.2.2) must also assess on the modification date whether the service or performance conditions of the original award are expected to be satisfied when measuring the effects of the modification. However, the entity accounts for forfeitures as incurred when subsequently accounting for the modified award.

In addition to modifications pertaining to an award that vests based on a service condition, performance condition, or combination of both, an entity may modify awards with market conditions (see Section 5.3.1.1).

5.3.1 Type I — Probable-to-Probable Modification

FASB REFERENCES

ASC 718-20-55-107 and ASC 718-20-55-111 through 55-112

A Type I modification occurs when an entity modifies an award that is expected to vest, and the modified award is still expected to vest. In that situation, an entity is required to recognize compensation cost because the award vests under the modified vesting condition and would have vested under the original vesting condition.

Entities may modify an award without affecting the probability of vesting for many reasons. Example 14, Case A, in ASC 718-20-55-111 through 55-112 illustrates one scenario: An entity changes the specified sales target for the grantee to vest in the award (the performance condition). The award was expected to vest under its original vesting conditions and is expected to vest under its modified vesting conditions. Because only the vesting condition is changed, there is no incremental compensation cost. In other words, the fair value of the modified award remains the same as the fair value of the original award immediately before modification. Modification accounting applies under ASC 718-20-35-2A(b) because the vesting condition changed, but since there is no change in fair value, compensation cost equal to the original grant-date fair value continues to be recognized over the award's remaining requisite service period.

If instead an additional change to the award was made that results in an increase in the award's fair value, compensation cost equal to the sum of the grant-date fair value of the original award and the incremental fair value resulting from the modification would be recognized over the award's remaining requisite service period. That is because both the original and modified awards are probable of vesting on the modification date.

Further, an entity's forfeiture policy (whether forfeitures are estimated versus recognized as incurred) does not affect the accounting for a Type I modification because compensation cost is recognized before and after the modification.

STATEMENT 123(R) RESOURCE GROUP — EXTENSION OF A GRANTEE'S REQUISITE SERVICE PERIOD

An entity may change the terms of an award **and** extend or increase a grantee's requisite service period. Based on discussions by the Statement 123(R)[8] Resource Group at its May 26, 2005 meeting, there are two acceptable methods to account for such instances:

- Method 1 — The unrecognized compensation cost based on the grant-date fair value of the original award is recognized over the remaining **original** requisite service period. The incremental compensation cost is recognized over the **new** requisite service period.
- Method 2 — The unrecognized compensation cost based on the grant-date fair value of the original award **and** the incremental compensation cost are recognized over the **new** requisite service period.

Example 5-4 illustrates the application of those methods.

EXAMPLE 5-4: TYPE I MODIFICATION THAT INCREASES THE REQUISITE SERVICE PERIOD

FACTS

On January 1, 20X1, an entity issued to an employee 5,000 stock options at a grant-date fair value of $10 per stock option. The stock options cliff vest on December 31, 20X4. The entity elected policies to account for forfeitures when they occur and to recognize compensation cost for the stock options on a straight-line basis over the requisite service period.

On January 1, 20X2, the entity reduced the exercise price of the stock options **and** extended the requisite service period by an additional year (to December 31, 20X5). The fair value of the original award immediately before modification is $8 per stock option, and the fair value of the modified award is $9 per stock option.

CONCLUSION

Method 1

The unrecognized compensation cost of $37,500 based on original grant-date fair value is recognized over the remaining original requisite service period. The incremental compensation cost of $5,000 resulting from the modification is recognized over the new requisite service period.

Method 2

Both the unrecognized compensation cost of $37,500 based on original grant-date fair value and the incremental compensation cost of $5,000 resulting from the modification are recognized over the new requisite service period.

---

[8] Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, was the pre-codification standard upon which the principles in ASC 718 are based.

ANALYSIS

- Method 1

As of December 31, 20X1, the entity recognized cumulative compensation cost of $12,500 as calculated below:

NUMBER OF STOCK OPTIONS ISSUED [A]	GRANT-DATE FAIR VALUE PER STOCK OPTION [B]	TOTAL COMPENSATION COST [C] = [A] * [B]	PERCENTAGE OF REQUISITE SERVICE PERIOD PROVIDED BY GRANTEE (1 YEAR / 4 YEARS) [D]	CUMULATIVE COMPENSATION COST [E] = [C] * [D]
5,000	$10	$50,000	25%	$12,500

As such, the unrecognized compensation cost of $37,500 ([C] -[E]) is recognized over the remaining original requisite service period through December 31, 20X4. That results in compensation cost of $12,500 recognized each year in Years 2 through 4.

The incremental fair value resulting from the modification is calculated as:

	VALUE	CALCULATION
Fair value of modified stock options	$ 45,000	5,000 * $9
Less fair value of original stock options immediately before modification	40,000	5,000 * $8
Incremental fair value	$ 5,000	5,000 * $1

The incremental compensation cost of $5,000 resulting from the modification is recognized over the new requisite service period through December 31, 20X5. That results in incremental annual compensation cost of $1,250 recognized in Years 2 through 5, as demonstrated in the table.

	YEAR 2	YEAR 3	YEAR 4	YEAR 5	TOTAL
Original compensation cost recognized over original requisite service period	$ 12,500	$ 12,500	$ 12,500	N/A	$ 37,500
Incremental compensation cost recognized over new requisite service period	1,250	1,250	$ 1,250	$ 1,250	$ 5,000
Total compensation cost	$ 13,750	$ 13,750	$ 13,750	$ 1,250	$ 42,500

Under Method 1, total compensation cost of $13,750 is recognized in Years 2 through 4 and $1,250 is recognized in Year 5. Specifically, under Method 1, if the employee leaves the entity after the end of the original requisite service period (December 31, 20X4) but before the end of the new requisite service period (December 31, 20X5), only the portion of incremental compensation cost of $5,000 that has been recognized to date would be reversed. In other words, if the employee leaves the entity on January 1, 20X5 (one day after December 31, 20X4), incremental compensation cost of $3,750 recognized to date would be reversed. Accordingly, the entity would have recognized cumulative compensation cost equal to the award's original grant-date fair value of $50,000 under Method 1.

- Method 2

Both the unrecognized compensation cost of $37,500 ([C] – [E]) and the incremental compensation cost of $5,000 resulting from the modification are recognized over the new requisite service period through December 31, 20X5. That results in total compensation cost of $10,625 recognized each year in Years 2 through 5 as follows:

	YEAR 2	YEAR 3	YEAR 4	YEAR 5	TOTAL
Original compensation cost recognized over new requisite service period	$ 9,375	$ 9,375	$ 9,375	$ 9,375	$ 37,500
Incremental compensation cost recognized over new requisite service period	1,250	1,250	1,250	1,250	5,000
Total compensation cost	$ 10,625	$ 10,625	$ 10,625	$ 10,625	$ 42,500

Under Method 2, if the employee leaves the entity after the end of the original requisite service period (December 31, 20X4) but before the end of the new requisite service period (December 31, 20X5), compensation cost is adjusted on the termination date to at least equal the original grant-date fair value of the stock options. In other words, if the employee leaves the entity on January 1, 20X5 (one day after December 31, 20X4), additional compensation cost of $5,625 (as calculated below) would be recognized on the termination date:

	YEAR 2	YEAR 3	YEAR 4	TOTAL
Original compensation cost recognized over new requisite service period	$ 9,375	$ 9,375	$ 9,375	$ 28,125
Incremental compensation cost recognized over new requisite service period	1,250	1,250	1,250	3,750
Total compensation cost	$ 10,625	$ 10,625	$ 10,625	$ 31,875

ADDITIONAL COMPENSATION COST RECOGNIZED ON TERMINATION DATE	
Compensation cost recognized in Year 1 ([E])	$ 12,500
Plus compensation cost recognized in Years 2 through 4	31,875
Less original grant-date fair value ([C])	50,000
Total additional compensation cost to be recognized	$ (5,625)

5.3.1.1 Changes to Market Conditions

Unlike a service or performance condition, a market condition is not treated as a vesting condition for recognition purposes. Rather, it is incorporated into the fair value measurement of a share-based payment award. See Section 4.2.2. Accordingly, a change to a market condition does not affect the probability of achieving the original market condition and in turn does not affect the recognition of compensation cost. However, a change to a market condition could result in an incremental compensation cost based on the modification principle in ASC 718-20-35-3. If a change in market condition reduces the value of the new award as compared to the value of the original award, compensation cost must at least equal the grant-date fair value of the original award.

5.3.2 Type II — Probable-to-Improbable Modification

FASB REFERENCES

ASC 718-20-55-113 through 55-115

In a Type II modification, an entity modifies an award that was probable of vesting under its original terms to one that is no longer probable of vesting under its modified terms. This type of modification is rare because changes to terms or conditions of a share-based payment award are generally made to encourage (rather than discourage) grantees. Further, grantees are typically not willing to accept a reduction in value unless they are compensated through other means.

Examples of a Type II modification include an increase to a performance metric such that the award is no longer probable of vesting (see ASC 718-20-55-113 through 55-115) or the addition of a change in control or IPO provision whereby only the occurrence of such events (or together with a service condition) will result in the vesting of the award. As discussed in Section 4.2.3.1, a change in control or IPO is not probable until it occurs, so that type of change results in a Type II modification.

For a Type II modification, no incremental compensation cost is recognized unless and until the award becomes probable of vesting under its modified terms. However, if the award continues to be probable of vesting under its original terms, compensation cost based on the grant-date fair value of the original award must continue to be recognized.

5.3.3 Type III — Improbable-to-Probable Modification

FASB REFERENCES

ASC 718-20-55-116 through 55-117 and ASC 718-20-55-121

A Type III modification occurs when an entity modifies an award that is not expected to vest, and the modified award is expected to vest. Type III modifications are common.

Type III modifications may relate to the award's performance condition (for example, lowering a sales target as illustrated in ASC 718-20-55-116 through 55-117 or accelerating vesting upon the sale of a business unit) or a service condition (for example, accelerating vesting upon employee termination or significantly reducing an employee's responsibilities). Examples 5-5 through 5-7 illustrate those concepts.

When a Type III modification occurs, compensation cost is measured and recognized based on the fair value of the modified award **even if** the value of the modified award is less than the grant-date value of the original award. Compensation cost based on the original grant-date fair value is no longer relevant because the award is not probable of vesting under the original terms of the award, so no cumulative compensation cost is recognized for the original award. Further, an entity's forfeiture policy to either estimate forfeitures or account for them as they occur becomes important for a Type III modification because it will affect the timing of recognition of compensation cost for the modified award.

Example 5-5 illustrates a Type III improbable-to-probable modification and how an entity's forfeiture policy impacts the accounting.

EXAMPLE 5-5: TYPE III IMPROBABLE-TO-PROBABLE MODIFICATION (QUOTED FROM EXAMPLE 15, ASC 718-20-55-121)

ASC 718-10-20-55-121

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.

Entities often modify share-based payment awards in connection with a grantee's voluntary or involuntary termination to compensate and recognize the grantee's historical contributions to the entity. A common example of such modification is the acceleration of vesting in anticipation of, or concurrent with, a grantee's termination, as illustrated in Example 5-6.

EXAMPLE 5-6: TYPE III MODIFICATION THAT ACCELERATES VESTING UPON EMPLOYEE TERMINATION

FACTS

On January 1, 20X2, an entity issues to its CEO 1,000 stock options with a grant-date fair value of $7 each. The stock options cliff vest on December 31, 20X5, and are equity-classified. The entity elected to recognize compensation cost for the stock options on a straight-line basis over the requisite service period. For simplicity, this example does not include forfeiture accounting.

On July 1, 20X3, the entity enters into a termination agreement with the CEO whereby the CEO's unvested stock options will vest upon termination. There were no other changes to the terms or conditions of the stock options. The entity determines the fair value of the modified award to be $10 per stock option on the modification date.

CONCLUSION

The acceleration of the stock options as of the modification date is treated as a Type III modification. Accordingly, compensation cost of $2,625 based on the original terms of the stock options is reversed on the modification date, and $10,000 based on the modified terms of the stock options is fully recognized.

ANALYSIS

On termination date, the stock options under the original terms are not probable of vesting but become probable of vesting under the modified terms. Therefore, the acceleration of unvested stock options in connection with the CEO's termination is a Type III modification. Compensation cost recognized to date as of the termination date is reversed, and compensation cost based on the fair value of the modified award is recognized instead.

The entity records the following journal entries:

Year 1

Debit	Compensation cost	$ 1,750	
Credit	APIC		$ 1,750

Compensation cost for the stock options based on original grant-date fair value is $7,000 (1,000 * $7 grant-date fair value per stock option). Accordingly, compensation cost recognized each year is $1,750 ($7,000 / 4 years).

January 1, 20X3, through June 30, 20X3

Debit	Compensation cost	$ 875	
Credit	APIC		$ 875

Compensation cost recognized for six months during Year 2 before the modification is $875 ($1,750 annual compensation cost based on original grant-date fair value divided by two).

July 1, 20X3 (modification date)

Debit	APIC	$ 2,625	
Credit	Compensation cost		$ 2,625
Debit	Compensation cost	10,0000	
Credit	APIC		10,000

At the modification date, the cumulative compensation cost for the stock options based on original grant-date fair value is $2,625. Because the stock options are not probable of vesting under the original terms, cumulative compensation cost of $2,625 is reversed on the modification date. Instead, compensation cost for the modified award of $10,000 (1,000 * $10 fair value per modified stock option) is recognized on that date.

In most cases, a change to the terms or conditions of a share-based payment award is apparent in the written agreements. However, sometimes, a grantee's responsibilities may change but the award's terms or conditions are not. A significant change in a grantee's responsibilities could indicate that a modification has occurred, as illustrated in Example 5-7.

EXAMPLE 5-7: SIGNIFICANT CHANGE IN GRANTEE'S RESPONSIBILITIES

FACTS

On January 1, 20X2, an entity issued to an executive stock options that cliff vest on December 31, 20X4. The stock options were issued in exchange for the executive's role as the entity's CEO. On July 1, 20X3, the entity hired an individual with more experience to fill the position of the CEO. The executive becomes the Vice President of Finance and reports to the new CEO. No changes to the terms or conditions of the stock options were made.

The CEO is responsible for developing, making, and managing the entity's strategic growth plans, and communicating progress about the entity's operations to the entity's board of directors and key shareholders. The Vice President of Finance is responsible for creating annual and quarterly budgets for the CEO's approval and comparing the entity's actual financial results against those budgets.

CONCLUSION

The executive's responsibilities have been significantly reduced; that change results in a Type III modification.

ANALYSIS

The nature and level of service required under the original award when the executive was the CEO is significantly reduced from the nature and level of service required after the executive became the Vice President of Finance. In other words, the executive's responsibilities were significantly changed. As a result, this is a Type III modification because the original award is not probable of vesting. That is, the executive is no longer providing services as the CEO but rather is providing significantly reduced services as the Vice President of Finance in exchange for CEO-level compensation. Therefore, compensation cost recognized to date as of the termination date is reversed, and compensation cost based on the fair value of the modified award is recognized instead.

5.3.4 Type IV — Improbable-to-Improbable Modification

FASB REFERENCES

ASC 718-20-55-118 through 55-119

Type IV modifications occur when an entity modifies an award that is not expected to vest, and the modified award is also not expected to vest.

While compensation cost is not recognized for a Type IV modification until and unless the vesting condition of the modified award becomes probable, the amount that is subsequently recognized if the award becomes probable of vesting is based on the value of the modified award because the value of the original award is no longer relevant. Once the vesting condition for the modified award becomes probable, compensation cost based on the terms of the modified award will be recognized, **even if** that amount is less than the original grant-date fair value of the award. Type IV modifications typically involve a performance condition or a combination of a performance condition and a service condition, as illustrated in ASC 718-20-55-118 through 119 and Example 5-8.

EXAMPLE 5-8: TYPE IV MODIFICATION TO AN AWARD THAT INCLUDES A SERVICE CONDITION AND A PERFORMANCE CONDITION

FACTS

On January 1, 20X1, an entity grants to its employees 5,000 restricted shares with a grant-date fair value of $7 each. The restricted shares vest in four years (December 31, 20X4) **and** require the entity to complete an IPO within the four-year period.

On January 1, 20X4, the entity extends the service period and time to complete the IPO by one year such that the restricted shares vest in two years (December 31, 20X5) if an IPO is completed before that date. The fair value of the modified award is $12 per share on January 1, 20X4.

The entity completes the IPO on January 1, 20X5.

CONCLUSION

No compensation cost is recognized until the entity completes the IPO on January 1, 20X5, at which time compensation cost of $30,000 based on the fair value of the modified award on January 1, 20X4, is recognized.

ANALYSIS

The original award includes a service condition and a performance condition (that is, the award vests only when the employees provide four years of service **and** the entity undergoes an IPO). The original grant-date fair value of the award is $35,000 (5,000 restricted shares * $7 per share). However, compensation cost based on the original grant-date fair value is not recognized because an IPO is not probable until it actually occurs.

Similarly, on January 1, 20X4, when the award is modified, no compensation cost is recognized because the modified award continues to include the performance condition related to the IPO.

When the IPO occurs on January 1, 20X5, the entity recognizes compensation cost for Year 1 of $45,000 ([5,000 restricted shares * $12 per share * 50%] plus [5,000 restricted shares * $12 per share * 50% * ½ years) based on the modified award's fair value on January 1, 20X4. The remaining compensation cost of $15,000 will be recognized over the period from January 1, 20X5, through December 31, 20X5. In other words, the value of the original award and the requisite service period the employees provided under the terms of the original award are no longer relevant because this is a Type IV modification and is treated as an exchange of the original award for a new award.

5.4 CHANGE IN AN AWARD'S CLASSIFICATION

FASB REFERENCES

ASC 718-10-35-15

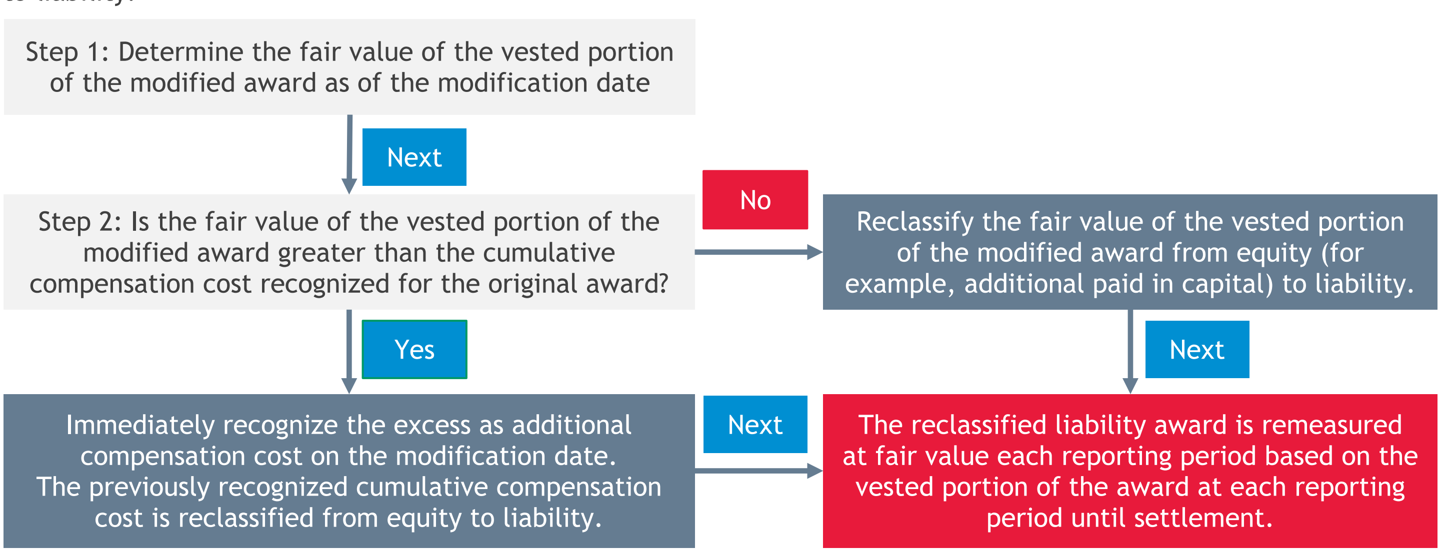
A modification can change the classification of a share-based payment award from equity to liability or vice versa. Further, even if an award is not modified, its classification might change because of changes in an entity's facts and circumstances. For example, an entity may no longer have the intent and ability to settle the award with shares but instead will settle in cash, or a repurchase feature may expire unexercised (see Section 3.2.2). An entity accounts for a change in classification in the same manner as a modification that changes the classification of an award. The accounting for such a modification depends on the classification of the award before and after the modification.

5.4.1 Equity to Liability Classification

FASB REFERENCES

ASC 718-20-55-123 through 55-133

The flowchart below summarizes the accounting for a modification that changes an award's classification from equity to liability.



If the original award was expected to vest, compensation cost must equal or exceed the original award's grant-date fair value as discussed in Section 5.1. If compensation cost is less than the original award's grant-date fair value, the entity must recognize additional compensation cost so that cumulative compensation cost is at least equal to the original award's grant-date fair value.

EXAMPLE 5-9 (ADAPTED FROM CASE A, ASC 718-20-55-123 THROUGH 55-133): CHANGE IN AN AWARD'S CLASSIFICATION FROM EQUITY TO LIABILITY

FACTS

On January 1, 20X1, an entity issued to an employee 1,000 stock options with a grant-date fair value of $5 each. The stock options vest based on a graded schedule with 25% vesting at the end of each year of service. The entity elected an accounting policy to recognize compensation cost for the stock options on a straight-line basis over the requisite service period.

On January 1, 20X3, the entity modified the stock options to give the employee the choice to settle the stock options in shares or cash. No other changes to the terms or conditions of the stock options were made. The fair value of the original award immediately before the modification and the fair value of the modified award are the same at $7 per stock option.

The fair value of the modified award on December 31, 20X3, and 20X4, is $4 and $6 per stock option, respectively.

Upon vesting on December 31, 20X4, the employee exercised the stock options in exchange for shares.

