TBH Consulting LLC

Share Based Payments

Executive Summary

Table of Contents

I. Introduction

Background and scope

ASC 718, *Compensation – Stock Compensation*, details the accounting for share-based payments that entities grant to employees or vendors in exchange for goods and services. The entities recognize the awards in their financial statements based on their fair value, generally on the date they were granted.

Generally, payments in stock options, restricted stock, restricted stock units, and other equity-based instruments to common law employees and most independent directors falls under the accounting model for employee awards in ASC 718.

Awards within the scope of ASC 718

According to the scope of ASC 718, the code applies to all equity-based compensation when a company receives employee services or nonemployee goods or services by issuing stock, stock options or other equity instruments. Also, the code applies when the company receives services and goods by incurring liabilities:

- to pay cash on the price of the company's stock or other equity instruments, or
- that may be settled through the issuance of company stock or other equity instruments.

For the transaction to be subject to the guidance in ASC 718, management must analyze the facts and circumstances to determine how to measure and classify the share-based payment as a liability or equity. If the equity instrument(s) are provided to an individual who is an employee or nonemployee service provider in exchange for such services, the transaction is subject to ASC 718. However, if the transaction is with a non-service providing shareholder, the transaction is not within the scope of ASC 718.

There are many forms of equity-based awards that are addressed by ASC 718. One of the most common forms is a stock option. These are contracts that give the holder the right, but not the obligation, to purchase (call) or sell (put) a certain number of shares at a predetermined price for a certain period of time. Typically, employee stock options are call options. The next two forms are restricted stock and restricted stock units. The difference between these two are the timing of the delivery of the shares.

Restricted stock are shares granted to an employee in which sale of the shares is prohibited for a specified period. Restricted stock units (RSUs) are a promise to the employee that once certain vesting conditions are met, they will receive shares at a future date.

Stock appreciation rights (SARs) are contracts that provide the employee the right to receive an amount of stock or cash. The value of the SARs equal the appreciation in the company's stock price between the grant date and the vesting/exercise date.

Employee stock purchase plans are meant to promote employee stock ownership with a convenient means of acquisition. These plans are often offered to employees at a discount through a payroll deduction. Employee stock ownership plans are similar in which the company makes it convenient for the employee by allowing deductions or contributions. The difference is that employee stock ownership plans are designed to invest in the employer's stock without having the employees purchase it, like a qualified stock bonus plan, or a combination with a money pension plan. There are also long-term incentive plans which are cash-settled plans that reward employees based on the performance of the company over the years. If the amount rewarded to the employees is based on the price of the company's stock or other equity instruments, it is within ASC 718 scope.

Definition of an employee

According to ASC 718-10-20, an employee is defined as someone over whom the grantor of a stock-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law. Any other individual who receives stock-based compensation is considered nonemployees (aside from a few exceptions). These exceptions include a board member, a part-time employee, and employees of a pass-through entity. Under ASC 718, a board member will be treated as an employee if they have been elected by the shareholders or appointed to a position that will be filled by another person elected by the shareholders when the term expires.

It is important to make the distinction between employee and nonemployee to correctly determined of how the award is treated under ASC 718. Although the accounting for the two are similar there are some differences such as the measurement of the awards.

II. Measurement of Awards

Fair value based

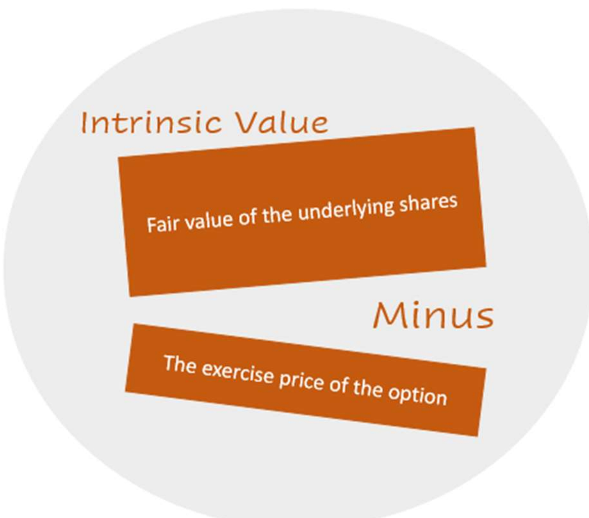
The definition of the term "fair value" in ASC 718 is different from how it is used in ASC 820, *Fair Value Measurement*. Under ASC 718, it is more of a fair value-based method when it comes to measuring the value of stock-based compensation. This is due to the fact that employee stock options are generally not traded in open markets and have features and restrictions that differ from options that are publicly traded. For example, the non-transferability or non-hedgeability of an employee stock option would affect the fair value. Companies are required to use an option-pricing model to accommodate the different characteristics of the employee stock options. The option pricing model chosen to measure the fair value of a share-based payment has direct effects on the amount of compensation cost recognized for the award. The main objective of measurement under ASC 718 is to determine the fair value of share-based awards at the grant date, with the assumption that the employees fulfill the vesting conditions. The fair value of the share-based compensation is the cost the company recognizes. In most cases, the cost is measured at the grant date fair value and is not adjusted for subsequent changes in fair value.