CONCLUSION

On the modification date, the stock options are no longer classified as equity and are reclassified as a liability. Because the fair value of the modified award is greater than the grant-date fair value of the original award, the excess vested amount is recognized as additional compensation cost on the modification date. Thereafter, the stock options are remeasured at fair value each reporting period based on the vested portion of the award at each reporting period until settlement. Also, in Year 3, because cumulative compensation cost recognized as of the end of Year 3 is less than cumulative compensation cost based on original grant-date fair value, additional compensation cost is recognized such that cumulative compensation cost is at least equal to the cumulative compensation cost based on the original grant-date fair value as of that date.

ANALYSIS

Modification Date

Step 1: Determine the fair value of the vested portion of the modified award as of the modification date

- The fair value of the modified award is $7 per stock option. As of the modification date, the award was 50% vested. Therefore, the fair value of the vested portion of the modified award as of the modification date is:

NUMBER OF STOCK OPTIONS [A]	FAIR VALUE OF MODIFIED AWARD [B]	PORTION OF AWARD VESTED FOR YEARS 1-2 [C]	FAIR VALUE OF VESTED PORTION OF MODIFIED AWARD [A X B X C]
1,000	$7	50%	$3,500

Step 2: Is the fair value of the vested portion of the modified award greater than the cumulative compensation cost recognized for the original award?

NUMBER OF STOCK OPTIONS [A]	FAIR VALUE OF ORIGINAL AWARD [B]	PORTION OF AWARD VESTED FOR YEARS 1-2 [C]	CUMULATIVE COMPENSATION COST RECOGNIZED FOR ORIGINAL AWARD [A X B X C]
1,000	$5	50%	$2,500

- As calculated in Step 1, the fair value of the vested portion of the modified award is $3,500. Therefore, the fair value of the vested portion of the modified award **is** greater than the cumulative compensation cost recognized for the original award.

- Immediately recognize the excess as additional compensation cost on the modification date; the previously recognized cumulative compensation cost is reclassified from equity to liability.
- On the modification date, the excess amount of fair value of the vested portion of the modified award over the cumulative compensation cost for the original award is calculated as:

Fair value of vested portion of the modified award	$ 3,500
Less cumulative compensation cost recognized for original award	2,500
Additional compensation cost	$ 1,000

- The amount of $1,000 is immediately recognized as additional compensation cost on the modification date. The previously recognized cumulative compensation cost of $2,500 is reclassified from equity to liability. Accordingly, the entity records the following journal entry on the modification date:

Debit	Compensation cost	$	1,000		
Debit	APIC		2,500		
Credit	Share-based compensation liability			$	3,500

Subsequent Measurement

The reclassified liability is remeasured at fair value each reporting period based on the vested portion of the award at each reporting period until settlement.

- On December 31, 20X3, the fair value of the new award is:

NUMBER OF STOCK OPTIONS [A]	FAIR VALUE ON REMEASUREMENT DATE [B]	PORTION OF AWARD VESTED FOR YEARS 1-3 [C]	FAIR VALUE OF VESTED PORTION OF AWARD ON REMEASUREMENT DATE [A X B X C]
1,000	$4	75%	$3,000

  - The remeasurement results in a share-based compensation liability of $3,000 related to the vested portion of the award as of year-end.
  - However, cumulative compensation cost recognized to date is less than cumulative compensation cost based on original grant-date fair value. In other words, cumulative compensation cost based on original grant-date fair value for Years 1-3 as of December 31, 20X3, would be $3,750 (1,000 stock options * $5 per stock option * 75%), and cumulative compensation cost recognized to date for Years 1 and 2 is $3,500 ($2,500 total; additional compensation cost on modification date of $1,000).
- Because total compensation cost must be at least equal to the original grant date fair value, additional compensation cost of $250 ($3,750 less $3,500) is recognized on December 31, 20X3. The entity records the following journal entry:

Debit	Compensation cost	$	250		
Debit	Share-based compensation liability		500		
Credit	APIC			$	750

- On December 31, 20X4, the entity remeasures the award again.

NUMBER OF STOCK OPTIONS [A]	FAIR VALUE ON REMEASUREMENT DATE [B]	PORTION OF AWARD VESTED FOR YEARS 1-4 [C]	FAIR VALUE OF VESTED PORTION OF AWARD ON REMEASUREMENT DATE [A X B X C]
1,000	$6	100%	$6,000

- The remeasurement results in a share-based compensation liability of $6,000 related to the fully vested award as of year-end.
- Cumulative compensation cost based on the original grant-date fair value as of December 31, 20X4 for Years 1-4, would be $5,000 (1,000 stock options * $5 per stock option * 100%), and cumulative compensation cost recognized to date is $6,000 ($2,500 total for Year 1 and Year 2; additional compensation cost on modification date of $1,000; $250 for Year 3; and $2,250 for Year 4). In this case, cumulative compensation cost recognized to date is not less than cumulative compensation cost based on original grant-date fair value.

- Accordingly, the entity records the following journal entry:

Debit	Compensation cost	$	2,250		
Debit	APIC		750		
Credit	Share-based compensation liability			$	3,000

Because the stock options are exercised (that is, the awards are settled) on the same date the award is fully vested, no further remeasurement is required.

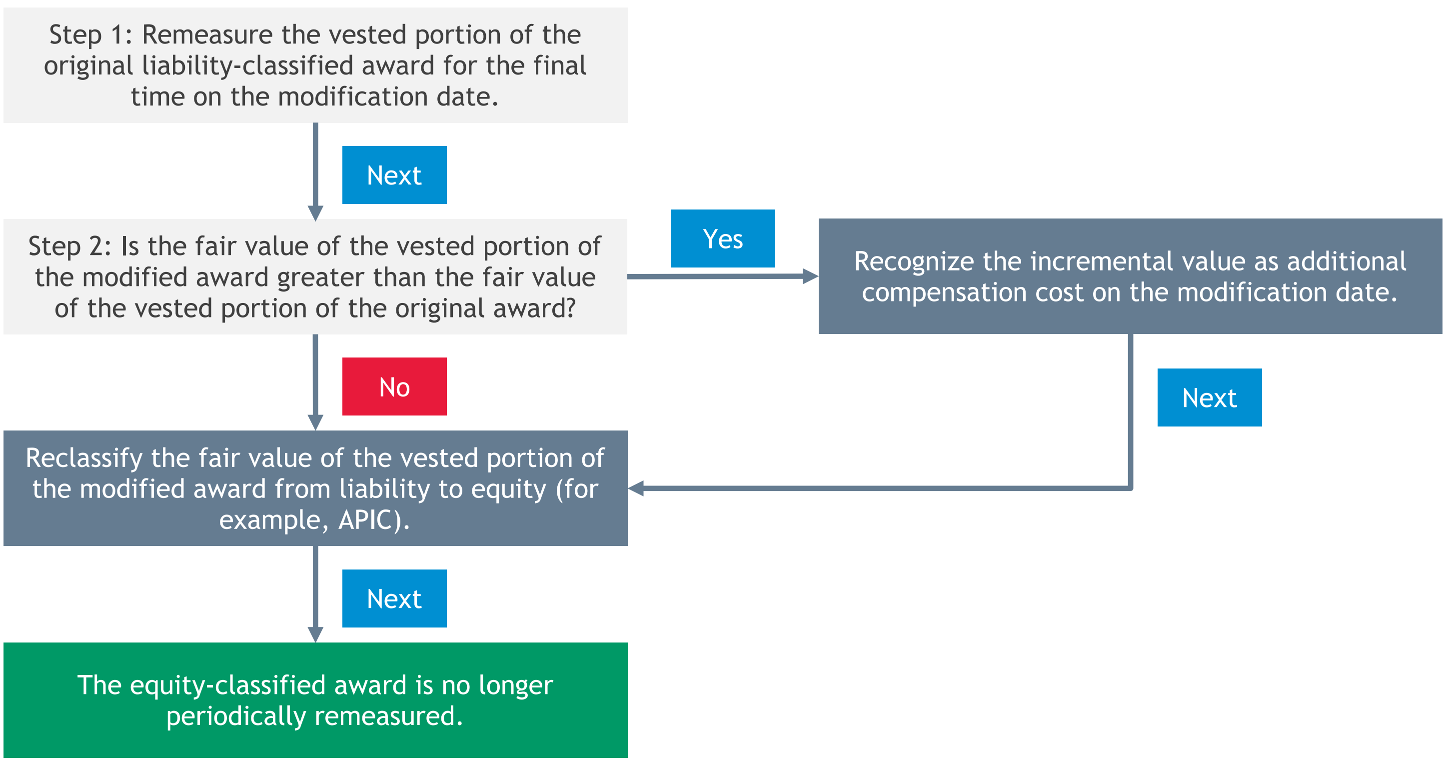
Accounting for a settlement of an equity-classified award is different from that of a modification that changes an award's classification. In other words, instead of changing an award's terms or conditions affecting classification, if a fully vested equity-classified award is settled for cash, the award does not require modification accounting. Rather, it is accounted for as a treasury stock transaction if the settlement amount is equal to or less than the award's current fair value. If the settlement amount is greater than the award's current fair value, the excess amount is recognized as additional compensation cost on the settlement date. See Section 5.8 for guidance on cash settlements and distinguishing between a settlement and a modification.

5.4.2 Liability to Equity Classification

FASB REFERENCES

ASC 718-20-55-135 through 55-138

The flowchart below summarizes the accounting for a modification that changes an award's classification from equity to liability.



EXAMPLE 5-10 (ADAPTED FROM CASE C, ASC 718-20-55-135 THROUGH 55-138): CHANGE IN AN AWARD'S CLASSIFICATION FROM LIABILITY TO EQUITY

FACTS

On January 1, 20X1, an entity issues to an employee 500 SARs. The SARs vest based on a graded schedule, with 25% vesting at the end of each year of service through December 31, 20X4, and will settle in cash. Their fair values on January 1, 20X1, and December 31, 20X1, are $10 and $12 per SAR, respectively. For simplicity, this example does not include forfeiture accounting.

On January 1, 20X2, the entity modified the SARs to replace the cash settlement feature with a share settlement feature. No other changes to the SARs' terms or conditions were made. Because the SARs are no longer settled in cash and will instead be settled in shares, their classification changes from liability to equity. The fair values of the SARs immediately before the modification and on the modification date are the same at $12 per SAR.

CONCLUSION

The original liability-classified SARs are remeasured for the final time on the modification date. Because the fair value of the modified SARs on the modification date is the same as the fair value of the original SARs immediately before the modification, there is no incremental value recognized as additional compensation cost on the modification date. The SARs are then reclassified from liability to equity and no longer remeasured.

ANALYSIS

Step 1: Remeasure the vested portion of the original liability-classified award for the final time on the modification date.

NUMBER OF STOCK OPTIONS [A]	FAIR VALUE OF ORIGINAL AWARD [B]	PORTION OF AWARD VESTED FOR YEARS 1 [C]	CUMULATIVE COMPENSATION COST RECOGNIZED FOR ORIGINAL AWARD [A X B X C]
500	$12	25%	$1,500

- The fair value of the vested portion of the SARs as of the modification date is $1,500, which represents the compensation cost the entity recognized for Year 1.

Step 2: Is the fair value of the vested portion of the modified award greater than the fair value of the vested portion of the original award?

- No. The fair value of the vested portion of the modified and original award is the same at $12 per SAR. Therefore, the entity does not recognize any incremental compensation cost on the modification date.
- Reclassify the fair value of the vested portion of the modified award from liability to equity (that is, APIC).
- As discussed in Step 1, the fair value of the vested SARs on modification date is $1,500. That amount is reclassified from liability to equity. Accordingly, the entity records the following journal entry on the modification date:

Debit	Share-based compensation liability	$	1,500		
Credit	APIC			$	1,500

- The equity-classified SARs are no longer periodically remeasured. Instead, the fair value of the unvested SARs of $4,500 (500 SARs * $12 per SAR * 75% for Years 2-4) will be recognized over the remaining requisite service period of three years.

5.5 EQUITY RESTRUCTURINGS

FASB REFERENCES

ASC 718-10-20: Equity Restructuring, ASC 718-20-35-6, and ASC 718-20-55-2

ASC 718-10-20 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.*" An entity may exchange share-based payment awards in conjunction with an equity restructuring. Often, that may change the terms of an existing award to add an antidilution provision to preserve the value of the award if an equity restructuring occurs. For example, the exercise price, the number of underlying shares in the share-based payment award, or both would be adjusted to offset the reduction in the per-share stock price of the award. Those changes to an award to **add** an antidilution provision are considered modifications under ASC 718 and may result in incremental compensation cost (see Section 5.5.2). On the contrary, an adjustment to an award pursuant to an **existing** antidilution provision does not result in incremental compensation cost (see Section 5.5.1).

5.5.1 Antidilution Provision Included in Original Award

FASB REFERENCES

ASC 718-20-55-103 through 55-104

A modification occurs when an award is adjusted pursuant to an existing antidilution provision. However, there is no incremental compensation cost resulting from the modification because an antidilution provision, by nature, is designed to preserve an award's value in the event of an equity restructuring. Therefore, there is no change in the award's fair value, vesting conditions, or classification when the adjustment is made. A modification resulting from an existing antidilution provision is excerpted below in Example 5-11.

EXAMPLE 5-11: ILLUSTRATION OF MODIFICATION OF AN AWARD WITH ANTIDILUTION PROVISIONS (EXCERPTED FROM EXAMPLE 13, CASE A, ASC 718-20-55-104)

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).*

Antidilution provisions can be discretionary, meaning that adjustments based on antidilution provisions are made at an entity's discretion. For example, an award's terms might give an entity the right, but not an obligation, to make an adjustment upon an equity restructuring. If an award includes a discretionary antidilution provision and is subsequently adjusted in connection with an equity restructuring because the entity exercised its discretion to make the adjustment, the adjustment is accounted for as if the antidilution provision were added in contemplation of an equity restructuring. That treatment could result in significant incremental compensation cost as discussed in Section 5.5.2.

In some cases, an adjustment based on the antidilution provision is required (that is, it is nondiscretionary), but the provision does not specify **how** to determine the adjustment. Modifications based on those kinds of provisions are accounted for similar to the modification in Example 13, Case A, in ASC 718-20-55-103 through 104, as shown in Example 5-11. In other words, the provisions are treated like a modification based on an existing antidilution provision.

DETERMINING WHETHER AN ANTIDILUTION PROVISION IS DISCRETIONARY OR NONDISCRETIONARY

The language regarding an antidilution provision is not always clear, so it can be difficult to determine whether the provision is discretionary or nondiscretionary. In that case, we believe an entity should seek advice from legal counsel and consider the following factors:

- Whether the compensation committee or board of directors believes it has discretion in exercising the antidilution provision
- Whether there is historical practice of making antidilution adjustments in the event of an equity restructuring.

We believe a vaguely worded antidilution provision is presumably discretionary unless legal analysis clearly demonstrates otherwise.

5.5.2 Antidilution Provision Added to an Award

FASB REFERENCES

ASC 718-20-55-103 and ASC 718-20-55-105 through 55-106

An entity may add an antidilution provision to an existing share-based payment award **in contemplation** of an equity restructuring or on the date of an equity restructuring. Alternatively, an antidilution provision may be added that is **not in contemplation** of an equity restructuring. Regardless, the addition of an antidilution provision is a modification. However, the amount of incremental compensation cost resulting from the modification will vary depending on whether the antidilution provision is added in contemplation of an equity restructuring. In other words, the change in an award's fair value before and after the modification that is not in contemplation of an equity restructuring would likely be the same (or not significantly different) because a market participant would generally not place significant value on the antidilution provision if an equity restructuring is not anticipated. Conversely, an antidilution provision that is added in contemplation of an equity restructuring generally results in a significant increase in a modified award's fair value because the market participant would assume the restructuring will happen, and that would add significant value to the antidilution feature.

Case B, in the excerpt below, illustrates a modification to add an antidilution provision in contemplation of an equity restructuring and Case C, in the excerpt below, illustrates the addition of an antidilution provision on the date of the equity restructuring.

EXAMPLE 5-12: ILLUSTRATION OF MODIFICATION OF AWARDS WITHOUT ANTIDILUTION PROVISIONS

(EXCERPTED FROM EXAMPLE 13, CASES B AND C, OF ASC 718-20-55-103 AND ASC 718-20-55-105 THROUGH 55-106)

ASC 718-20-55-103

As a reminder, exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring are considered modifications for purposes of this Topic. The following Cases illustrate the guidance in paragraph 718-20-35-6:

a. *Original award contains antidilution provisions (Case A).*
b. *Original award does not contain antidilution provisions (Case B).*
c. *Original award does not contain an antidilution provision but is modified on the date of equity restructuring (Case C).*

Case B: Original Award Does Not Contain Antidilution Provision

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.

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.

5.5.3 Spinoffs

FASB REFERENCES

ASC 505-60-20: Spinoff

A spinoff is a type of equity restructuring event in which an entity transfers assets that constitute a business (as defined in ASC 805, *Business Combinations*) into a new legal entity followed by a distribution of the shares of the new entity (the spinnee) to its shareholders without the surrender by the shareholders of any stock of the spinnor. Generally, the value of the parent's stock declines after a spinoff, reflecting the transfer of value to the spinnee in the spinoff. Entities often make changes to share-based payment awards in connection with a spinoff to preserve the award's original value despite the decline. To keep the employees in an equitable position after the spinoff, the employees that hold share-based payment awards in the parent may receive awards of the spinnee, or the exercise price and the number of awards in the parent may be adjusted such that the employees are made whole despite the decline in the parent's value after the spinoff.

Regardless of the method used to preserve the original awards' value, an adjustment to the awards in connection with a spinoff is accounted for as a modification and may result in incremental compensation cost. That is the case unless the adjustment was made in accordance with an existing antidilution provision (see Section 5.5.1) and all the conditions in the scope exception of ASC 718-20-35-2A are met (see Section 5.2).

BDO INSIGHTS — MODIFICATION IN A SPINOFF

Consistent with any modification, incremental compensation cost in a spinoff is determined based on the original award's fair value immediately before the spinoff and the modified award's fair value immediately after the spinoff. That approach is consistent with our understanding of previous SEC staff discussions. Depending on the structure of the adjustment and spinoff, the market price of the parent's shares immediately before and after the spinoff and of the spinnee's shares after the spinoff are relevant in determining fair value. The table summarizes the application of the SEC staff discussion.

Award being measured	Spinnee's shares are trading on a when-issued basis[(a)]	Spinnee's shares are not trading on a when-issued basis[(b)]
Fair value of parent's shares immediately before spinoff	Sum of the closing prices of parent's shares and spinnee's shares on the distribution date	The closing share price on the record date
Fair value of parent's shares immediately after spinoff	Price of the parent's shares at the time of the spinoff	The opening share price on the first trading date after the distribution
Fair value of the spinnee's shares immediately after spinoff	Closing price of the spinnee's shares on the distribution date	Opening price of the spinnee's shares on the first trading date after the distribution

(a) If parent's shares **are** traded on an ex-dividend basis (that is, the value of parent's shares first exclude the spinnee's value a few business days before the spinoff date or the record date), the spinnee's shares are trading on a when-issued basis (that is, after the spinnee's registration statement is declared effective).

(b) If parent's shares **are not** traded on an ex-dividend basis, the spinnee's shares are not trading on a when-issued basis.

After the spinoff, the parent and spinnee recognize compensation cost only with respect to the awards that are held by their respective employees. In other words, if the spinnee's employees continue to hold unvested awards of the parent after the spinoff, the spinnee would recognize the remaining compensation cost associated with those awards held by its employees over the remaining requisite service period. The parent would no longer recognize compensation cost related to unvested awards that are now held by the spinnee's employees. That approach is consistent with the FASB's conclusion at its September 1, 2004 meeting, quoted below. While this guidance was not codified in ASC 718, we believe it continues to be appropriate.

FASB DISCUSSIONS — SEPTEMBER 1, 2004

In connection with a spinoff transaction and as a result of the related modification, employees of the former parent may receive nonvested equity instruments of the former subsidiary, or employees of the former subsidiary may retain nonvested equity instruments of the former parent. The Board decided that, based on the current accounting model for spinoff transactions, the former parent and former subsidiary should recognize compensation cost related to the nonvested modified awards for those employees that provide service to each respective entity. For example, if an employee of the former subsidiary retains nonvested equity instruments of the former parent, the former subsidiary would recognize in its financial statements the remaining unrecognized compensation cost pertaining to those instruments. In those cases, the former parent would recognize no compensation cost related to its nonvested equity instruments held by those former employees that subsequent to the spinoff provide services solely to the former subsidiary.

If the spinnee issued new awards to the employees to compensate for the decline in market value of the parent entity's shares because of the spinoff, the aggregate fair value of the awards immediately before and after the spinoff is measured as shown in the table above. Incremental compensation cost related to unvested awards is recognized in the spinnee's financial statements over the remaining requisite service period. Incremental compensation cost related to vested awards is immediately recognized in the spinnee's financial statements on the modification date.

EXAMPLE 5-13: EXCHANGE OF PARENT'S AWARDS FOR SPINNEE'S AWARDS

FACTS

On July 1, 20X3, Entity P spins off a subsidiary that is a business into a separate legal entity, Entity S. All of the subsidiary's former employees become full-time employees of Entity S as a result of the spinoff. Further, all vested and unvested awards of Entity P granted to the subsidiary's employees are exchanged for awards of Entity S pursuant to the antidilution provision of the original award agreement. The fair value of Entity P's awards immediately before the spinoff and the fair value of Entity S's awards immediately after the spinoff are the same.

CONCLUSION

There is no incremental compensation cost to be recognized by either Entity P or S. Previously recognized compensation cost by Entity P is not reversed. Compensation cost related to Entity S's unvested awards is recognized over the remaining requisite service period.

ANALYSIS

On July 1, 20X3, neither Entity P nor S recognizes any additional compensation cost related to vested or unvested awards because there is no incremental fair value of the awards immediately after the spinoff as compared to the value immediately before the spinoff.

Also, Entity P does not reverse previously recognized compensation cost related to the awards. However, Entity P no longer recognizes compensation cost related to awards granted to its former employees that have now become employees of Entity S as of the spinoff date. Rather, Entity S begins recognizing compensation cost related to the unvested awards granted to those employees over the remaining requisite service period.

5.6 INDUCEMENTS

FASB REFERENCES

ASC 718-20-20: Short-Term Inducement and ASC 718-20-35-5

ASC 718-20-20 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*." Unless the scope exception in ASC 718-20-35-2A is met (see Section 5.2), a short-term inducement is accounted for as a modification; however, modification accounting applies only to the awards of employees who accept the offer. Also, the FASB did not intend for a short-term inducement that is a settlement of an award (that is, acceptance of the offer) to affect the award's classification (that is, a change from equity to liability). However, if there is a history of cash-settling awards through frequent inducements, an entity must consider whether the awards are substantive liability instruments (see Section 3.2.6.1).

For a short-term inducement, the measurement date (that is, the modification date) is generally the date the employee accepts the offer. However, if employees can subsequently withdraw their acceptance of the offer, the measurement date is the expiration date of the withdrawal right.

The accounting differs for a long-term inducement. Modification accounting applies to all awards subject to a long-term inducement, regardless of whether the employee accepts the offer. For a long-term inducement, the measurement date is the date the offer is made.

BDO INSIGHTS — INTERPRETATION OF LIMITED PERIOD OF TIME

An offer that is available for only a limited period of time is accounted for as a short-term inducement. ASC 718 does not provide guidance on what constitutes a limited period of time, so judgment is required. We believe a limited period of time is generally measured in days or weeks rather than months or years because inducements offered without a restrictive time limit are not, by their structure, changes made to induce prompt acceptance, similar to the FASB's observation with respect to induced conversions of debt.[9] However, depending on the facts and circumstances, the period may be extended. For example, if an entity makes an offer to all its employees, including those located across several countries, it may take longer than a few weeks for the entity to communicate the offer in accordance with each country's applicable securities laws.

5.7 CANCELLATION AND REPLACEMENT

FASB REFERENCES

ASC 718-20-35-8 through 35-9

A cancellation of an award is not the same as a forfeiture of an award. A cancellation may occur when the award is canceled even though the grantee expects to provide the goods or services. In contrast, a forfeiture occurs when the goods or services are not expected to be provided by the grantee because of, for example, termination by the entity. Therefore, with a forfeiture, an entity reverses any compensation cost it previously recognized, but does not reverse previously recognized compensation cost with a cancellation.

A cancellation of an award that **is accompanied** by a concurrent grant of (or offer to grant) a replacement award or other valuable consideration is accounted as a modification. Therefore, any incremental value must be recognized as compensation cost on the cancellation date for vested awards or over the remaining requisite service or vesting period for unvested awards. That incremental value is calculated as the excess of the fair value of the replacement award over the fair value of the canceled award on the cancellation date.

EXAMPLE 5-14: CANCELLATION OF AN AWARD ACCOMPANIED BY A CONCURRENT GRANT OF A REPLACEMENT AWARD

FACTS

On July 1, 20X2, an entity grants to its key executives 500,000 restricted shares with a grant-date fair value of $8 each (or $4 million for 500,000 restricted shares). The restricted shares cliff vest at the end of five years (on June 30, 20X7). The entity elects the straight-line method and recognizes compensation cost of $800,000 each year (500,000 * $8 per restricted share / 5 years).

On December 31, 20X3, the entity cancels all the restricted shares and concurrently issues 500,000 replacement stock options with the same vesting conditions. As of December 31, 20X3, the cancellation date, the entity recognized compensation cost of $1,200,000 (500,000 * $8 * 30% for July 1, 20X2, through December 31, 20X3). The fair values of the original and replacement awards on the cancellation date are $7 and $9 each, respectively.

CONCLUSION

The excess of fair value of the replacement award over the fair value of the canceled award ($1 million incremental compensation cost) on the cancellation date plus the unrecognized compensation cost based on the grant date fair value of the canceled awards ($2.8 million) is recognized over the remaining requisite service period of 3.5 years.

9 See paragraph 34 of Statement of Financial Accounting Standards No. 84, *Induced Conversions of Convertible Debt*.

ANALYSIS

The cancellation of the restricted shares is accompanied by a concurrent issuance of stock options and therefore is accounted for as a modification. In accordance with ASC 718-20-35-3 through 35-8, the entity recognizes incremental compensation cost of $1 million ($9 fair value per share of replacement awards less $7 fair value per share of canceled awards on cancellation date multiplied by 500,000 awards) over the remaining requisite service period of 3.5 years (January 1, 20X4, through June 30, 20X7). Also, the entity recognizes the remaining compensation cost of $2.8 million ($4 million grant-date fair value less $1.2 million compensation cost recognized as of cancellation date) related to the canceled awards over the remaining requisite service period of 3.5 years. Accordingly, total compensation cost of $3.8 million ($1 million incremental compensation cost of replacement award plus $2.8 million unrecognized compensation cost related to canceled awards) will be recognized over the remaining requisite service period of 3.5 years.

However, a cancellation of a share-based payment award that is **not accompanied** by a concurrent grant of (or offer to grant) a replacement award or other valuable consideration is accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost is recognized on the cancellation date. If, however, the award contains a performance or service condition that was not expected to vest based on its original vesting conditions, no compensation cost is recognized on the cancellation date.

EXAMPLE 5-15: AWARD CANCELLATION

FACTS

On January 1, 20X2, an entity grants to its CEO 20,000 stock options with an exercise price of $7 per stock option. The grant-date fair value of the award is $5 per stock option. The stock options vest based on a graded schedule (25% at the end of each year of service) over four years. The entity has elected the straight-line method and recognizes compensation cost of $25,000 each year (20,000 * $5 per stock option / 4 years).

Since the grant date, the entity's share price has significantly declined. Therefore, on June 30, 20X4, the entity cancels all stock options to make additional shares available in its stock option plan for future issuance. No replacement award or other consideration is granted to the CEO. For January 1, 20X2, through June 30, 20X4 (cancellation date), the entity has recognized compensation cost of $62,500 (20,000 * $5 * 62.5%).

CONCLUSION

The cancellation of the stock options is not accompanied by a concurrent grant of a replacement award or other consideration. Therefore, all previously unrecognized compensation cost of $37,500 is recognized on the cancellation date of June 30, 20X4.

ANALYSIS

The cancellation of the award is not accompanied by a concurrent grant of a replacement award or other consideration. Accordingly, the cancellation is accounted for as a repurchase of the award for no consideration. In accordance with ASC 718-20-35-9, all unrecognized compensation cost of $37,500 ($100,000 grant-date fair value of award less $62,500 compensation cost recognized as of cancellation date) is recognized on June 30, 20X4.

In some instances, an award may be canceled with a subsequent grant that is not concurrent with the cancellation. In those situations, the cancellation must be accounted for separately from the new grant, as illustrated in Example 5-16.

EXAMPLE 5-16: CANCELLATION OF AWARD NOT ACCOMPANIED BY CONCURRENT GRANT OF REPLACEMENT AWARD

FACTS

Assume the same facts in Example 5-14, except the entity intended to issue concurrent replacement awards but did not issue them until July 1, 20X4 (six months after the cancellation date of December 31, 20X3). The fair value of the replacement awards as of July 1, 20X4 was $10 each.

CONCLUSION

The cancellation of the award is not accompanied by a concurrent grant of a replacement award and therefore is accounted for as a repurchase for no consideration. Accordingly, all previously unrecognized compensation cost of $2.8 million is recognized on the cancellation date of December 31, 20X3. Also, compensation cost of $5 million for the new awards is recognized over the requisite service period of 3.5 years.

ANALYSIS

The cancellation of the restricted shares is not accompanied by a concurrent grant of a replacement award and therefore is accounted for as a repurchase for no consideration. In accordance with ASC 718-20-35-9, all unrecognized compensation cost of $2.8 million is recognized on December 31, 20X3, the cancellation date.

When the entity issues the replacement awards six months later, it accounts for them as a new grant of awards. As such, the entity recognizes $5 million ($10 fair value per option times 500,000 restricted shares) over the requisite service period of 3.5 years.

BDO INSIGHTS — CONCURRENT GRANT

A replacement award may not be granted on the same date as the cancellation of the original award. For example, there can be administrative delays, given that an entity must obtain all necessary approvals and execute agreements with the grantee before issuing the replacement awards. If any delays stem solely from administrative causes, we generally believe a replacement award may be issued within a relatively short period (that is, a few days or weeks) after the original award is canceled. An entity must evaluate all facts and circumstances, including the reason for the delay, to determine whether a replacement award is deemed a concurrent grant. Significant judgment may be required when making that determination.

5.8 CASH SETTLEMENTS AND REPURCHASES

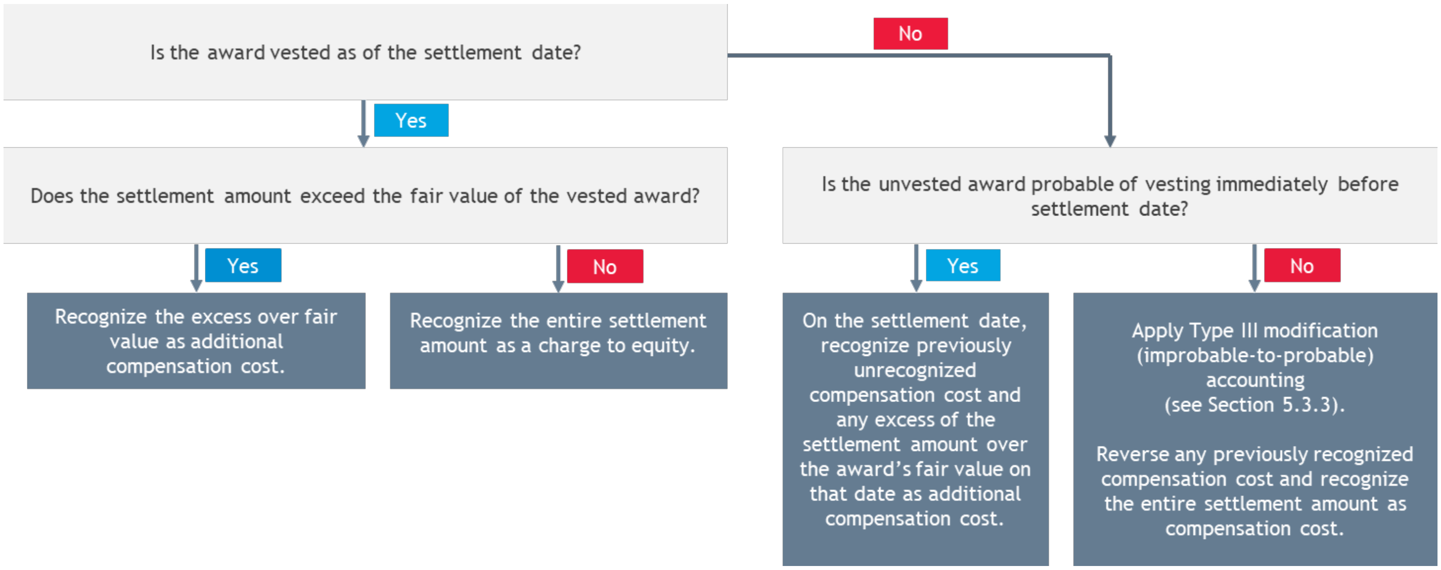
FASB REFERENCES

ASC 718-20-35-7, ASC 718-20-55-97, and ASC 718-20-55-102

An entity may settle a share-based payment award in cash instead of shares. In some instances, an award may require cash settlement. For example, phantom shares are typically settled in cash (see Section 3.2.3.1). In other instances, an award may allow settlement in either cash or shares, determined by either the grantee or grantor (see Section 3.2.3.3), or based on the occurrence of a contingent event (see Section 3.2.3.2). Further, an entity may repurchase an award through the issuance of cash even though the award's terms do not allow for cash settlement. An entity must determine whether any cash settlement features or its history of settling or repurchasing awards in cash result in liability classification of the award (see Section 3.2.6).

Cash settlements are charged to equity (or liability if the award is classified as a liability) as long as the cash settlement amount is equal to or less than the award's fair value on the settlement date. If the cash settlement amount is greater than the award's fair value on the settlement date, the excess of the settlement amount over the fair value is recognized as additional compensation cost. Further, if an entity settles an unvested award that was probable of vesting, any previously unrecognized compensation cost must be recognized on the settlement date. That approach is consistent with a Type I modification (see Section 5.3.1). Conversely, if an entity settles an unvested award that was not probable of vesting, the entire settlement amount is charged to compensation cost. That approach is consistent with a Type III modification (see Section 5.3.3).

The flowchart below illustrates the accounting for settlements of share-based payment awards.



BDO INSIGHTS — DETERMINING WHETHER A REPURCHASE IS A SETTLEMENT OR MODIFICATION

Instead of immediately settling a share-based payment award, an entity may promise to repurchase the award in the future (that is, the entity effectively adds a repurchase feature to the award). Such promise to repurchase an award for cash is accounted for either as a settlement (that is, in substance, a short-term offer) or modification that changes the award's classification from equity to liability and then a settlement of a liability-classified award, depending on the facts and circumstances.

We believe the promise to repurchase is accounted for as a modification if either of the following exists:

- The settlement amount continues to be indexed to the grantor's equity (that is, the settlement amount is not fixed or determinable at the amendment date)
- Future service is required by the grantee.

The two models (settlement or modification) result in different accounting outcomes.

If either factor is present, the promise to repurchase the award generally results in an immediate modification that changes the award's classification from equity to liability (see Section 5.4.1) and a subsequent settlement of a liability-classified award. Incremental compensation cost is recognized to adjust the original grant-date fair value of the equity award to the increased fair value of the liability-classified award, and the liability is then adjusted to the current fair value each period until settlement. Also, cumulative compensation cost cannot be less than the original grant-date fair value of the award (see Section 5.4.1).

If neither factor applies, the promise to repurchase the award is generally accounted for as a settlement. No incremental compensation cost is recognized in a settlement of a vested award as long as the consideration is equal to or less than the award's fair value on the settlement date. Conversely, the entity recognizes additional compensation cost for the excess value if the settlement amount exceeds the current fair value of the award. See the above flowchart on accounting for settlements in this section.

EXAMPLE 5-17: CASH SETTLEMENT OF VESTED AND UNVESTED AWARDS

FACTS

On January 1, 20X1, an entity issued to its CFO 10,000 equity-classified stock options with a grant-date fair value of $8 each. Of the 10,000 stock options, 5,000 are fully vested on the grant date and the remaining 5,000 will cliff vest at the end of four years (December 31, 20X4).

On December 31, 20X3, the entity entered into a termination agreement with the CFO. Pursuant to that agreement, upon termination, the entity will pay the CFO $100,000 in cash to cancel all existing stock options.

The CFO terminates employment on December 31, 20X3. As of the termination date, the fair value of the stock options is $9 per stock option, and the entity has recognized $70,000 to date in compensation cost (5,000 fully vested options * $8 grant-date fair value, plus 5,000 unvested options * $8 grant-date fair value * 3/4 years).

CONCLUSION

- Vested Stock Options — The cash payment settles the vested stock options. Therefore, the cash settlement amount is recognized as a charge to equity up to the fair value of the vested stock options of $45,000 on the termination date.
- Unvested Stock Options — The cash settlement results in a Type III modification for the unvested stock options. All previously recognized compensation cost of $30,000 should be reversed, and the remaining cash settlement amount of $55,000 is recognized on the termination date as the incremental compensation cost.

ANALYSIS

- **Vested Stock Options** — Does the settlement amount exceed the fair value of the vested award?
  - The fair value of the vested stock options on December 31, 20X3 (termination date), is $45,000 ($9 fair value per stock option times 5,000 vested stock options). The cash payment settles the vested stock options at their fair value. Therefore, the cash settlement amount is recognized as a charge to equity up to the fair value of the vested stock options on the termination date. The following journal entry is recorded on termination date for the vested stock options:

Debit	APIC	$	45,000		
Credit	Cash			$	45,000

- **Unvested Stock** Options — Is the unvested award probable of vesting immediately before settlement date?
  - Because the CFO is no longer expected to vest in the stock options, the entity accounts for the settlement as a Type III modification (improbable-to-probable). In other words, the fair value of the unvested stock options is zero immediately before the termination date, and the cash paid for the unvested stock options of $55,000 ($100,000 cash payment less $45,000 of cash payment related to the vested stock options) is the incremental compensation cost recognized on the termination date. Also, previously recognized compensation cost for Years 1-3 of $30,000 ($8 grant-date fair value per stock option * 5,000 * 75%) related to the unvested stock options is reversed on the termination date. The following journal entry is recorded on the termination date for the unvested stock options:

Debit	APIC	$	30,000		
Credit	Compensation cost			$	30,000
Debit	Compensation cost		55,000		
Credit	Cash				55,000

EXAMPLE 5-18: REPURCHASE OF VESTED AWARDS IS A SETTLEMENT

FACTS

On July 1, 20X2, an entity issued 5,000 equity-classified stock options with a grant-date fair value of $5 per stock option that vest in one year.

Once the stock options vest on June 30, 20X3, the entity offers to repurchase them at the current fair value of $8 per stock option. At the offer date, the stock options are fully vested, and no additional service is required by the grantee.

CONCLUSION

The repurchase is accounted for as a settlement. The cash settlement of $40,000 is charged to APIC because the settlement amount does not exceed the current fair value of the stock options on the settlement date.

ANALYSIS

The repurchase is accounted for as a settlement because as of the offer date:

- The settlement amount is fixed at $8 per stock option and
- The grantee is not required to provide future service.

Because the settlement amount does not exceed the current fair value of the stock options as of the offer date, the cash settlement of $40,000 ($8 settlement amount * 5,000 stock options) is charged to APIC. The entity records the following journal entry on the repurchase date:

Debit	APIC	$	40,000		
Credit	Cash			$	40,000

EXAMPLE 5-19: REPURCHASE OF AWARDS IS A MODIFICATION

FACTS

Assume the same facts as in Example 5-18, except the settlement amount will be based on the fair value of the stock options on December 31, 20X3 (the settlement date). The fair value of the stock options on that date is $10 per stock option.

CONCLUSION

The repurchase is accounted for as a modification because the settlement amount continues to be indexed to the entity's equity after the amendment. Therefore, the stock options are reclassified from equity to liability, and incremental compensation cost of $15,000 is recognized on the modification date. Thereafter, the liability awards are remeasured at fair value until the settlement date of December 31, 20X3.

ANALYSIS

The repurchase is accounted for as a modification because the settlement amount continues to be indexed to the entity's equity after June 30, 20X3 (the offer date). Specifically, the settlement amount will be based on the fair value of the stock options at a future date of December 31, 20X3, and therefore is not fixed on the offer date. As a result, the stock options are reclassified from equity to liability with any incremental compensation cost recognized on the offer date, which is also the modification date in this example. Thereafter, the liability awards are remeasured at fair value until settlement on December 31, 20X3. The entity records the following journal entry on the repurchase date:

June 30, 20X3 (Offer/Modification Date)

Debit	APIC	$	25,000		
Debit	Compensation cost		15,000		
Credit	Share-based compensation liability			$	40,000

To reclassify the grant-date fair value of $25,000 ($5 grant-date fair value per stock option multiplied by 5,000 stock options) that was recorded as APIC to share-based compensation liability of $40,000 ($8 fair value per stock option on modification date multiplied by 5,000 stock options) and recognize incremental compensation cost of $15,000 ($40,000 less $25,000).

December 31, 20X3 (Settlement Date)

Debit	Compensation cost	$	10,000		
Credit	Share-based liability			$	10,000

To remeasure the liability award at fair value as of December 31, 20X3 [($10 fair value per stock option on settlement date multiplied by 5,000 stock options) less $40,000 liability award previously recognized].

Debit	Share-based liability	$	50,000		
Credit	Cash			$	50,000

To recognize the cash payment amount on settlement date.

5.9 CHANGES AFTER A GRANTEE IS NO LONGER PROVIDING GOODS OR SERVICES OR IS NO LONGER A CUSTOMER OR EMPLOYEE

FASB REFERENCES

ASC 718-10-35-10 through 35-14

A share-based payment award continues to be subject to ASC 718 unless the award is modified after **any** of the following:

- The grantee is no longer employed.
- The award granted to a nonemployee is earned and the nonemployee is no longer providing goods or services.
- The award granted to a customer is earned and the entity is no longer a customer.

If an award is modified after any of those conditions are met, the grantor accounts for the modification in accordance with ASC 718 unless the modification applies equally to all awards of the same class regardless of the holder of the award. However, after the modification, the award will be subject to other U.S. GAAP (for example, ASC 480 or ASC 815).

However, if a change to an award is made solely to reflect an equity restructuring pursuant to an existing antidilution provision (see Section 5.5.1), the change is not accounted for as a modification if **both** of the following conditions are met:

- There is no increase in the award's fair value or the antidilution provision is not added to the award's terms in contemplation of an equity restructuring.
- All holders of the same class of equity instruments are treated the same in the modification regardless of the holder of the instrument.

5.10 CHANGES TO AN AWARD PREVIOUSLY ACCOUNTED FOR UNDER ASC 710

An entity may modify or settle an instrument that was accounted for under ASC 710 by issuing share-based payment awards that are subject to ASC 718.

BDO INSIGHTS — MODIFICATION THAT CHANGES AN INSTRUMENT'S SCOPE

An entity may replace a deferred cash-based compensation arrangement that was subject to ASC 710 with an award subject to ASC 718 (for example, stock options). In that situation, we believe the entire transaction (including the arrangement that was in the scope of ASC 710) should be accounted for under ASC 718 on the modification date, as illustrated in Example 5-20. If an entity replaces a compensation plan that was not previously accounted for under ASC 710 with a share-based payment award that is in the scope of ASC 718, we believe the entity should seek consultation from tax and accounting advisors.

EXAMPLE 5-20: MODIFICATION THAT CHANGES AN AWARD'S SCOPE

FACTS

On January 1, 20X1, an entity and its CEO entered a bonus arrangement whereby the CEO would be entitled to a cash payout five years from the agreement date (December 31, 20X5). Compensation cost related to the arrangement is recognized in a systematic and rational manner over the five years in accordance with ASC 710.

On January 1, 20X3, the bonus arrangement was terminated, and the entity instead granted the CEO 10,000 stock options. The number of stock options granted was calculated based on the value of the bonus arrangement at the time of the exchange, which was $100,000. The fair value of each stock option on the exchange date was $10 per stock option, so 10,000 stock options were granted to the CEO ($100,000 value of bonus arrangement / $10 fair value per stock option). The stock options are classified as equity and cliff vest at the end of the year on December 31, 20X3. As of the exchange date, compensation cost of $40,000 related to the bonus arrangement had been recognized under ASC 710.

CONCLUSION

The exchange of a cash bonus for stock options is accounted for under ASC 718. The liability accrued thus far under the bonus arrangement is reclassified to equity (APIC) on the modification date, and the remaining compensation cost of $60,000 is recognized over the one-year requisite service period (January 1, 20X3, through December 31, 20X3).

ANALYSIS

The exchange of a cash bonus for stock options is accounted for under ASC 718 even though the bonus arrangement was previously accounted for under ASC 710. The exchange is treated like a modification that changes the classification of an award from liability to equity. Therefore, the liability accrued thus far under the bonus arrangement is reclassified to equity (APIC), and the remaining compensation cost of $60,000 ($100,000 grant-date fair value of stock options less $40,000 compensation cost recognized to date on the bonus arrangement under ASC 710) is recognized over the remaining vesting period of one year, resulting in the following journal entries:

January 1, 20X3 (Modification Date)

Debit	Accrued liability	$	40,000		
Credit	APIC			$	40,000

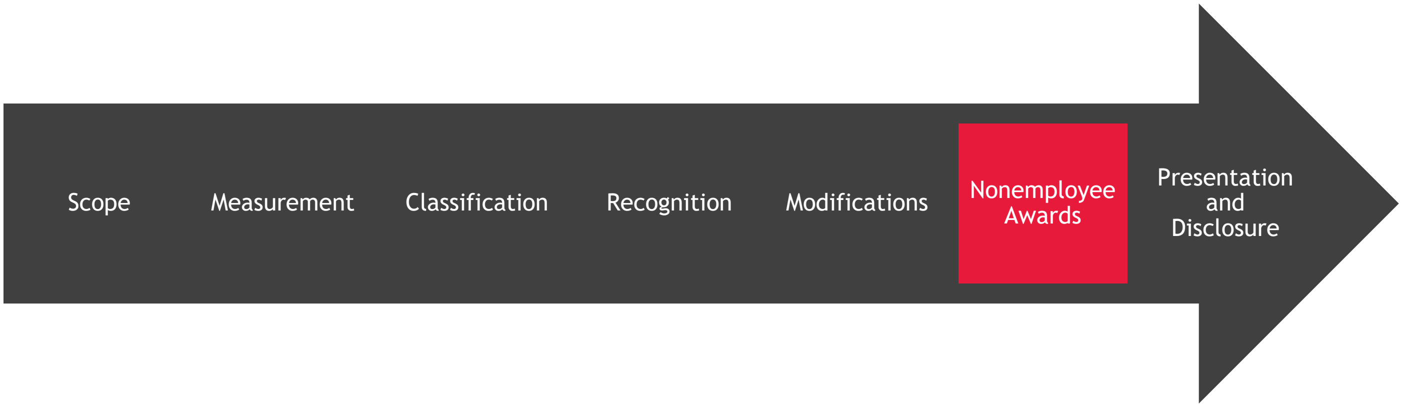
To reclassify accrued liability previously recognized as a bonus arrangement under ASC 710 as equity related to the stock options on the modification date.

January 1, 20X3, through December 31, 20X3 (Remaining Vesting Period)

Debit	Compensation cost	$	60,000		
Credit	APIC			$	60,000

To record compensation cost related to the replacement of stock options for the one-year requisite service period from January 1, 20X3, through December 31, 20X3.

Chapter 6 — Nonemployee Awards



6.1 OVERVIEW

ASC 718 applies to shared-based payment awards issued in exchange for goods and services. While ASC 718 substantially aligns the accounting for share-based payment awards issued to employees and nonemployees, some differences remain, primarily regarding expense attribution and some aspects of measurement. Therefore, an entity must determine whether the grantee is an employee (see Section 1.3.1) or a nonemployee (see Section 1.3.4).

The table below summarizes differences in the accounting for employee and nonemployee awards.

	EMPLOYEE AWARDS	NONEMPLOYEE AWARDS
Measurement	The measurement principles for share-based payment awards are generally the same for nonemployee and employee awards (see Chapter 2). Nonemployee awards are measured based on the fair value (or in some instances, calculated value or intrinsic value) of the equity instruments issued, except:	
	▶ An entity must use the expected term (rather than the contractual term) in measuring the fair value of an employee stock option or similar instrument (see Section 2.3.2.4).	▶ An entity may elect, on an award-by-award basis, to use the contractual term (rather than the expected term) when valuing awards granted to nonemployees (see Section 6.3.1.1).
	▶ A nonpublic entity may elect an accounting policy to measure all liability-classified awards at intrinsic value or at fair value (see Section 2.4.2.2).	▶ A nonpublic entity must initially and subsequently measure share-based consideration payable to a customer at fair value. In other words, a nonpublic entity cannot elect to measure its liability-classified awards issued as consideration payable to a customer at intrinsic value (see Section 6.3.1.2).

	EMPLOYEE AWARDS	NONEMPLOYEE AWARDS
Classification	The conditions for determining the appropriate classification of share-based payment awards are generally the same for nonemployee and employee awards (see Chapter 3), except:	
	▶ For awards that permit net settlement, if an employer withholds payment due to employees to meet statutory withholding requirements resulting from the exercise of stock options or vesting of nonvested shares, liability classification of instruments is not required if the conditions in ASC 718 are met (see Section 3.2.4.3).	▶ The guidance for employees does not apply to nonemployee awards (including nonemployee directors) because there are no statutory withholding requirements for nonemployees. As such, any nonemployee awards, including awards to nonemployee directors, that allow the grantor to withhold taxes would be liability-classified (see Section 6.4.1).
Recognition	The recognition principles for nonemployee awards differ from those for employee awards:	
	▶ An entity recognizes the fair value of employee awards over the requisite service period (see Section 4.3).	▶ An entity recognizes the fair value of nonemployee awards in the same period(s) and in the same manner as if the entity had paid cash for goods or services (see Section 6.5).
	▶ For employee awards that have only service conditions, an entity can elect an accounting policy to recognize compensation cost either on a graded vesting basis (that is, as if each tranche were a separate award) or a straight-line basis (that is, the entire award is treated as a single award) (see Section 4.3.1).	▶ An entity must apply judgment to determine the cost attribution pattern for nonemployee awards. The policy election to recognize compensation cost on a graded vesting basis or straight-line basis is limited to employee awards and is not available for nonemployee awards (see Section 6.5.4).

6.2 SCOPE

FASB REFERENCES

ASC 718-10-15-3, ASC 718-10-15-5 through 15-5A, ASC 718-10-35-10, and ASC 718-10-35-14

ASC 718 applies to shared-based payment awards issued to employees and nonemployees in exchange for goods and services to be used or consumed in the grantor's own operations. For nonemployee awards, the FASB included the requirement that goods and services must be used or consumed in the grantor's own operations to clarify that ASC 718 does not apply to instruments granted to provide financing to the grantor.[10] ASC 718 also applies to shared-based payment awards issued to customers (see Section 1.3.5).

[10] BC21 of ASU 2018-07 *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*.

Like employee awards (see Section 1.2), a nonemployee award is in the scope of ASC 718 if the grantor **either**:

- Issues or offers to issue its shares, share options, or other equity instruments
- Incurs a liability that meets either of the following conditions:
  - The amounts are at least partly based on the price of the entity's shares or other equity instruments.
  - The awards require or may require settlement by issuing the entity's equity shares or other equity instruments .

Consistent with employee awards (see Section 5.9), a nonemployee share-based payment award continues to be subject to ASC 718 unless the award is modified after either of the following:

- The award granted to a nonemployee is earned and the nonemployee is no longer providing goods or services.
- The award granted to a customer is earned and the entity is no longer a customer.

If a grantor modifies a nonemployee award after either condition is met, it accounts for the modification in accordance with ASC 718, unless the modification applies equally to all awards of the same class regardless of the holder of the award. However, after the modification, the award is subject to other U.S. GAAP (for example, ASC 480 or ASC 815).

While ASC 718 substantially aligns the accounting for share-based payment awards issued to employees and nonemployees, some differences remain, as discussed in this chapter.

BDO INSIGHTS — DIVERSITY IN PRACTICE FOR ACCOUNTING FOR EQUITY ISSUED IN EXCHANGE FOR ASSETS

Different views exist on whether equity issued in an asset acquisition is accounted for in accordance with ASC 805 as an asset acquisition, or in accordance with ASC 718 as a share-based payment granted to a nonemployee in exchange for an asset. Based on discussions at the FASB's March 3, 2021, agenda prioritization meeting, we believe that an acquirer may apply either alternative as a policy election that must be applied consistently. See BDO's Blueprint, Business Combinations Under ASC 805, for more guidance.

6.3 MEASUREMENT OF NONEMPLOYEE AWARDS

FASB REFERENCES

ASC 718-10-30-2 through 30-3 and ASC 718-10-30-7 through 30-10A

Consistent with employee awards (see Section 2.1), an entity generally must recognize the cost of nonemployee awards using a fair-value-based measure. ASC 718 requires the fair value of a stock option or similar instrument to be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available. However, when market prices are not available, the entity must estimate the fair value using an option pricing model.

The inputs to an option pricing model are generally consistent for estimating the value of employee and nonemployee awards. However, ASC 718 allows an entity to use the **contractual term** or the **expected term** when valuing awards granted to nonemployees. That election is not available for employee awards (see Section 2.3.2.4).

The election is allowed for nonemployee awards because it may be difficult to determine the expected term of a nonemployee award. Also, the FASB observed that stock options granted to nonemployees often have different characteristics than employee options. For example, employee options are typically not transferable; therefore, the only way an employee can benefit from an award is to exercise it, which often results in exercise before the end of the contractual term. Nonemployee options often do not have the same restrictions, so the holders are more likely to wait to exercise an option until the end of the contractual term.[11]

[11] BC15 through BC16 of ASU 2018-07.

An entity may elect to use the contractual term rather than the expected term for valuing nonemployee awards on an award-by-award basis. In other words, an entity may use the contractual term to value some nonemployee awards and the expected term to value others. If an entity elects to use the expected term for nonemployee awards, it must determine the expected term based on the expected exercise behavior of nonemployees, which may be different than the exercise behavior of employees.

6.3.1 Practical Expedients and Accounting Alternatives for Nonpublic Entities

ASC 718 allows nonpublic entities the election to apply the practical expedients or accounting alternatives below when measuring the value of nonemployee awards, with exceptions as discussed in the following sections:

- Estimating expected term (Section 2.3.2.4 and 6.3.1.1)
- Using calculated value to estimate volatility (Section 2.4.2.1)
- Measuring liability-classified awards at intrinsic value (Section 2.4.2.2 and 6.3.1.2)
- Determining current value of share price (Section 2.3.2.1)

6.3.1.1 Expected Term

FASB REFERENCES

ASC 718-10-30-10B

A nonpublic entity may elect an entity-wide accounting policy to apply a practical expedient to estimate the expected term for stock options and similar awards. The conditions for applying this practical expedient are the same for nonemployee and employee awards (see Section 2.3.2.4). However, even if a nonpublic entity has elected this policy, it may still elect, on an award-by-award basis, to use the contractual term (rather than the expected term) to value a nonemployee award.

6.3.1.2 Intrinsic Value

FASB REFERENCES

ASC 606-10-32-25 and ASC 718-30-30-2

A nonpublic entity may elect an accounting policy to measure all liability-classified awards at intrinsic value or at fair value. The conditions for applying this alternative are the same for most nonemployee awards as for employee awards (see Section 2.4.2.2). However, this election does not apply to liability-classified awards issued as consideration payable to a customer. A nonpublic entity must initially and subsequently measure share-based consideration payable to a customer (as described in ASC 606-10-32-25) at fair value.

6.4 CLASSIFICATION OF NONEMPLOYEE AWARDS

Accounting for a share-based payment award differs depending on whether it is classified as equity or as a liability. An award is typically equity-classified if its terms result in its settlement in the entity’s stock and is typically liability-classified if its terms result in its settlement in cash or other assets. For equity-classified awards, the measurement is generally fixed on the grant date, with compensation cost recognized over the requisite service period. Liability-classified awards are remeasured at fair-value each reporting period until settlement. The conditions for classifying share-based payment awards are generally the same for nonemployee and employee awards (see Chapter 3) except for statutory tax withholding (see Section 6.4.1).

6.4.1 Statutory Tax Withholding for Nonemployees

FASB REFERENCES

ASC 718-10-25-18

If an employer withholds payment due to employees to meet statutory withholding requirements resulting from the exercise of stock options or vesting of nonvested shares for an award that allows net settlement, it may classify the award as equity if the conditions in ASC 718-10-25-18 are met (see Section 3.2.4.3).

However, that guidance does not apply to nonemployee awards because there are no statutory withholding requirements for nonemployees. As such, a nonemployee award that allows the grantor to withhold taxes would be liability-classified. The same is true for tax withholdings for awards to nonemployee directors.

6.5 RECOGNITION OF NONEMPLOYEE AWARDS

FASB REFERENCES

ASC 718-10-25-2, ASC 718-10-25-2B through 25-2C, ASC 718-10-35-1A through 35-1C, and ASC 718-10-35-1E through 35-1F

Consistent with the principle that compensation cost for a share-based payment award issued to an employee is recognized over the requisite service period, as discussed in Section 4.3, share-based payment awards granted to nonemployees are recognized as the goods or services are received. However, ASC 718 does not address the manner (that is, capitalize or expense) or the period(s) in which the cost of nonemployee awards are recognized. ASC 718 only requires the asset or expense for a nonemployee award to be recognized in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services.

As such, an entity recognizes compensation cost (with a corresponding increase in equity or liability) for a nonemployee award over the nonemployee's vesting period based on the nature of the goods or services received as the goods or services are disposed of or consumed). For example, an entity that grants an award to a vendor in exchange for raw materials would capitalize the awards' value into inventory in accordance with ASC 330 when the raw materials are received. An entity that grants an award to a vendor in exchange for services would expense the costs of the awards as the services are performed. The entity must use judgment to determine the appropriate manner and period(s) to recognize nonemployee awards.

Consistent with the accounting for employee awards (see Section 4.2.1), an entity does not reverse a recognized asset or expense if a vested stock option granted to a nonemployee expires unexercised.

6.5.1 Service Condition

FASB REFERENCES

ASC 718-10-20: Service Condition

A service condition requires a nonemployee to deliver goods or services to earn (vest in) the share-based payment award. As such, for an award with a service condition, the nonemployee vesting period and the method of attributing the award's cost of the award could be determined based on the performance of services or the delivery of goods, as applicable. For example, if an award is issued as payment for goods to be delivered in the future, it may be appropriate to recognize the award based on the pattern of delivery of the goods rather than on a straight-line basis.

BDO INSIGHTS — GRANTS OF FULLY VESTED NONEMPLOYEE AWARDS

When an entity issues a fully vested, nonforfeitable share-based payment award to a nonemployee (that is, no specific performance is required by the nonemployee to retain the award), we believe the award generally relates to prior service and the entity should record compensation cost at the grant date. However, an entity granting such an award should consider all facts and circumstances. Judgment may be required to determine the appropriate vesting period and attribution method for nonemployee awards.

6.5.1.1 Forfeitures of Nonemployee Awards

FASB REFERENCES

ASC 718-10-35-1D

As discussed in Section 4.2.1.2, for employee awards with service conditions, ASC 718 allows an entity to elect an accounting policy to either:

- Estimate the number of forfeitures expected to occur
- Recognize the effect of forfeitures as they occur.

Similarly, an entity must elect an accounting policy for nonemployee awards with service conditions. The accounting policy election for nonemployee awards does not have to be the same as that for employee awards but must be applied consistently to all nonemployee awards.

BDO INSIGHTS — ESTIMATING FORFEITURES FOR NONEMPLOYEE AWARDS

When evaluating whether to adopt a policy for estimating forfeitures for nonemployee awards, an entity should consider the nature and volume of awards it expects to issue. If it does not expect the number of nonemployee awards to be significant, or if it expects the nature of the awards to vary, the lack of sufficient comparable historical data may make it difficult to estimate forfeitures. It would generally not be appropriate for an entity to estimate forfeitures for nonemployee awards based on historical forfeiture patterns for employee awards unless the nature and characteristics of the awards and grantees are similar.

FASB PROJECT — SHARE-BASED CONSIDERATION PAYABLE TO A CUSTOMER

In September 2024, the FASB proposed to clarify how to distinguish between service conditions and performance conditions in share-based consideration payable to a customer. In addition to revising the definition of the term “performance condition” for share-based consideration payable to a customer, the proposed amendments would eliminate the policy election allowing entities to account for forfeitures as they occur for customer awards containing service conditions. The proposal also provides a one-time option for entities that previously elected to estimate forfeitures for nonemployee awards to change upon transition and account for forfeitures as they occur. The FASB tentatively decided to proceed with a final ASU in February 2025.

6.5.2 Performance Condition

FASB REFERENCES

ASC 718-10-20: Performance Condition

Performance conditions for nonemployee awards involve the achievement of a specified performance target that is defined solely by reference to the grantor's own operations or activities or to the grantee's performance related to the grantor's own operations or activities. Because nonemployee awards may have different vesting conditions than employee awards, it may sometimes be unclear whether a vesting condition is a service condition or performance condition, so judgment may be necessary. However, to be considered a performance condition, the vesting condition must relate to the **grantor's** operations and activities rather than only to the grantee's activities. Thus, if vesting is based on tasks that must be performed by the grantee, the vesting condition is likely a service condition rather than a performance condition.

That distinction is important because the cost attribution is often different for awards with performance conditions than for those with service conditions. Consistent with employee awards (see Section 4.2.3), an entity recognizes the compensation cost of an award with a performance condition only if the achievement of the performance condition is probable.

EXAMPLE 6-1: EVALUATING VESTING CONDITIONS

FACTS

- An entity grants a warrant to a vendor for 1,000 shares of the entity's common stock.
- The warrant vests if the vendor delivers 10,000 custom-built engines to the entity during the next two years.
- If the entity realizes more than $100 million in sales from the engines during that two-year period, an additional warrant for 100 shares of the entity's common stock will vest.

CONCLUSION

The warrant for 1,000 shares of common stock includes a service condition, whereas the additional warrant for 100 shares of common stock includes a performance condition.

ANALYSIS

The award contains two vesting conditions:

- The warrant for 1,000 shares of common stock vests based on a service condition because the requirement to deliver 10,000 custom-built engines to the entity during the next two years relates to the vendor's performance (that is, it requires the vendor to deliver goods to the entity). The entity must determine the vesting period and attribution pattern for the warrant. Because the warrant vests based on the delivery of engines, it may be appropriate to attribute its cost based on the pattern of delivery rather than on a straight-line basis.
- The warrant for an additional 100 shares of common stock vests based on a performance condition because the achievement of $100 million in sales from the engines relates solely to the entity's operations. The entity must determine whether the performance condition is probable of being achieved; if so, the entity must determine the warrant's vesting period and attribution pattern.

6.5.3 Market Condition

FASB REFERENCES

ASC 718-10-20: Derived Service Period and Market Condition

A market condition affects the exercise price, exercisability, or other pertinent factors used to determine the fair value of an award in a share-based payment arrangement that relates to a specified:

- Price of the entity's shares.
- Amount of intrinsic value indexed solely to the entity's shares.
- Price of the entity's shares in terms of a similar (or index of similar) equity security (securities).
- Return on the entity's share price based on invested capital.

Unlike service and performance conditions, a market condition is **not** considered a vesting condition for recognition purposes. In other words, the compensation cost for an award with a market condition is recognized **regardless** of whether the market condition is satisfied.

The period over which an award with only a market condition is recognized is called a "derived service period." A derived service period is inferred from the application of valuation methods used to estimate the fair value of an award with a market condition. Market conditions must be considered when determining the nonemployee's vesting period. For example, if a nonemployee award vests upon the achievement of a 20% increase in the grantor's share price, the grantor would need to derive the vesting period based on its expectations of when the market condition will be achieved likely using an open-form model as discussed in Section 2.3.1.2.

Further, consistent with employee awards (see Section 4.2.2), the cost recognized for an award with a market condition is not reversed if the market condition is not met as long as the nonemployee provides the required goods or services. For example, if, based on a Monte Carlo simulation, an entity expects a 20% increase in its share value to occur within two years, it would recognize the award's cost over the two-year period (as long as the nonemployee continues to perform under the contract) and would not reverse the cost recognized in future periods, even if the market condition is not ultimately achieved.

6.5.4 Nonemployee Awards With Graded Vesting

FASB REFERENCES

ASC 718-10-35-8

For employee awards that have only service conditions, an entity can elect an accounting policy to recognize compensation cost either on a graded vesting basis (that is, as if each tranche were a separate award) or a straight-line basis (that is, as if the entire award were a single award) (see Section 4.3.1). However, this policy election is limited to employee awards and is not available for nonemployee awards.

As discussed in Section 6.5, for nonemployee awards, the asset or expense is recognized in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services. Often, the expense attribution pattern for a nonemployee award is similar to that of an employee award recognized on a graded vesting basis because each tranche of a nonemployee award must be treated as a separate award.

6.6 SHARE-BASED PAYMENTS AWARDED TO CUSTOMERS

FASB REFERENCES

ASC 606-10-32-23 and ASC 606-10-32-25 through 32-27, ASC 606-10-55-88A through 55-88B, and ASC 718-10-15-5A

An entity may pay consideration to a customer in the form of equity instruments or other share-based payments. Share-based payments issued by an entity to a customer are subject to the guidance regarding consideration payable to a customer in ASC 606 but are measured and classified in accordance with ASC 718. Accordingly, an entity must account for consideration payable to a customer as a reduction of the transaction price (and therefore of revenue) unless the payment to the customer is in exchange for a distinct good or service the customer transfers to the entity.

If consideration payable to a customer is issued in exchange for a distinct good or service from the customer, an entity accounts for the purchase of the good or service the same way it accounts for other purchases from suppliers and recognizes the share-based payments issued to the customer consistently with other nonemployee awards. However, if the amount of consideration payable to the customer exceeds the fair value of the distinct good or service the entity receives from the customer, the entity must account for such excess as a reduction of the transaction price (in other words, as a reduction of revenue). If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it must account for all the consideration payable to the customer as a reduction of the transaction price. See BDO's Blueprint, Revenue Recognition Under ASC 606, for more guidance on accounting for consideration payable to a customer.

Share-based payments issued to a customer are measured and classified in accordance with ASC 718. The award, whether equity- or liability-classified, is measured at the grant date in accordance with ASC 718. Changes in the measurement of the award (through the application of ASC 718) after the grant date that are due to the form of the consideration (for example, the change in fair value of a liability-classified award) are not included in the transaction price. Rather, changes due to the form of the consideration are reflected elsewhere in the grantor's income statement. Changes in the expected outcome of a service or performance condition (both those that affect vesting and those that affect factors other than vesting) are not considered changes due to the form of the consideration and hence are reflected in the transaction price (and therefore as revenue).

BDO INSIGHTS — PRESENTATION OF CHANGES IN MEASUREMENT DUE TO THE FORM OF CONSIDERATION

ASC 606 states that "*any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement*." However, there is no guidance on where in the income statement such changes are reflected. An entity may consider how it presents similar fluctuations in value for derivative liabilities in the income statement. Determining where to present changes in the measurement of the equity instrument due to the form of consideration requires the application of professional judgment based on the facts and circumstances.

When an estimate of the fair value of a share-based payment to a customer is required before the grant date in accordance with the guidance on variable consideration, the estimate is based on the award's fair value on the reporting dates that occur before the grant date. An entity must update 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.

MEASURING LIABILITY-CLASSIFIED AWARDS GRANTED TO CUSTOMERS

A nonpublic entity may elect an accounting policy to measure all liability-classified awards at their intrinsic value or at fair value. However, this election does not apply to liability-classified awards issued as consideration payable to a customer. A nonpublic entity must initially and subsequently measure awards determined to be consideration payable to a customer (as described in ASC 606-10-32-25) at fair value.

If the number of equity instruments promised in a contract is variable because of a service or performance condition that affects the vesting of an award, an entity must estimate the number of equity instruments it will be obligated to issue to its customer and update that estimate until the award ultimately vests. Also, the entity must include the effect of any market conditions and service or performance conditions that affect factors other than vesting when measuring each instrument (see Section 2.3.5).

FASB PROJECT — SHARE-BASED CONSIDERATION PAYABLE TO A CUSTOMER

In September 2024, the FASB proposed to clarify how to distinguish between service conditions and performance conditions in share-based consideration payable to a customer. The proposed amendments would revise the definition of the term “performance condition” for share-based consideration payable to a customer to incorporate conditions (including vesting conditions) that are based on the volume of a customer’s purchases of goods or services from the entity. The revised definition also would incorporate performance targets based on the volume of purchases made by its customers’ customers. The proposed amendments would eliminate the policy election allowing entities to account for forfeitures as they occur for customer awards containing service conditions, requiring estimation instead.

The FASB proposed the amendments to reduce diversity in practice in determining whether some conditions (for example, those based on customer purchases) are service conditions or performance conditions, which can affect when the grantor recognizes revenue. The FASB tentatively decided to proceed with a final ASU in February 2025.

Examples 6-2 and 6-3 demonstrate the accounting for share-based consideration payable to a customer. These examples assume that the FASB’s proposed amendments on share-based consideration payable to a customer are finalized as proposed.

EXAMPLE 6-2: EQUITY-CLASSIFIED AWARD GRANTED TO A CUSTOMER UPON ACHIEVEMENT OF AGGREGATE PURCHASES

FACTS

On July 1, 20X2, an entity enters into a master sales agreement with a customer to sell units of a specified product at $1,000 each. The customer concurrently issues a purchase order for 500 units of the product. All conditions in ASC 606 are met on July 1, 20X2 for a contract with a customer to exist.

Also, the entity issues 100 stock options exercisable for its common stock to the customer. The stock options vest and become exercisable if the customer purchases 5,000 more products by July 1, 20X3. The stock options are not issued in exchange for a distinct good or service and are classified as equity in accordance with ASC 718. The entity estimates that the customer will purchase the 5,000 products by July 1, 20X3 based on the facts and circumstances.

On September 1, 20X2, and March 31, 20X3, the customer purchases 2,000 units and 3,000 units of the product, respectively. Accordingly, the 100 stock options become exercisable as of June 30, 20X3.

CONCLUSION

The fair value of the stock options, measured in accordance with ASC 718, is included in total arrangement consideration as a reduction in transaction price on July 1, 20X2, and is recognized in accordance with ASC 606.

ANALYSIS

The stock options are not issued in exchange for a distinct good or service and therefore are recognized as a reduction in transaction price in accordance with ASC 606-10-32-25 and 32-27. They are share-based consideration payable to a customer and therefore are measured and classified under ASC 718 at contract inception in accordance with ASC 606-10-32-25A. Also, the vesting condition tied to the customer’s purchases is a performance condition because it relates to achieving a specified performance target that is defined solely by reference to the entity’s own operations (or activities). Accordingly, the entity must determine whether it is probable that the customer will satisfy the performance condition. If the customer purchases less than 5,000 products during the one-year period, the fair value of the stock options the entity previously recognized is reversed pursuant to ASC 606-10-55-88A.

EXAMPLE 6-3: LIABILITY-CLASSIFIED AWARD TO A CUSTOMER UPON ACHIEVEMENT OF AGGREGATE PURCHASES

FACTS

Assume the same facts as in Example 6-2, except that the stock options are liability-classified and the fair value declines as of December 31, 20X2.

CONCLUSION

The change in fair value of the stock options is due to the form of consideration and therefore is not included in the transaction price.

ANALYSIS

Because the stock options are liability-classified, they must be remeasured at fair value at each reporting period. While the initial fair value of the options at the grant date is treated as a reduction in transaction price, subsequent changes in the fair value are due to the form of the consideration (that is, due to the instrument being liability-classified). Accordingly, the subsequent changes in fair value are not reflected in the transaction price. Instead, the changes are recognized elsewhere in the entity's income statement.

6.7 MODIFICATIONS OF NONEMPLOYEE AWARDS

ASC 718's guidance on accounting for modifications applies to all share-based payment awards, including those issued to employees and nonemployees. ASC 718 does not provide guidance specific to modifications of share-based payment awards to customers.

BDO INSIGHTS — ACCOUNTING FOR NONEMPLOYEE AWARD MODIFICATIONS

We believe that modifications of customer awards should be accounted for consistently with other awards. Said differently, the entity should compare the ASC 718 fair value of the award immediately before and after modification to determine if the modification provides incremental value to the customer. An entity should evaluate the guidance in ASC 606 for contract modifications and consideration payable to a customer to determine how to recognize any incremental consideration, which may require judgment based on the facts and circumstances. See BDO's Blueprint, Revenue Recognition Under ASC 606.

6.8 AWARDS TO NONEMPLOYEES OF EQUITY-METHOD INVESTEES

An investor may issue share-based payment awards to the nonemployees of an equity method investee in exchange for goods or services consumed by the investee. The accounting for such awards is consistent with the accounting for awards to the employees of an equity-method investee (see Section 1.4.2).

6.9 NONEMPLOYEE AWARDS EXCHANGED IN A BUSINESS COMBINATION

In some business combinations, an acquirer may exchange its share-based payment awards for awards held by the acquiree's grantees. The replacement awards can be part of the consideration transferred, post-combination compensation, or a combination of both. The accounting for the exchange of nonemployee awards in a business combination is discussed in BDO's Blueprint, Business Combinations Under ASC 805.

6.10 PRESENTATION FOR NONEMPLOYEE AWARDS

FASB REFERENCES

ASC 505-10-45-2 and ASC 718-10-45-3

The presentation requirements for nonemployee awards are generally consistent with those for employee awards (see Section 7.2).

ASC 505, *Equity*, indicates that it is typically not appropriate for an entity to report as an asset a note receivable issued in exchange for its equity. However, ASC 718 clarifies that an entity must not present as contra-equity an asset (other than a note or receivable) received in exchange for fully vested, nonforfeitable nonemployee share-based payment awards. Instead, the entity must apply other relevant guidance to classify the asset based on its nature.

6.11 DISCLOSURE FOR NONEMPLOYEE AWARDS

FASB REFERENCES

ASC 718-10-50-2(g)

The disclosure requirements in ASC 718 (see Section 7.3) apply equally to employee and nonemployee awards; there are no incremental disclosure requirements for nonemployee share-based payment arrangements. However, separate disclosures for nonemployee awards are required if the award's characteristics are sufficiently different such that separate disclosures are needed to understand the entity's use of share-based compensation.

Chapter 7 — Presentation and Disclosure

7.1 OVERVIEW

ASC 718 provides limited guidance on the presentation of share-based payment awards, which mostly focuses on the balance sheet classification of awards (see Section 7.2.1). However, ASC 718-10-S99-1 requires that compensation cost be presented in the same line(s) in the income statement as if the entity had paid cash for any goods or services received (see Section 7.2.2).

Although the issuance of a share-based payment award generally is a noncash transaction, ASC 230, *Statement of Cash Flows*, provides guidance on the presentation of cash flows upon exercise of a share-based payment award (see Section 7.2.3).

ASC 718 also requires disclosures about share-based payment awards and provides examples of such disclosures. The disclosure requirements are meant to provide transparency to investors and other stakeholders about the effects of share-based payment awards on the entity's financial position, performance, and cash flows (see Section 7.3).

ASC 718 and ASC 270, *Interim Reporting,* do not require specific disclosures for share-based payment arrangements in interim financial statements. However, an entity must consider what information would be useful to financial statement users on an interim basis (see Section 7.4).

Equity stock options, nonvested shares, and similar equity instruments granted under share-based payment arrangements must be treated as potential common shares in computing diluted EPS. Diluted EPS includes all equity-classified stock options or shares granted that are not yet forfeited, regardless of the entity's accounting policy for forfeitures, unless doing so would be antidilutive (see Section 7.5).

If vesting or the ability to exercise (or retain) an award is contingent on a performance or market condition, the stock options or shares are treated as contingently issuable shares. Also, if equity stock options or other equity instruments are outstanding for only part of a reporting period, the entity weights the shares issuable to reflect the portion of the period during which the equity instruments are outstanding (see Section 7.5).

7.2 PRESENTATION

ASC 718 provides limited guidance on the presentation of share-based payment awards.

7.2.1 Balance Sheet Presentation

FASB REFERENCES

ASC 210-10-S99-1, ASC 310-10-S99-2, ASC 505-10-45-2, ASC 718-10-25-2, and ASC 718-10-45-3

As discussed in Chapter 3, share-based payment awards are presented as equity or liabilities, depending on the relevant provisions.

Also, if fully vested, nonforfeitable equity instruments are granted to a nonemployee (that is, no specific performance is required by the nonemployee to retain the instruments), the entity recognizes those instruments when they are granted. Whether the corresponding cost is recognized immediately as an expense or as a prepaid asset depends on the specific facts and circumstances (see Section 6.5). If an asset is recognized, the entity cannot present the asset as contra-equity, regardless of the awards' transferability (or lack thereof). Instead, the entity would apply other U.S. GAAP to determine the appropriate presentation of the asset.

A note receivable is generally not presented as an asset in accordance with ASC 505-10-45-2, except in very limited circumstances; for example, as discussed in ASC 210-10-S99-1 for public entities whereby the note receivable is presented as a reduction in shareholders' equity. That limited circumstance applies to a recourse note (see Section 4.6.1).

DETERMINE WHETHER TO CAPITALIZE OR EXPENSE AWARDS

ASC 718 does not provide guidance on whether or when to capitalize or expense share-based payment costs. Those costs should generally be recognized consistently with all other forms of compensation. For example, a manufacturing entity that allocates compensation paid to its production employees to its cost of inventory would apply a similar methodology for allocating and capitalizing salaries, benefits, share-based payments, and other forms of compensation. The allocation methodology requires the application of professional judgment based on the facts and circumstances (see Section 7.2.2).

ASC 718 also requires disclosure of the amounts of share-based compensation cost capitalized and expensed for each year presented (see Section 7.3).

7.2.2 Income Statement Presentation

FASB REFERENCES

ASC 718-10-S99-1

Compensation cost for share-based payment awards is presented as an expense in the income statement. Further, the SEC staff provided guidance related to the classification of compensation cost for share-based payment awards, excerpted below.

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

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 or nonemployees. 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.* [Footnotes omitted.]

FASB PROJECT — DISSAGGREGATION OF INCOME STATEMENT EXPENSES

In November 2024, the FASB issued ASU 2024-03, which requires public business entities to disclose more detailed information about the types of expenses (including employee compensation) included in commonly presented expense captions (such as cost of sales; selling, general, and administrative expenses; and research and development costs). Employee compensation includes share-based payment arrangements. However, an entity is not required to separately present share-based compensation expense from other forms of compensation, such as cash compensation. The amendments are effective for fiscal years beginning after December 15, 2026, and interim periods within fiscal years beginning after December 15, 2027. See BDO Bulletin, FASB Finalizes ASU to Disaggregate Income Statement Expenses.

7.2.3 Cash Flow Statement Presentation

FASB REFERENCES

ASC 230-10-45-14(a), ASC 230-10-45-15(a), and ASC 230-10-55-1

The issuance of a share-based payment award generally is a noncash transaction. When an entity presents the statement of cash flows using the indirect method, the compensation cost for a share-based payment award is presented as a reconciling item from net income to cash from operations.

Some share-based payment awards (for example, stock options) require the grantee to pay cash upon exercise. All proceeds received from such exercise are presented as financing activities in the statement of cash flows.

Similarly, cash paid to reacquire the entity's equity instruments are presented as a financing activity. Cash paid to a tax authority by an entity when withholding shares from a grantee's award for tax withholding is also presented as a financing activity. That is because the FASB believes[12] that the cash flows related to tax withholding are similar to a repurchase. In substance, the employer issues a gross number of shares to the employee then repurchases a portion of the shares, subsequently remitting the cash related to the in-substance repurchase to the taxing authorities on behalf of the employee.

7.3 DISCLOSURES

ASC 718 requires disclosures about share-based payment awards and provides examples of such disclosures. The disclosure requirements apply to awards granted to both employees and nonemployees. However, separate disclosures are required if the characteristics of nonemployee awards differ from those of employee awards, such that separate disclosures are needed for a user to understand the entity's use of share-based payment awards.

[12] BC19 of ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*.

7.3.1 Objective of Disclosures

FASB REFERENCES

ASC 718-10-50-1

The disclosure objective in ASC 718 requires an entity to disclose information that enables users of the financial statements to understand all of the following:

- The nature and terms of share-based payment arrangements that existed during the period and the potential effects of those arrangements on shareholders.
- The effect of compensation cost arising from share-based payment arrangements on the income statement.
- The method of estimating the fair value of the equity instruments granted (or offered to grant), during the period.
- The cash flow effects resulting from share-based payment arrangements.

7.3.2 Required Disclosures

FASB REFERENCES

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.*

vi. *Practical expedient for current price input. A nonpublic entity that elects to apply the practical expedient in paragraphs 718-10-30-20C through 30-20F shall disclose that election.*

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.*

FASB REFERENCES

ASC 718-10-50-2A and ASC 718-10-50-4

In addition to the minimum disclosures listed above, ASC 718 requires an entity to disclose the amount of cash received from the exercise of stock options and similar instruments, as well as tax benefits from stock options exercised during the annual period, if not disclosed elsewhere.

Further, an entity may disclose other information that may be useful to investors and creditors. That supplemental information, which can include a range of values based on different assumptions, must be reasonable and must not detract from the required disclosures. An entity must describe the alternative assumptions to help users understand the basis for supplemental information.

7.3.2.1 Disclosures for Spring-Loaded Awards

FASB REFERENCES

ASC 718-10-50-1 through 50-2 and ASC 718-10-S99-1

An entity may grant share-based payment awards in connection with (or shortly before) publicly announcing information that is likely to increase its share price (for example, an earnings release with better-than-expected results or a disclosure of a significant acquisition). Those awards are commonly referred to as “spring-loaded awards” (see Section 2.3.2.1). The SEC staff issued guidance on disclosures for spring-loaded awards, as excerpted below.

SEC STAFF GUIDANCE

Staff Accounting Bulletin Topic 14: Share-Based Payment

D.3 Current Price of the Underlying Share (Including Considerations for Spring-Loaded Grants)

> ***Facts:*** *Company D is a public company that entered into a material contract with a customer after market close. Subsequent to entering into the contract but before the market opens the next trading day, Company D awards share options to its executives. The share option award is non-routine, and the award is approved by the Board of Directors in contemplation of the material contract. Company D expects the share price to increase significantly once the announcement of the contract*

is made the next day. Company D's accounting policy is to consistently use the closing share price on the day of the grant as the current share price in estimating the grant-date fair value of share options.

Question 2: *What disclosures would the staff expect Company D to include in its financial statements regarding its determination of the current price of shares underlying newly-granted share options?*

Interpretive Response: *FASB ASC paragraph 718-10-50-1 requires disclosure of information that enables users of the financial statements to understand, among other things, the nature and terms of share-based payment arrangements that existed during the period and the potential effects of those arrangements on shareholders. FASB ASC paragraph 718-10-50-2 prescribes the minimum information needed to achieve the Topic's disclosure objectives, including a description of the method used and significant assumptions used to estimate the fair value of awards under share-based payment arrangements.*

Accordingly, the staff expects that, at a minimum, Company D would disclose in a footnote to its financial statements how it determined the current price of shares underlying share options for purposes of determining the grant-date fair value of its share options in accordance with FASB ASC Topic 718. For example, the staff would expect Company D to disclose its accounting policy related to how it identifies when an adjustment to the closing price is required, how it determined the amount of the adjustment to the closing share price, and any significant assumptions used to determine such adjustment, if material. Further, the characteristics of the share options, including their spring-loaded nature, may differ from Company D's other share-based payment arrangements to such an extent Company D should disclose information regarding these share options separately from other share-based payment arrangements to allow investors to understand Company D's use of share-based compensation.

Additionally, Company D should consider the applicability of MD&A and other disclosure requirements, including those related to liquidity and capital resources, results of operations, critical accounting estimates, executive compensation, and transactions with related persons. [Footnotes omitted]

7.3.2.2 Disclosures When the Simplified Method Is Used

FASB REFERENCES

ASC 718-10-S99-1

In SAB Topic 14.D.2, the SEC staff acknowledged that entities that are unable to rely on historical exercise data may find it challenging to obtain alternative information, such as exercise data for employees of other entities. Accordingly, the SEC staff allows the use of a simplified method to estimate the expected term of “plain vanilla” options when there is not sufficient historical data (see Section 2.3.2.4.2).

The SEC staff issued the guidance below on disclosure requirements when an entity uses the simplified method.

SEC STAFF GUIDANCE

[Staff Accounting Bulletin Topic 14: Share-Based Payment]

D.2 Expected Term

> *If a company uses this simplified method, the company should disclose in the notes to its financial statements the use of the method, the reason why the method was used, the types of share option grants for which the method was used if the method was not used for all share option grants, and the periods for which the method was used if the method was not used in all periods. Companies that have sufficient historical share option exercise experience upon which to estimate expected term may not apply this simplified method. In addition, this simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.*

7.3.3 Example Disclosures

FASB REFERENCES

ASC 718-10-55-136 through 55-137

Examples 7-1 and 7-2 illustrate disclosures that meet the requirements in ASC 718.

EXAMPLE 7-1: DISCLOSURE FOR A SHARE OPTION PLAN
(QUOTED FROM EXAMPLE 9, CASE A, ASC 718-10-55-136)

ASC 718-10-55-136

> *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*
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.

Non vested 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 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.

EXAMPLE 7-2: DISCLOSURE FOR PERFORMANCE SHARE OPTION PLAN (QUOTED FROM EXAMPLE 9, CASE B, ASC 718-10-55-137)

ASC 718-10-55-137

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	*995*	*60*		
Exercised	*(100)*	*36*		
Forfeited	*(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.

7.4 INTERIM REPORTING

FASB REFERENCES

ASC 270-10-45-1, ASC 270-10-50-1, and ASC 718-10-50-1

ASC 270 states that interim financial information is essential for providing investors and others with timely information about the entity's progress. The usefulness of such information depends on its relationship to the annual results of operations. Accordingly, each interim period must be viewed primarily as an integral part of an annual period.

BDO INSIGHTS — INTERIM REPORTING DISCLOSURES

ASC 718-10-50-1 explicitly indicates that disclosure requirements for annual periods are not required for interim periods and accordingly does not specify the disclosure requirements for share-based payment arrangements in interim financial statements. However, paragraph B239 of Statement 123(R) states that when "*share-based compensation cost is significant, entities may wish to provide additional information, including the total amount of that cost, on a quarterly basis*." Similarly, SEC Regulation S-X, Rule 10-01(a)(5), requires registrants to disclose information that is "*sufficient so as to make the interim information presented not misleading*." That principle is consistent with ASC 270-10-50-1 that requires an entity to present in its interim financial statements changes in accounting principles (for example, a change in measuring awards using the calculated value method to the fair-value-based method (see Section 2.3.3)) or estimates (for example, a change in probability of a performance condition (see Section 4.2.3.6)) and significant changes in financial position (for example, modifications to awards and repurchases of awards (see Chapter 5)).

Determining which disclosures about share-based payment awards are required in interim financial statements requires the application of professional judgment based on the facts and circumstances.

FASB PROJECT — INTERIM REPORTING

In November 2024, the FASB proposed improvements to ASC 270 to improve the navigability of the required interim disclosures and clarify when that guidance applies. Although the proposal would not modify the ASC 718 disclosure requirements, it would add a principle requiring entities to disclose events and changes since the end of the last annual reporting period that have a material impact on the entity. The proposal includes an example of an entity that issues significant share-based awards during an interim period, stating that it might not be sufficient for the entity to disclose only that it issued the awards. Rather, the entity should consider all required disclosures in ASC 718. While the entity might not need to comply with all the annual disclosure requirements for the interim period, it should provide relevant disclosures from ASC 718 focused on the issuance of share-based compensation that was determined to be a significant change.

7.5 EARNINGS PER SHARE

FASB REFERENCES

ASC 260-10-45-28 and ASC 718-10-45-1

An entity must apply ASC 260 to share-based payment awards issued to grantees for goods received, services rendered, or as consideration payable to a customer in accordance with ASC 606. A grantor is required to account for nonvested shares, stock options, and similar equity instruments as potential common stock when calculating diluted EPS.[13]

Generally, unvested share-based payment awards do not affect the denominator used in the calculation of basic EPS unless they are participating securities (see Section 7.5.4). However, compensation cost recognized in the current reporting period is included in the numerator.

An entity must consider the vesting conditions of equity-settleable awards to determine their potential impact on diluted EPS:

- Awards that vest based only on service conditions are accounted for using the treasury stock method (see Sections 7.5.2.1 and 7.5.2.2) unless they are participating securities and the two-class method is more dilutive (see Section 7.5.4).
- Awards that vest based on the achievement of performance or market conditions are accounted for as contingently issuable shares (see Section 7.5.2.3).

Share-based payment awards that require cash settlement do not affect EPS because their settlement will never result in an issuance of shares. However, share-based payment awards that may be settled in cash or shares will generally be included in diluted EPS (see Section 7.5.3).

7.5.1 Basic EPS

FASB REFERENCES

ASC 260-10-45-10, ASC 260-10-45-12C through 45-13, and ASC 718-20-35-2

Basic EPS is a measure of the performance of an entity over a specific reporting period, calculated by dividing the income available to common stockholders (the numerator) by the weighted-average number of common shares outstanding during the reporting period (the denominator). Shares issued or reacquired during the period are included in the denominator for the number of days they are outstanding.

Compensation cost recognized from share-based payment awards is already reflected in the income available to common stockholders; therefore, the numerator does not require adjustment.

In evaluating the impact of share-based payment awards on the denominator for basic EPS, an entity must consider the facts and circumstances of each award separately. Generally, unvested share-based payment awards and vested but unexercised options or similar instruments do not affect the denominator for basic EPS unless they are participating securities (see Section 7.5.4). However, vested shares are included in the denominator for basic EPS for the number of days they are outstanding.

Outstanding common shares are included in the denominator for basic EPS once they are vested, even if they could be subject to clawback by the entity. A clawback feature is a contingent feature that serves as a protective provision that requires or permits the recovery of value from grantees upon specific events. It is not considered in determining the grant-date fair value of an award or in recognizing compensation cost. Rather, its effect is recognized only upon the occurrence of the contingent event (see Section 4.5). As such, vested common shares are included in the denominator for basic EPS, regardless of any clawback features.

[13] This section addresses only the effects of share-based payments awards on EPS and does not include other EPS matters.

Contingently issuable shares include shares that meet **any** of the following criteria:

- They will be issued in the future upon the satisfaction of specified conditions.
- They have been placed in escrow and all or part must be returned if specified conditions are not met.
- They have been issued but the holder must return all or part if specified conditions are not met.

Contingently issuable shares are generally excluded from the denominator in basic EPS. They are included in the denominator only when there is no circumstance under which they would not be issued. For example, an entity may grant common shares to an employee that vest when the employee retires. If the employee has reached full eligibility for retirement and there are no other conditions that must be met for the award to vest, the shares are included in the calculation of basic EPS.

The impact on basic EPS is summarized below.

Included in the denominator

- Participating securities
- Vested shares that have a clawback feature

Further evaluation is required

- Contingently issuable shares

Not included in the denominator

- Unvested stock options or similar instruments
- Vested (but unexercised) stock options or similar instruments
- Nonvested shares

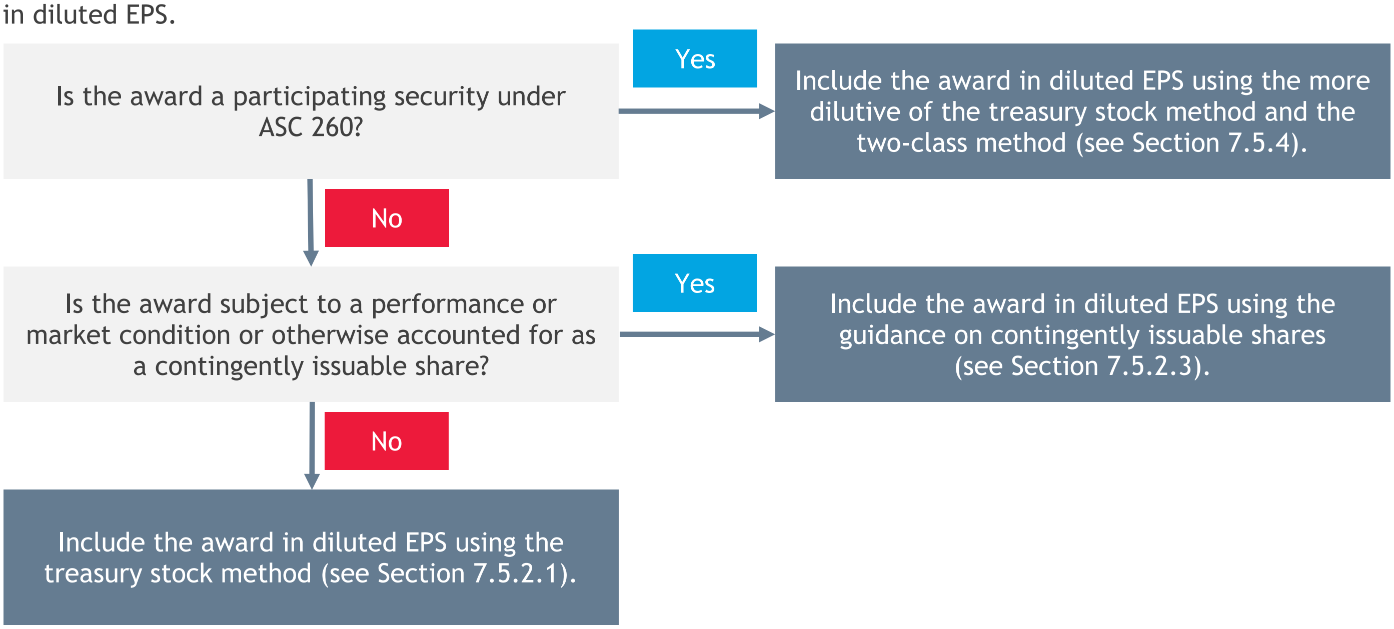
7.5.2 Diluted EPS

FASB REFERENCES

ASC 260-10-45-16 through 45-18, ASC 260-10-45-22, and ASC 260-10-45-28A

Diluted EPS is a measure of the performance of an entity over a specific reporting period, assuming all dilutive potential common shares were outstanding during the reporting period. Potential common shares include stock options, warrants, convertible securities, and contingent stock agreements.

The flowchart below describes the determination of the appropriate method for including share-based payment awards in diluted EPS.



Basic EPS is the starting point for calculating diluted EPS. However, the denominator is increased to reflect common shares that would have been outstanding if the dilutive potential common shares had been issued. Also, the numerator is adjusted to eliminate the effects on the income available to common stockholders that would not have occurred if the potential common shares had been issued. For example, because share settlement is generally assumed, share-based payment awards that are accounted for as liabilities will require an adjustment to the numerator for any changes in income or loss that would result if the award had been reported as an equity instrument during the reporting period (see Section 7.5.3).

Diluted EPS is intended to reflect the maximum potential dilution; as such, the calculation excludes potential common shares that would have an antidilutive effect on EPS. To determine whether potential common shares are dilutive, an entity must separately consider the terms and conditions of each share-based payment award.

Further, when an entity has multiple types of potential common shares, it evaluates whether they would have a dilutive effect on EPS using a ranking system, referred to as the “antidilution sequence.” The entity includes potential common stock in the diluted EPS calculation beginning with the most dilutive (those that would result in the greatest decrease in earnings per incremental share) to the least dilutive (those that would result in the smallest decrease in earnings per incremental share). If the inclusion of an instrument has an antidilutive effect on EPS after consideration of other more dilutive instruments, it is excluded from the calculation.

To determine which instruments are the most dilutive, an entity calculates the earnings per incremental share that would be included in diluted EPS for each potential common share by dividing the increase in income that would result from adjusting the numerator (assuming that the instrument had been exercised or converted) by the increase in the weighted average number of common shares to the denominator. The instruments with the lowest incremental earnings per incremental share (that is, the instruments that reduce EPS the most) are included in diluted EPS before those with higher earnings per incremental share (that is, the instruments that reduce EPS the least).

For example, assume that an entity has issued equity-classified warrants and stock options, as well as convertible debt. If the entity is generating net income, the equity-classified stock options and warrants would generally be more dilutive than convertible debt because they do not require any adjustments to the numerator, whereas the entity would adjust the numerator to add back the after-tax amount of interest expense on the convertible debt, resulting in an increase to the earnings per incremental share. Accordingly, the entity would first include the warrants and options in the diluted EPS calculation if dilutive and then include the impact of the convertible debt if it results in additional dilution.

Generally, an entity calculates the dilutive effect of share-based payment awards using the treasury stock method (see Section 7.5.2.1) unless the instruments are participating securities and the two-class method is more dilutive (see Section 7.5.4). However, for share-based payment awards that include performance or market conditions, before applying the treasury stock method, the entity must apply the guidance on contingently issuable shares (see Section 7.5.2.3) to determine if the awards are reflected in the diluted EPS calculation under the treasury stock method.

Share-based payment awards are considered outstanding as of the grant date (see Section 2.2) for purposes of calculating diluted EPS, even though their exercise may be contingent upon vesting and the grantee may not receive (or be able to sell) the stock until some future date.

7.5.2.1 Treasury Stock Method

FASB REFERENCES

ASC 260-10-45-22 through 45-23, ASC 260-10-45-25 through 45-26, ASC 260-10-45-29, ASC 260-10-45-31, ASC 260-10-55-68 through 55-70, and ASC 718-10-45-1

An entity must apply the treasury stock method to reflect the dilutive effect of share-based payment awards on EPS, except when an award is a participating security and the two-class method is more dilutive (see Section 7.5.4). However, for share-based payment awards that include performance or market conditions, the entity must apply the guidance on contingently issuable shares (see Section 7.5.2.3) before applying the treasury stock method.

To calculate the impact of potential common stock on diluted EPS, the treasury stock method assumes the following:

- Stock options and similar instruments are exercised for common stock (and nonvested shares are vested) at the beginning of the period (or at the grant date, if later (see Section 2.2)).
- The assumed proceeds from exercise equals the sum of the award's exercise price and the average unrecognized compensation cost.
- The assumed proceeds are 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) are added to the denominator in calculating diluted EPS.
- Diluted EPS is based on the actual number of options or shares granted and not yet forfeited, regardless of the entity's accounting policy for forfeitures (see Section 4.2.1.2) unless doing so would be antidilutive.

The treasury stock method is summarized below.

Step 1

Calculate the Assumed Proceeds

- The awards' exercise price, which equals the weighted-average number of options outstanding multiplied by the exercise price plus
- The average unrecognized compensation cost for awards during the reporting period. Unrecognized compensation cost equals the difference between an award's grant-date fair value and cumulative recognized compensation expense. Average unrecognized compensation cost equals the average of the unrecognized compensation cost at the beginning and end of the period.

Step 2

Calculate the Incremental Shares to Include in the Denominator

- Divide the assumed proceeds by the average market price of the common stock during the reporting period to determine the number of shares assumed to be purchased.
- The number of incremental shares equals the difference between the number of shares assumed issued and number of shares assumed purchased.

Step 3

Calculate Diluted EPS for the Period

- Identify the control number for determining whether including potential common shares in diluted EPS would be antidilutive — typically, income from continuing operations.
- Apply the antidilution sequence (summarized in the diagram below) when the capital structure includes multiple types of potential common stock. Consider each issue or series of potential shares in sequence from the most dilutive to the least dilutive.
- Calculate the weighted-average number of common shares assumed to be outstanding.
- Divide the income available to common stockholders by the weighted-average number of common shares.

Antidilution sequence

First, include dilutive potential common shares with the lowest earnings per incremental share (for example, options and warrants that do not affect the numerator)

Then sequentially include each additional dilutive potential common share with higher earnings per incremental share (for example, convertible preferred stock and convertible debt)

BDO INSIGHTS — CALCULATING ASSUMED PROCEEDS

The proceeds from the assumed exercise of share-based compensation awards used to calculate the number of incremental shares to include in the denominator of diluted EPS includes both any exercise price and the average unrecognized compensation cost for the reporting period. The requirement to include average unrecognized compensation cost is based on an interpretation of Accounting Principles Board Opinion No. 15, *Earnings Per Share (APB 15)*.[14] That interpretation viewed the unrecognized compensation cost as a proxy for the services to be provided by the recipients and thus a noncash amount that must be paid to exercise the awards. It resulted in treating shares for which past service have already been delivered as outstanding. Therefore, an award will generally be more dilutive in the early stages of its vesting period than in the later stages when there is less future service to be provided (holding its intrinsic value constant) and thus fewer assumed proceeds.

Stock options and warrants will be dilutive under the treasury stock method only when the average market price during the period exceeds the exercise price of the stock options or warrants (that is, when they are in-the-money). If changes in market prices result in an instrument becoming in-the-money (or out-of-the-money) in subsequent periods, previously reported EPS data is not retroactively adjusted.

Dilutive options or warrants that are issued during a period or that expire or are canceled during a period are included in the denominator for the period when they were outstanding. Similarly, dilutive options or warrants exercised during the period are included in the denominator for the period before exercise. The common stock issued upon exercise of options or warrants is included in the denominator for the period after the exercise date.

7.5.2.1.1 Quarterly and Year-to-Date EPS Calculations

FASB REFERENCES

ASC 260-10-55-3 through 55-3B

When applying the treasury stock method, an entity calculates the number of incremental shares included in quarterly diluted EPS using the average market price during the three months included in the reporting period. For year-to-date diluted EPS, an entity determines the number of incremental shares included in the denominator by calculating a year-to-date weighted average of the incremental shares included in each standalone quarterly diluted EPS calculation. Accordingly, year-to-date diluted EPS might not equal the sum of the quarterly diluted EPS amounts.

The calculation of year-to-date diluted EPS under the treasury stock method depends on whether the entity has income or loss from continuing operations, as shown below.

Year-to-date income from continuing operations →	If contingent shares or in-the-money options or warrants were excluded from any quarterly diluted EPS calculations because the effect was antidilutive (because there was a loss from continuing operations in those periods), they are included in the year-to-date calculation if dilutive.
Year-to-date loss from continuing operations →	Exclude all potential common stock from the calculation of diluted EPS under the treasury stock method.

[14] APB 15 was superseded by Statement of Financial Accounting Standards No. 128 (as amended), *Earnings per Share*, which was later codified in ASC 260. However, the concept of including average unrecognized compensation cost in the diluted EPS computation was preserved as demonstrated by Example 8 (ASC 260-10-55-68 through 55-70).

7.5.2.2 Awards Subject to a Service Vesting Condition

FASB REFERENCES

ASC 260-10-45-28A, ASC 260-10-45-29A, ASC 260-10-45-32, ASC 260-10-55-68 through 55-70, and ASC 718-10-45-1

Share-based payment awards that vest based only on satisfying a service condition are considered outstanding for purposes of diluted EPS and are included in the calculation of the weighted-average common stock outstanding as of the grant date, assuming their effect is dilutive. Such awards are not treated as contingently issuable shares for EPS because the issuance of the underlying shares is contingent only upon the passage of time, unlike contingencies that require satisfying conditions other than the passage of time (in other words, performance conditions (see Section 7.5.2.3)).

An entity must apply the treasury stock method (see Section 7.5.2.1) to reflect the dilutive effect on EPS of share-based payment awards that include only a service condition, except when the award is a participating security (see Section 7.5.4).

For diluted EPS, an entity must consider the shares issuable under a share-based payment arrangement on a weighted-average basis to reflect the portion of the period the awards were outstanding. That calculation incorporates the actual forfeitures, expired options, and grants during the period. Specifically, the denominator used for diluted EPS is based on the actual number of awards granted that have not yet been forfeited, regardless of the entity's policy to estimate or not estimate forfeitures in computing compensation cost under ASC 718 (see Section 4.2.1.2).

Example 7-3 demonstrates how an entity would apply the treasury stock method to outstanding stock options with a service condition. Example 7-4 demonstrates that method's application to outstanding restricted stock with a service condition.

EXAMPLE 7-3 (ADAPTED FROM ASC 260-10-55-68 THROUGH 55-70): APPLYING THE TREASURY STOCK METHOD TO STOCK OPTIONS WITH A SERVICE CONDITION

FACTS

- An entity adopted a stock option plan on January 1, 20X4, and granted 900,000 at-the-money share options with an exercise price of $30.
- All stock options vest at the end of three years (cliff vesting).
- The entity's accounting policy is to estimate the number of forfeitures expected to occur (see Section 4.2.1.2.1). At the grant date, the entity assumes an annual forfeiture rate of 3 percent and therefore expects to receive the service for 821,406 [900,000 * (.97 $^{\wedge 3}$)] stock options.
- On January 1, 20X4, the grant date fair value of each stock option is $14.69.
- Grantees forfeited 15,000 stock options ratably during 20X4, resulting in 885,000 remaining outstanding at the end of 20X4.
- The average share price during 20X4 is $44.
- Net income for the period is $97,385,602.
- For the year ended December 31, 20X4, there are 25 million weighted-average common shares outstanding.
- The stock options do not have the right to participate in dividends before being exercised and thus do not meet the definition of participating securities.
- The entity has no potential common stock other than the stock option awards.

CONCLUSION

Basic EPS is $3.90. The stock options are included in the calculation of diluted EPS using the treasury stock method. Diluted EPS is $3.89.

ANALYSIS

The following illustrates the calculation of basic and diluted EPS for the year ended December 31, 20X4:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR)	EPS
Basic EPS	$ 97,385,602	25,000,000	**$ 3.90**

In determining the weighted-average common shares outstanding for basic EPS, the entity disregards the impact of the stock options because stock options do not affect basic EPS unless they are participating securities (see Section 7.5.4).

Because the stock options are not participating securities, the entity calculates diluted EPS using the treasury stock method in accordance with the following steps:

Step 1: Calculate the assumed proceeds

The assumed proceeds equal the sum of the exercise price of the award and the average unrecognized compensation cost for the award in 20X4.

The entity calculates the assumed proceeds as follows:

Exercise price	$	26,775,000 [(a)]
Average unrecognized compensation cost in 20X4		10,944,050 [(b)]
Assumed proceeds	$	37,719,050

(a) The exercise price is calculated by multiplying the weighted-average number of options outstanding (892,500) by the exercise price ($30). The weighted-average number of options outstanding is calculated as the sum of the stock options outstanding at the beginning of the year (900,000) and at the end of the year (885,000) divided by 2.

(b) The average unrecognized compensation cost is calculated as follows:

Unrecognized compensation cost at the beginning of period [A]	$	13,221,000 [(c)]
Compensation cost recognized in 20X4, including the impact of estimated forfeitures		(4,022,151) [(d)]
Compensation cost not recognized in 20X4 related to options for which the requisite service is not expected to be rendered		(311,399) [(e)]
Total compensation cost of actual forfeited options		(220,350) [(f)]
Total unrecognized compensation cost at the end of the period [B]		8,667,100
Subtotal [A+B]		21,888,100
Average unrecognized compensation cost in 20X4 [A+B]/2	$	10,944,050

(c) 900,000 stock options granted at the beginning of the year multiplied by the grant-date fair value of $14.69.

(d) 821,406 stock options expected to vest multiplied by the grant-date fair value of $14.69 divided by 3.

(e) 885,000 stock options outstanding at the end of the year less 821,406 options for which service is expected to be rendered multiplied by the grant-date fair value of $14.69 divided by 3.

(f) 15,000 forfeited stock options multiplied by the grant-date fair value of $14.69.

Step 2: Calculate the incremental shares to include in the denominator

The assumed proceeds calculated in Step 1 are assumed to be used to purchase common stock at the average market price during the period. The entity calculates the incremental shares as follows:

Weighted-average number of common shares assumed issued	892,500
Number of common shares assumed purchased ($37,719,050/$44)	(857,251)
Incremental shares	35,249

Step 3: Calculate diluted EPS for the period

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 97,385,602	25,000,000	$ 3.90	
Stock options	—	35,249		
Diluted EPS	$ 97,385,602	25,035,249	**$ 3.89**	**Yes**

This example assumes that no potential common shares are outstanding other than the stock options; therefore, the antidilution sequence is not relevant. Because the stock options increase the weighted-average number of common shares (denominator) and do not adjust income available to common stockholders (numerator), they have a dilutive effect and are included in the calculation. The entity presents diluted EPS of $3.89.

EXAMPLE 7-4: APPLYING THE TREASURY STOCK METHOD TO RESTRICTED STOCK WITH A SERVICE CONDITION

FACTS

- On January 1, 20X5, an entity granted to its employees 300,000 RSUs with a grant date fair value of $8 each.
- The RSUs vest after six years of service (cliff vesting).
- The entity's accounting policy is to recognize forfeitures as they occur (see Section 4.2.1.2.2).
- Grantees forfeited 30,000 RSUs ratably during 20X5, resulting in 270,000 RSUs outstanding at the end of 20X5.
- The average share price during 20X5 is $12.
- For the year ended December 31, 20X5, net income is $3 million and there are 1 million weighted-average common shares outstanding.
- The RSUs do not have the right to participate in dividends before being vested and thus do not meet the definition of participating securities.
- There are no potential common shares other than the RSUs.

CONCLUSION

Basic EPS is $3.00. The RSUs are included in diluted EPS using the treasury stock method. Diluted EPS is $2.70.

ANALYSIS

The following illustrates the calculation of basic and diluted EPS for the year ended December 31, 20X5:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR)	EPS
Basic EPS	$ 3,000,000	1,000,000	**$ 3.00**

In determining the weighted-average common shares outstanding for basic EPS, the entity disregards the impact of the RSUs because RSUs do not affect basic EPS unless they are participating securities (see Section 7.5.4).

Because the RSUs are not participating securities, the entity calculates diluted EPS using the treasury stock method in accordance with the following steps:

Step 1: Calculate the assumed proceeds

The assumed proceeds equal the sum of the exercise price of the award and the average unrecognized compensation cost for the award in 20X5. The entity calculates the assumed proceeds as follows:

Exercise price		— [(a)]
Average unrecognized compensation cost in 20X5	$	2,100,000 [(b)]
Assumed proceeds	$	2,100,000

(a) There is no exercise price for the RSUs.

(b) The average unrecognized compensation cost is calculated as follows:

Unrecognized compensation cost at the beginning of period [A]	$	2,400,000 [(c)]
Compensation cost recognized in 20X5		(360,000) [(d)]
Total compensation cost of actual forfeited options		(240,000) [(e)]
Total unrecognized compensation cost at the end of the period [B]		1,800,000
Subtotal [A+B]		4,200,000
Average unrecognized compensation cost in 20X5 [A+B]/2	$	2,100,000

(c) 300,000 RSUs granted at the beginning of the year multiplied by the grant-date fair value of $8.

(d) 270,000 RSUs (300,000 RSUs granted less 30,000 forfeited in 20X5) multiplied by the grant-date fair value of $8 divided by 6 (one of six years vested).

(e) 30,000 forfeited RSU multiplied by the grant-date fair value of $8.

Step 2: Calculate the incremental shares to include in the denominator

The assumed proceeds calculated in Step 1 are assumed to be used to purchase common stock at the average market price during the period. The entity calculates the incremental shares as follows:

Weighted-average number of common shares assumed issued	285,000 [(f)]
Number of common shares assumed purchased ($2,100,000/$12)	(175,000)
Incremental shares	110,000

(f) 300,000 RSUs granted plus 270,000 RSUs outstanding at the end of 20X5 divided by 2.

Step 3: Calculate diluted EPS for the period

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 3,000,000	1,000,000	$ 3.00	
RSUs	—	110,000		
Diluted EPS	$ 3,000,000	1,110,000	**$ 2.70**	Yes

This example assumes that no potential common shares are outstanding other than the RSUs; therefore, the antidilution sequence is not relevant. Because the RSUs increase the weighted-average number of common shares (denominator) and do not adjust income available to common stockholders (numerator), they have a dilutive effect and are included in the calculation. The entity presents diluted EPS of $2.70.

7.5.2.3 Awards Subject to a Performance or Market Condition

FASB REFERENCES

ASC 260-10-45-31 through 45-32, ASC 260-10-45-48, and ASC 260-10-45-51 through 45-54

Generally, the dilutive effect of share-based payment awards is calculated using the treasury stock method (see Section 7.5.2.1) unless the instruments are participating securities (see Section 7.5.4). However, for share-based payment awards that include performance or market conditions, before applying the treasury stock method, the entity must apply the guidance on contingently issuable shares, which requires the entity to evaluate whether the share-based payment awards would have vested if the end of the reporting period were the end of the contingency period. Accordingly, when a share-based payment award is subject to a performance or market condition, the underlying shares are considered outstanding and included in the denominator of diluted EPS as shown below.

If all necessary conditions have been satisfied by the end of the reporting period…	…Include the contingently issuable shares in the denominator as of the beginning of the period (or the grant date, if later) using the treasury stock method, if dilutive.
If all necessary conditions have not been satisfied by the end of the reporting period…	…Include only the number of any contingently issuable shares that would be issuable if the end of the reporting period were the end of the contingency period (for example, the number of shares issuable based on current period earnings or period-end market price), if dilutive.

An entity recognizes compensation cost for share-based payment awards subject to a performance vesting condition only if the achievement of the performance condition is probable. Accordingly, an entity might recognize compensation cost, which is reflected in the numerator for diluted EPS, but it does not include the underlying shares in the denominator under the treasury stock method because the performance condition has not yet been met. For example, consider an award that vests if the entity's revenue increases by 10% over the prior year. If the entity concludes that it is probable the performance condition will be achieved, it recognizes compensation cost over the service vesting period. However, if revenue has not increased by 10% as of the end of an interim reporting period, the entity does not include any additional shares in diluted EPS. The recognition (or nonrecognition) of compensation cost for awards with performance conditions does not determine the impact on the denominator of diluted EPS.

Additional considerations for determining the impact of contingently issuable shares on diluted EPS are listed below.

Performance condition	▶ If an award vests based on the attainment or maintenance of a specified amount of earnings or a similar performance indicator (for example, EBITDA), the calculation includes the underlying shares in the denominator of diluted EPS if the amount was attained and the effect is dilutive. ▶ The assumption underlying this calculation is that the current amount of earnings will remain unchanged throughout the award's term.
Market condition	▶ If the number of shares that will become issuable depends on the stock's market price at a future date, the calculation of diluted EPS for the current reporting period includes the number of shares that would be issued, assuming that the market price at the end of the reporting period will be the market price at the end of the contingency period. ▶ If the market condition is based on an average of market prices over a specific period, the average for the reporting period is assumed to be the average for the contingency period.
Multiple conditions	▶ If the number of shares contingently issuable depends on more than one performance or market condition, determining the number of shares included in diluted EPS is based on both conditions. ▶ If both conditions are not met at the end of the reporting period, no contingently issuable shares are included in diluted EPS.

BDO INSIGHTS — DETERMINING WHETHER A PERFORMANCE TARGET WILL REMAIN UNCHANGED

An award may contain a performance condition specific to each reporting period within the requisite service period. Those performance conditions may be discrete, cumulative, or based on averages over several periods. ASC 260 refers to the number of shares to be included in the diluted EPS calculation that would be issued, assuming that a condition's current status (for example, earnings) will remain unchanged.

Different views have emerged in practice on the meaning of the phrase "will remain unchanged." One approach is to assume that the condition's status in the current reporting period will be replicated in each future period when applying the contingently issuable shares guidance. For example, assume an entity issues an award of 30 stock options at the beginning of Year 1 that vests at the end of Year 3 if the entity achieves average earnings of $10 million over Years 1 through 3. Under this approach, if, at the end of Year 1, the entity achieves earnings of $12 million, it is assumed that the entity will achieve earnings of $12 million again in Years 2 and 3, so all shares contingently issuable under the award are assumed to be issued when calculating diluted EPS for Year 1.

An alternative approach is to assume no additional progress toward achievement of the performance target in future periods. Applying this approach to the example above, although the entity achieved earnings of $12 million in Year 1, the entity would assume earnings of $0 in each of Years 2 and 3. Therefore, the average earnings over the three-year period is $4 million ([$12 million + $0 + $0]/3). The entity would assume the target will not be met and exclude all contingently issuable shares from exercise of the stock options when calculating diluted EPS.

EXAMPLE 7-5: DILUTED EPS FOR A SHARE-BASED PAYMENT AWARD WITH SERVICE AND PERFORMANCE CONDITIONS

FACTS

- On January 1, 20X1, an entity granted to its employees 450,000 stock options with an exercise price of $18 each and a grant-date fair value of $12 each.
- The options vest upon meeting the following vesting conditions:
  - Requisite service period of three years (cliff vesting).
  - The entity's average annual sales during the three-year service period is at least $150 million.
  - The entity's annual EBITDA during the three-year service period is at least $20 million.
- The entity's accounting policy is to recognize forfeitures as they occur (see Section 4.2.1.2.2).
- Grantees forfeited 30,000 stock option awards in each of the years 20X1 through 20X3.
- The stock options do not have a nonforfeitable right to participate in dividends before being exercised.
- There are no potential common shares other than the stock option awards.
- The entity's net income, weighted-average number of common shares outstanding, and average share prices throughout the requisite service period are:

	NET INCOME	AVERAGE SHARE PRICE	WEIGHTED-AVERAGE COMMON SHARES
20X1	$ 16,000,000	$ 23	4,000,000
20X2	$ 15,000,000	$ 24	5,000,000
20X3	$ 20,000,000	$ 26	8,000,000

The entity's annual sales and EBITDA for the years 20X1 through 20X3 are:

	SALES	AVERAGE SALES	EBITDA	AVERAGE EBITDA
20X1	$ 150,000,000	$ 150,000,000	$ 19,500,000	$ 19,500,000
20X2	$ 149,000,000	$ 149,500,000	$ 20,500,000	$ 20,000,000
20X3	$ 153,550,000	$ 150,850,000	$ 22,220,000	$ 20,740,000

CONCLUSION

	BASIC EPS	DILUTED EPS
20X1	$ 4.00	$ 4.00
20X2	$ 3.00	$ 3.00
20X3	$ 2.50	$ 2.49

ANALYSIS

The calculation of basic and diluted EPS for the year ended December 31, 20X1, is:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR)	EPS
Basic EPS	$ 16,000,000	4,000,000	**$ 4.00**

In determining the weighted-average common stock outstanding for basic EPS, the entity disregards the impact of the stock options because they do not affect basic EPS unless they are participating securities (see Section 7.5.4).

Because the stock options are not participating securities, the entity calculates diluted EPS using the treasury stock method. However, for share-based payment awards that include performance or market conditions, before applying the treasury stock method, the entity must first apply the guidance on contingently issuable shares.

In 20X1, one of the performance conditions is met because average sales meet the annual $150 million target. However, average EBITDA ($19.5 million) is less than the targeted average annual EBITDA ($20 million); therefore, the second performance condition is not met. Accordingly, if the end of 20X1 were assumed to be the end of the contingency period, the award would not vest and no shares would be issuable. Therefore, the entity excludes the stock options from the calculation of diluted EPS. As a result, both basic and diluted EPS for 20X1 are $4.00.

The calculation of basic and diluted EPS for the year ended December 31, 20X2, is:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR	EPS
Basic EPS	$ 15,000,000	5,000,000	**$ 3.00**

Consistent with the analysis in 20X1, the entity disregards the impact of the stock options for basic EPS. It calculates diluted EPS using the treasury stock method. However, for share-based payment awards that include performance or market conditions, before applying the treasury stock method, the entity must first apply the guidance on contingently issuable shares.

In 20X2, one performance condition is met because average EBITDA ($20 million) meets the $20 million target. However, the average annual sales ($149.5 million) is less than the target ($150 million); therefore, the second performance condition is not met. Accordingly, if the end of 20X2 were assumed to be the end of the contingency period, the award would not vest and no shares would be issuable. Therefore, the entity excludes the stock options from the calculation of diluted EPS. As a result, both basic and diluted EPS for 20X2 are $3.00.

The calculation of basic and diluted EPS for the year ended December 31, 20X3, is:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR)	EPS
Basic EPS	$ 20,000,000	8,000,000	**$ 2.50**

As of December 31, 20X3, the service condition is met for 360,000 stock option awards outstanding (450,000 stock options granted less 90,000 forfeited during the three-year service period). Also, both performance conditions are met. Therefore, the outstanding stock option awards vest as of December 31, 20X3. However, in determining the weighted-average common stock outstanding for basic EPS, the entity disregards the impact of the stock options because they do not affect basic EPS until they are exercised.

Because the performance conditions are met, the entity calculates diluted EPS using the treasury stock method in accordance with the following steps:

Step 1: Calculate the assumed proceeds

The assumed proceeds equal the sum of the exercise price of the award and the average unrecognized compensation cost for the award in 20X3. The entity calculates the assumed proceeds as follows:

Exercise price	$ 6,750,000	(a)
Average unrecognized compensation cost in 20X3	2,340,000	(b)
Assumed proceeds	$ 9,090,000	

(a) The exercise price is calculated by multiplying the weighted-average number of options outstanding (375,000) by the exercise price ($18). The weighted-average number of stock options outstanding is calculated as the sum of the stock options outstanding at the beginning of the year (390,000) and at the end of the year (360,000) divided by 2.

(b) The average unrecognized compensation cost is calculated as follows:

Unrecognized compensation cost at the beginning of period [A]	$ 4,680,000 [c]
Compensation cost recognized in 20X3	(4,320,000) [d]
Total compensation cost of actual forfeited options	(360,000) [e]
Total unrecognized compensation cost at the end of the period [B]	—
Subtotal [A+B]	4,680,000
Average unrecognized compensation cost in 20X3 [A+B]/2	$ 2,340,000

(c) 390,000 stock options outstanding at the beginning of 20X3 multiplied by the grant-date fair value of $12.

(d) 360,000 stock options (390,000 stock options outstanding less 30,000 forfeited in 20X3) multiplied by the grant-date fair value of $12. No compensation expense was recognized in 20X1 because the EBITDA target was not met, and no compensation expense was recognized in 20X2 because the sales target was not met.

(e) 30,000 forfeited stock options in 20X3 multiplied by the grant-date fair value of $12.

Step 2: Calculate the incremental shares to include in the denominator

The assumed proceeds calculated in Step 1 are assumed to be used to purchase common stock at the average market price during the period. The entity calculates the incremental shares as follows:

Weighted-average number of common shares assumed issued	375,000
Number of common shares assumed purchased ($9,090,000/$26)	(349,615)
Incremental shares	25,385

Step 3: Calculate diluted EPS for the period

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 20,000,000	8,000,000	$ 2.50	
Stock options	—	25,385		
Diluted EPS	$ 20,000,000	8,025,385	**$ 2.49**	**Yes**

This example assumes that there are no potential common shares outstanding other than the stock options; therefore, the antidilution sequence is not relevant. Because the stock options increase the weighted-average number of common shares and do not adjust income available to common stockholders, they are dilutive and are included in the calculation. The entity presents diluted EPS of $2.49.

7.5.2.4 EPS Effects of Modifying Share-Based Payment Awards

Modifications of share-based payment awards must be considered when calculating diluted EPS.

BDO INSIGHTS — PERFORM SEPARATE CALCULATIONS TO DETERMINE THE OVERALL IMPACT ON DILUTED EPS

An entity generally accounts for the modification of a share-based payment award in accordance with ASC 718 as the exchange of the original award for a new award (see Chapter 5). Accordingly, we believe that an entity should treat the original and modified awards as two separate awards when calculating diluted EPS. As a result, an entity should determine how a modification of a share-based payment award affects diluted EPS by performing separate calculations under the treasury stock method for the pre- and post-modification periods, as follows:

CALCULATION	AWARD TERMS AND AVERAGE MARKET SHARE PRICE CONSIDERED
Pre-modification	▶ Award terms as of the beginning of the reporting period and before the modification date ▶ Average market share price for the period before the modification date
Post-modification	▶ Terms of the modified award as of the modification date ▶ Average share price for the period after the modification date until the reporting period end

The incremental shares from each calculation is used to calculate weighted-average shares outstanding for the number of days (or months) that each award was outstanding. For example, assume that the modification occurred on May 1, 20X4, and that the incremental shares calculated on a 12-month basis for the pre- and post-modification awards is 120,000 and 126,000, respectively. The incremental shares included in the denominator for the year ended December 31, 20X4, would be 124,000 (120,000 * 4/12 + 126,000 * 8/12).

7.5.3 Awards That May Be Settled in Cash or Shares

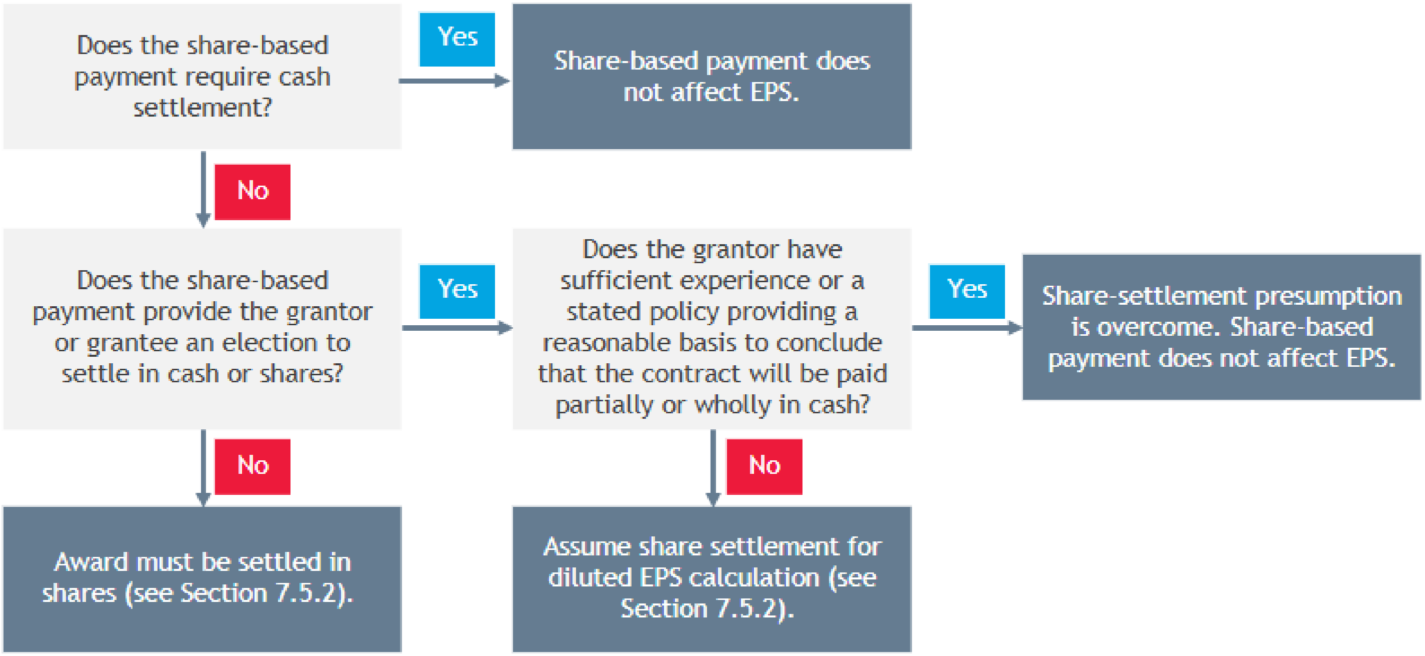
FASB REFERENCES

ASC 260-10-45-30, ASC 260-10-45-45 through 45-46, ASC 260-10-55-33, and ASC 718-10-25-15

Share-based payment awards that require cash settlement do not affect EPS because their settlement will never result in issuing common stock. However, when share-based payment awards allow the grantor or grantee to elect cash or share settlement, then regardless of which party makes the election, an entity must assume that the contract will be settled in shares for EPS. That presumption of share settlement may be overcome for a liability-classified share-based payment under ASC 718-10-25-15 because the grantor has a substantive liability to settle it in cash if sufficient past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash. For example, if an entity that has the choice of settling awards by issuing shares predominantly settles them in cash, or if it usually settles the awards in cash whenever a grantee requests cash settlement, it would be required to account for the awards as substantive liabilities. If the presumption of share settlement is overcome, the awards are not included in the denominator because of the assumed cash settlement and there is no adjustment to the numerator because settlement in cash is consistent with the award’s accounting classification.

For all other awards that may be settled in cash or shares, an entity must assume that the contract will be settled in shares for EPS purposes. Therefore, the potential common shares are included in the denominator for diluted EPS, if dilutive, using the treasury stock method (see Section 7.5.2.1). However, for share-based payment awards for which share settlement is contingent upon the occurrence of a specified event or circumstance, before applying the treasury stock method, the entity must apply the guidance on contingently issuable shares (see Section 7.5.2.3).

The flowchart below describes the impact on EPS of these settlement alternatives.



Because share settlement is generally assumed, liability-classified share-based payment awards require an adjustment to the numerator for any changes in income or loss that would result if the contract had been equity-classified during the reporting period. In other words, the effect on earnings of remeasuring the liability-classified awards each period through the settlement date are added back to the numerator in calculating diluted EPS under the treasury stock method. As a result, the numerator includes only the compensation cost that would have been recognized if the award had been equity-classified. Similarly, when calculating the award's average unrecognized compensation cost, the entity uses only the amounts that would have been unrecognized if the award had been equity-classified.

7.5.4 Two-Class Method for Participating Securities

FASB REFERENCES

ASC 260-10-20: Participating Security, ASC 260-10-45-60 through 45-61A, and ASC 260-10-45-67

A participating security is one that participates in undistributed earnings with common stock, regardless of whether that participation is conditional upon a specified event. Any form of participation in undistributed earnings constitutes participation by that security, regardless of whether the payment to the security holder is referred to as a dividend.

A share-based payment award may provide the grantee a nonforfeitable right to participate in distributions with the common stockholders before the award vests (nonvested shares) or is exercised (options or similar instruments). In such cases, the award is a participating security and the two-class method must be used to calculate EPS.

A share-based payment award is not a participating security and does not require the two-class method when it:

- Entitles the grantee to participate in distributions only after vesting (nonvested shares) or exercise (options),
- Provides the grantee with rights to dividends or dividend equivalents in the form of adjustments to the exercise price, or
- Requires the grantee to return dividends or dividend equivalents if the award does not vest or is forfeited.

The two-class method is an allocation method under which EPS is calculated separately for each participating security based on each security's rights to participate in distributions, assuming that all earnings for the period would be distributed.

The steps in the two-class method are summarized below.

	STEP 1: Reduce income from continuing operations (or net income) for dividends declared in the current period for each class of stock and by the contractual amount of other dividends that must be paid for the current period (for example, unpaid cumulative dividends). Those amounts are collectively referred to as "distributed earnings."
	STEP 2: Allocate the remaining earnings (undistributed earnings) to the common stock and participating securities to the extent each security would be entitled to receive dividends, assuming that all earnings for the period would be distributed.
	STEP 3: Divide total earnings (distributed and undistributed earnings) allocated to each participating security by the weighted-average shares outstanding to determine EPS for each participating security.
	STEP 4: Present basic and diluted EPS data for each class of common stock. Presentation of EPS data is required only for each class of common stock. Presentation of EPS for a participating security other than common stock is not precluded.

In periods of net loss, entities allocate losses to a participating security only if the security has a contractual obligation to share in the losses on an objectively determinable basis, as discussed in ASC 260-10-45-67.

BDO INSIGHTS — APPLY JUDGMENT WHEN IDENTIFYING CONTRACTUAL OBLIGATION TO SHARE IN LOSSES

We believe the terms of many share-based payment awards do not include a contractual obligation to share in losses; therefore, losses are generally not allocated to those awards. For instance, a holder of a stock option is not required to exercise the option and is therefore not required to absorb losses like a common stockholder. However, some awards absorb losses; for example, a vested restricted stock award that participates equally in earnings and residual net assets with other stockholders. Entities must exercise judgment based on the facts and circumstances.

7.5.4.1 Basic EPS

FASB REFERENCES

ASC 260-10-45-68B, ASC 260-10-55-76A through 55-76D, and ASC 718-10-55-45

To compute basic EPS under the two-class method, an entity assumes that all earnings for the period would be distributed and allocated to the common stock and participating securities. The allocation is made based on the actual dividends paid to each security (distributed earnings) and the other dividends that each instrument would be entitled to receive if all earnings were distributed (undistributed earnings).

Undistributed earnings are allocated among the various instruments, regardless of whether the instruments are vested (or expected to vest) or unvested.

However, the allocation of distributed earnings depends on how such distributed earnings have been accounted for ASC 718 requires an entity to reflect distributions for share-based payment awards that are not expected to vest as additional compensation cost, whereas distributions for share-based payment awards that are expected to vest are reflected in retained earnings. ASC 260 states *"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."* As such, to avoid reducing income twice for the same amount, distributed earnings for awards that are not expected to vest must be excluded from the earnings allocation for calculating EPS under the two-class method.

When determining how to allocate distributed earnings to the share-based payment awards, an entity's policy for accounting for forfeitures under ASC 718 must be considered, as follows:

- For an entity that elects to estimate forfeitures, the distributed earnings allocated to unvested share-based payment awards are total dividends distributed for all share-based payment awards less dividends related to awards expected to be forfeited.
- For an entity that recognizes forfeitures when they occur, the distributed earnings allocated to unvested share-based payment awards are total dividends distributed for all share-based payment awards less dividends paid for awards that were forfeited during the period and reclassified to compensation cost.

Example 7-6 illustrates the calculation of basic EPS for awards that are participating securities.

EXAMPLE 7-6 (ADAPTED FROM ASC 260-10-55-76A THROUGH 55-76D): PARTICIPATING SHARE-BASED PAYMENT AWARD — BASIC EPS UNDER THE TWO-CLASS METHOD

FACTS

- An entity had 25,000 shares of common stock and 5,000 unvested RSUs outstanding during 20X6 and reported net income of $100,000.
- The RSUs participate in any dividends with common stock on a 1:1 per-share ratio, and the dividends are nonforfeitable.
- There are no other instruments that participate in dividends with common stock.
- The entity's accounting policy is to estimate the forfeitures expected to occur.
- At the beginning of 20X6, the entity estimated that the requisite service will not be provided for 200 of the 5,000 RSUs. At the end of 20X6, the entity adjusts its estimate to reflect an increased expected forfeiture rate and now expects that the requisite service will not be provided for 300 RSUs. It recognizes the cumulative effect of that change in compensation cost in the current period.
- The entity paid a $1.50 per-share dividend on December 31, 20X6. Net income includes an expense of $450 related to dividends paid to the grantees for which the requisite service is not expected to be rendered.

CONCLUSION

Basic EPS is $3.35.

ANALYSIS

The unvested share-based payment awards have a nonforfeitable right to participate in dividend distributions with the common stock and are therefore participating securities subject to the two-class method. To calculate basic EPS under the two-class method for 20X6, the entity first calculates the undistributed earnings:

Net income		$ 100,000
Less dividends paid:		
Common stock	$ 37,500 (a)	
Unvested share-based payment awards	7,050 (b)	
Distributed earnings		$ 44,550
Undistributed earnings		$ 55,450

(a) 25,000 outstanding common shares multiplied by a $1.50 dividend per share.

(b) Reflects the dividends paid to unvested share-based payment awards of $7,500 (5,000 awards outstanding multiplied by $1.50 dividend per share) less the dividends of $450 paid to awards for which the requisite service is not expected to be rendered (300 awards multiplied by $1.50 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 in accordance with ASC 718-10-55-45 and are therefore excluded from the allocation of earnings.

The entity then allocates the undistributed earnings between the common stock and participating securities:

	OUTSTANDING	% OF TOTAL	AMOUNT ALLOCATED
Common stock	25,000	83.33%	$ 46,208
Participating share-based payment awards	5,000	16.67%	9,242
Total	30,000	100.00%	$ 55,450

The entity then calculates basic EPS:

	NET INCOME (NUMERATOR)	WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING (DENOMINATOR)	EPS
Basic EPS	$ 83,708[(c)]	25,000	**$ 3.35**

(c) 37,500 dividends paid to common stock (distributed earnings) plus 46,208 undistributed earnings allocated to common stock.

7.5.4.2 Diluted EPS

FASB REFERENCES

ASC 260-10-45-60B

To calculate diluted EPS under the two-class method, an entity assumes that all potential common shares assumed issued are included in outstanding common shares.

BDO INSIGHTS — CALCULATION OF DILUTED EPS UNDER THE TWO-CLASS METHOD

In January 2007, the FASB proposed Staff Position No. FAS 128-a, *Computational Guidance for Computing Diluted EPS Under the Two-Class Method*. According to the proposed guidance, when applying the two-class method for diluted EPS, entities should add back the undistributed earnings allocated to the participating security in calculating basic EPS (increasing the numerator) and assume that all dilutive potential common shares other than the participating securities have been exercised, converted, or issued, giving specific consideration to the antidilution sequencing provisions. Entities should then reallocate the undistributed earnings to the common shares and participating security, giving effect to any additional common shares and any additional income that would result from exercise, conversion, or issuance of potential common shares.

While the FASB did not finalize the proposed Staff Position, we believe the proposal provides an acceptable methodology for computing diluted EPS under the two-class method. For share-based payment awards that are participating securities, an entity generally calculates diluted EPS under both the two-class method and the treasury stock method and presents diluted EPS using the method that is most dilutive.

An entity that elects to apply the methodology as proposed in FASB Staff Position No. FAS 128-a calculates diluted EPS for participating share-based payment awards using the steps below.

Step 1 **Compute Basic EPS Using the Two-Class Method**	▶ Compute basic EPS using the two-class method (see Section 7.5.4.1).
Step 2 **Calculate Diluted EPS Using the Treasury Stock Method**	▶ Compute diluted EPS under the treasury stock method (see Section 7.5.2.1). ▶ Assume that the share-based payment award that is a participating security has been exercised, converted, or issued (that is, apply the treasury stock method). Further assume that all other dilutive potential common shares have been exercised, converted, or issued, giving specific consideration to the antidilution sequence.
Step 3 **Calculate Diluted EPS Using the Two-Class Method**	▶ Add back to the numerator the undistributed earnings allocated to the participating security under the basic EPS calculation in Step 1. ▶ Assume all dilutive potential common shares other than the participating securities have been exercised, converted, or issued, giving specific consideration to the antidilution sequence. ▶ Reallocate undistributed earnings to the common shares and participating security, giving effect to any additional common shares (denominator) and income (numerator) that would result from exercise, conversion, or issuance of potential common shares.
Step 4 **Report Diluted EPS**	▶ Report diluted EPS using the treasury stock method (Step 2) or the two-class method (Step 3), whichever is more dilutive.

EXAMPLE 7-7: PARTICIPATING SHARE-BASED PAYMENT AWARD — DILUTED EPS

FACTS

Assume the same facts as in Example 7-6, plus the following incremental facts:

- The RSUs cliff vest four years after the grant date, which was January 1, 20X6. The grant-date fair value of each RSU is $15.
- No RSUs were forfeited in 20X6.
- The average market price of the entity's share during 20X6 is $20.
- As calculated in Example 7-6 using the two-class method, basic EPS is $3.35.

CONCLUSION

Diluted EPS is $3.35.

ANALYSIS

The unvested RSUs have a nonforfeitable right to participate in dividend distributions with the common stock and are therefore participating securities subject to the two-class method. Because diluted EPS is intended to represent the maximum potential dilution, the entity must calculate it under both the treasury stock method and the two-class method and then use the method that is more dilutive.

Step 1: Compute basic EPS using the two-class method

The total earnings allocated to common stock was $83,708 ($37,500 distributed earnings and $46,208 undistributed earnings). Total earnings allocated to participating share-based payment awards was $16,292 ($7,050 distributed earnings and $9,242 undistributed earnings). Basic EPS is $3.35.

Step 2: Calculate diluted EPS using the treasury stock method

In this example, the antidilution sequence is not required because the RSUs are the only potential common stock.

Step 2a: Calculate the assumed proceeds

The assumed proceeds equal the sum of the award's exercise price and the average unrecognized compensation cost for the award. The entity calculates the assumed proceeds as follows:

Exercise price		—	(a)
Average unrecognized compensation cost in 20X6	$	65,625	(b)
Assumed proceeds	$	65,625	

(a) There is no exercise price for the RSUs.

(b) The average unrecognized compensation cost is calculated as follows:

Unrecognized compensation cost at the beginning of period [A]	$	75,000	(c)
Compensation cost recognized in 20X6 based on estimated forfeitures		(17,625)	(d)
Compensation cost not recognized in 20X6 related to RSUs for which the requisite service is not expected to be rendered		(1,125)	(e)
Total compensation cost of actual forfeited RSUs		—	(f)
Total unrecognized compensation cost at the end of the period [B]		56,250	
Subtotal [A+B]		131,250	
Average unrecognized compensation cost in 20X6 [A+B]/2	$	65,625	

(c) 5,000 RSUs granted at the beginning of the year multiplied by the grant-date fair value of $15.

(d) 4,700 RSUs expected to vest multiplied by the grant-date fair value of $15 divided by 4.

(e) 300 RSUs for which service is not expected to be rendered multiplied by the grant-date fair value of $15 divided by 4.

(f) There were no forfeitures of RSUs in 20X6.

Step 2b: Calculate the incremental shares to include in the denominator

The assumed proceeds calculated in Step 1 are assumed to be used to purchase common shares at the average market price during the period. The entity calculates the incremental shares as follows:

Weighted-average number of common shares assumed issued	5,000
Number of common shares assumed purchased ($65,625/$20)	(3,281)
Incremental shares	1,719

Step 2c: Calculate diluted EPS for the period using the treasury stock method

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 83,708	25,000	$ 3.35	
RSUs	16,292 (g)	1,719		
Diluted EPS	$ 100,000	26,719	$ 3.74	**No**

(g) Amount representing the earnings previously allocated to the participating security, which equals the sum of distributed earnings ($7,050) and undistributed earnings ($9,242).

The RSUs are antidilutive. Therefore, the entity excludes the RSUs from the calculation. Diluted EPS, using the treasury stock method, is $3.35, equal to basic EPS.

Step 3: Calculate diluted EPS using the two-class method

Because there are no other types of potential common stock, diluted EPS using the two-class method is the same as basic EPS, or $3.35.

Step 4: Calculate diluted EPS using the method that results in a more dilutive amount

The entity presents diluted EPS of $3.35, which is the same under both the two-class method and the treasury stock method.

EXAMPLE 7-8: PARTICIPATING SHARE-BASED PAYMENT AWARD — DILUTED EPS WHEN THERE IS OTHER POTENTIAL COMMON STOCK OUTSTANDING

FACTS

Assume the same facts as in Example 7-7, plus the following incremental facts:

- The entity had 10,000 equity-classified warrants to purchase common stock outstanding in 20X6 that were not issued under share-based payment transactions.
- The warrants can be exercised at any time for an exercise price of $15 each, and they expire after three years. None of the warrants were exercised in 20X6.
- Unlike the RSUs, the warrants do not have the right to participate with common stock in distributions.

CONCLUSION

The entity must present diluted EPS of $3.04 under the treasury stock method, which is more dilutive than the diluted EPS of $3.07 under the two-class method.

ANALYSIS

The unvested RSUs have a nonforfeitable right to participate in dividend distributions with the common stock and are therefore participating securities subject to the two-class method. Because diluted EPS is intended to represent the maximum potential dilution, the entity must calculate it under both the treasury stock method and the two-class method and then use the method that is more dilutive.

The warrants are not participating securities and therefore are included in diluted EPS using the treasury stock method.

Step 1: Compute basic EPS using the two-class method

See Example 7-6 for the computation of basic EPS using the two-class method. The total earnings allocated to common stock was $83,708 ($37,500 distributed earnings and $46,208 undistributed earnings). Total earnings allocated to participating share-based payment awards is $16,292 ($7,050 distributed earnings and $9,242 undistributed earnings). Basic EPS is $3.35.

Step 2: Calculate diluted EPS using the treasury stock method

Because there are multiple types of potential common shares, the entity first considers the antidilution sequence:

	INCREASE IN INCOME (NUMERATOR ADJUSTMENT) [X]	INCREMENTAL SHARES (DENOMINATOR ADJUSTMENT) [Y]	EARNINGS PER INCREMENTAL SHARE [X/Y]
Warrants	$ —	2,500 (c)	$ —
RSUs	$ 16,292 (a)	1,719 (b)	$ 9.48

(a) Amount represents the distributed earnings ($7,050) and undistributed earnings ($9,242) allocated to the RSUs.

(b) See calculation of the incremental shares for the RSUs in Example 7-7.

(c) This amount is calculated using the following steps.

Step 2a: Calculate the assumed proceeds

The assumed proceeds equal the sum of the award's exercise price and the average unrecognized compensation cost for the award. The entity calculates the assumed proceeds as follows:

Exercise price (10,000 weighted average number of warrant shares multiplied by the $15 exercise price)	$ 150,000
Average unrecognized compensation cost	N/A
Assumed proceeds	$ 150,000

Step 2b: Calculate the incremental shares to include in the denominator

Number of common shares assumed issued [A]	10,000 (d)
Number of common shares assumed purchased [B]	7,500 (e)
Incremental shares underlying the warrants [A-B]	2,500

(d) Weighted average number of warrant shares outstanding.

(e) The assumed proceeds of $150,000 divided by the average share price of $20.

Because the warrants have the lower earnings per incremental share ($0 compared to $9.48 in the table above), the entity first considers the dilutive effect of the warrants and includes the RSUs only if they result in additional dilution.

Step 2c: Calculate diluted EPS for the period using the treasury stock method

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 83,708	25,000	$ 3.35	
Warrants	—	2,500		
Diluted EPS with warrants	83,708	27,500	**$ 3.04**	**Yes**
RSUs	16,292 (f)	1,719		
Diluted EPS with RSUs	$ 100,000	29,219	$ 3.42	**No**

(f) Amount representing the earnings previously allocated to the participating security, which equals the sum of distributed earnings ($7,050) and undistributed earnings ($9,242).

Because the warrants increase the weighted-average number of common shares and do not adjust income available to common stockholders, they are dilutive and included in the calculation. Even though the RSUs are antidilutive after considering the warrants in accordance with the antidilution sequence, the entity includes the RSUs in the calculation solely for purposes of determining which method is more dilutive. Diluted EPS, using the treasury stock method, is $3.42.

Step 3: Calculate diluted EPS using the two-class method

The entity elects to apply the proposed guidance in FASB Staff Position No. FAS 128-a (see BDO Insights in this section). Therefore, it calculates diluted EPS using the two-class method, as follows:

	NUMERATOR	DENOMINATOR	EPS	DILUTIVE EFFECT?
Basic EPS	$ 83,708	25,000	$ 3.35	
Add back undistributed earnings allocated to RSUs	9,242 (g)	—		
Warrants	—	2,500		
Reallocated amount of undistributed earnings to RSUs	(8,531) (h)	—		
Diluted EPS	84,419	27,500	**$ 3.07**	**Yes**

(g) Amount representing the undistributed earnings previously allocated to the RSUs.

(h) Amount representing the undistributed earnings reallocated to the RSUs after the warrants are considered. It is equal to the weighted average number of stock options outstanding (5,000) divided by the total common shares and potential common shares outstanding (32,500 = 25,000 common shares + 5,000 RSUs + 2,500 warrant shares) multiplied by the undistributed earnings of $55,450 (see Example 7-6).

The entity determines that diluted EPS is $3.07 using the two-class method.

Step 4: Calculate diluted EPS using the method that results in a more dilutive amount

The entity must present diluted EPS of $3.07 under the two-class method, which is more dilutive than the diluted EPS of $3.42 under the treasury stock.

BDO INSIGHTS — COMPARING THE TREASURY STOCK AND TWO-CLASS METHODS

As demonstrated in Example 7-8, even if the participating securities are antidilutive, an entity must include them as potential common shares in the denominator for calculating diluted EPS using the treasury stock method solely for purposes of determining which approach is more dilutive. That would not be the case if the entity had not issued participating shares (that is, under the true treasury stock method, any potential common shares are excluded if their effect is antidilutive).

7.5.5 Early Exercise of Stock Options

FASB REFERENCES

ASC 260-10-45-12C through 45-13

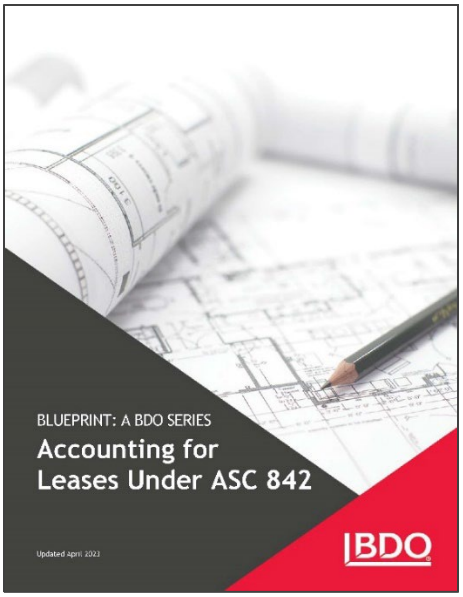
For tax purposes, the terms of a stock option may allow a grantee to exercise the award before it vests while allowing the entity to repurchase the shares at the exercise price (or for the lesser of the fair value of the shares at the repurchase date and the exercise price) if the grantee does not vest in the award. The purpose of the repurchase feature is to force the grantee to meet the vesting conditions to receive any economic benefit from the award. That type of early exercise of a stock option is not considered substantive for accounting purposes because the shares issued to the grantee are considered contingently returnable (see Section 4.2.6).

Contingently returnable shares are treated the same as contingently issuable shares (see Section 7.5.2.3). As such, an entity must exclude the shares from the denominator of basic EPS even if they are outstanding (unless they are participating securities as discussed in Section 7.5.4).

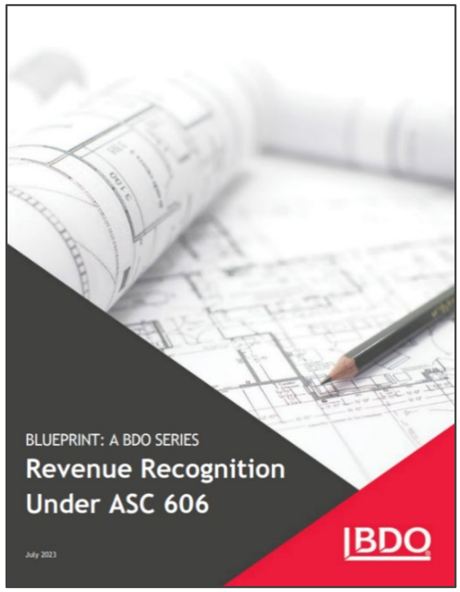
In calculating the incremental shares to be included in the denominator of diluted EPS under the treasury stock method (see Section 7.5.2.1), an entity must include any exercise price to be paid by the grantee as part of the assumed proceeds. However, in calculating diluted EPS for awards that have been exercised early, an entity must exclude the exercise price from the assumed proceeds because it was already received from the grantee.

Appendix A — Other BDO Blueprints

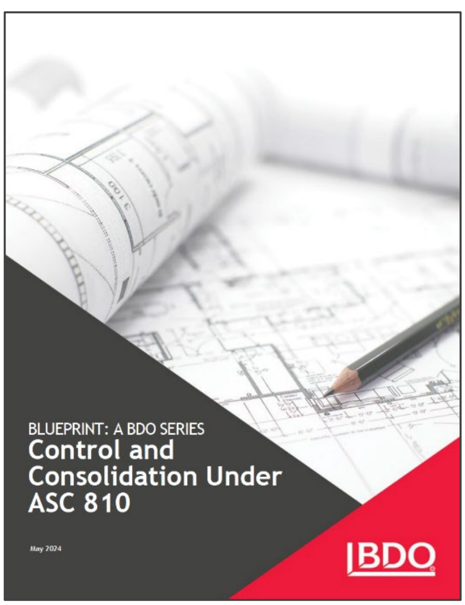
Other publications in BDO's Blueprint series are available on the BDO Center for Accounting Standards and Reporting Matters.



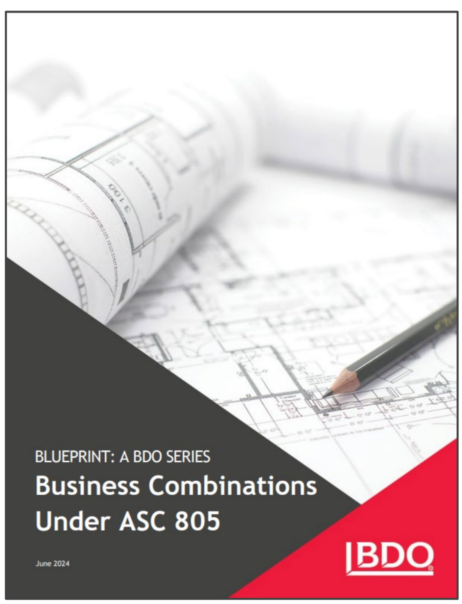
Accounting for Leases Under ASC 842



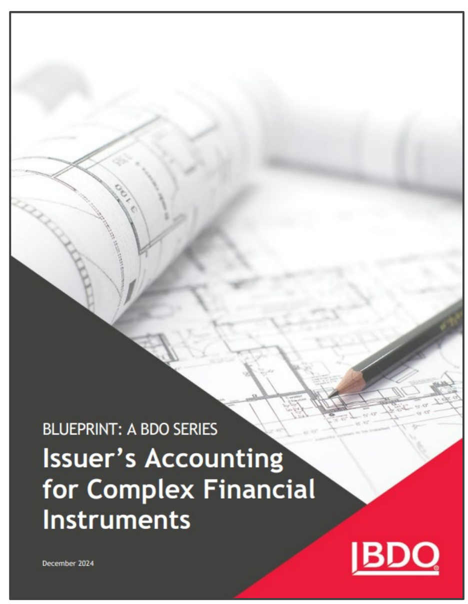
Revenue Recognition Under ASC 606



Control and Consolidation Under ASC 810



Business Combinations Under ASC 805



Issuer's Accounting for Complex Financial Instruments

Contacts

ADAM BROWN
National Managing Principal — Accounting
214-665-0673 / **abrown@bdo.com**

ANGELA NEWELL
Professional Practice Principal — Accounting
214-689-5669 / **ajnewell@bdo.com**

JENNIFER KIMMEL
Professional Practice Principal — Accounting
203-905-6284 / **jkimmel@bdo.com**

JIN KOO
Professional Practice Principal — Accounting
214-243-2941 / **jkoo@bdo.com**

JON LINVILLE
Professional Practice Principal — Accounting
214-243-2940 / **jlinville@bdo.com**