Companies should take the following 3 steps when determining fair value:

1. Consider the market prices of ***identical*** instruments, including the terms and conditions as well.
2. Consider the market prices of ***similar*** instruments, including the terms and conditions as well. The similarity of instruments is based on management assessment.
3. Utilize an option-pricing model if identical or similar instruments are not available. The valuation method should be based on established principles of economic theory and accepted by experts. It should be consistent with ASC 718's fair value measurement objective and capable of reflecting any substantive characteristics of the award.

In occasions where the terms of the share-based payment are complex such that it is not reasonable to estimate the fair value on the grant date, a nonpublic company may elect to measure a liability classified award's compensation costs using its intrinsic value. The intrinsic value is the difference between the fair value of the underlying shares and the exercise price of the option, or the redemption value of the option.

The fair value is measured each reporting period through the exercise date or other settlement. This remeasurement of awards that occur each reporting period at their intrinsic value may cause the compensation cost to fluctuate. If the company were to say it can reasonably estimate the fair value of the award at a later date, they must still use the intrinsic-value method until the award is settled.



Measurement date, vesting conditions

According to ASC 718-10-20, measurement date is 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. The measurement date is a very important concept when accounting for share-based awards and it differs by how the award is classified. Share-based awards may be classified as equity or liabilities. However, the majority are classified as equity. For equity classified awards, the grant date is the measurement date. The definition of grant date according to ASC 718, is the date at which a grantor and grantee reach a mutual understanding of the key terms and conditions of the share-based payment award. When both parties have the information essential for understanding the nature of the award, the grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers the goods or renders services.

For liability classified awards, the settlement date is the measurement date. Liability classified awards must be remeasured each reporting period until settlement.

Vesting conditions are not a direct factor of the fair-value based measurement of the share-awards. However, they can indirectly affect the measurement. Any service or performance condition that affects the vesting or exercisability of an award is by definition a vesting condition. This enforces the importance of both parties understanding all relevant terms and conditions of an award. These conditions are meant to motivate and retain employees in exchange for share-based awards. Once the vesting conditions are satisfied, an award is considered vested, and an employee may be able to exercise the option.

Nonemployee awards

Similar to the measurement of employee share-based awards, nonemployee awards are measured at the grant date fair value. However, for nonemployee awards the company may elect to use the contractual term as the expected term in the option-price model. This is because it may be difficult for a company to determine the expected term for nonemployee awards. The election is on an award-by-award basis and the company may still estimate the expected term if they choose to.

III. Classification of Awards

Equity classified awards

The most common classification of share-based payment awards is equity-classified. Most types of equity-classified awards are mentioned in Section 1 under Award within the scope of ASC 718. Equity classified awards are measured on the fair value basis on the grant date of the share-based payment. The company takes into consideration the fair value of identical and similar equity instruments and their terms and conditions as well. For those awards that don't have an identical or similar instrument in the market, an option pricing model is utilized. Black Scholes and other valuation techniques are considered. Compensation cost is then recognized at the grant date and is not adjusted for subsequent changes in the fair value.

Liability classified awards

Outlined in ASC 718-10-25-6 through 18, is the criteria for determining whether an award is classified as equity or a liability. The following are types of awards that should be classified as liabilities:

- Award with conditions that are indexed to something other than a market, performance, or service condition (e.g., stock option indexed to a commodity or Consumer Price Index)
- Award that meets certain criteria of ASC 480 Distinguishing Liability from Equity
- Award with a repurchase feature or where it is probable that the employer would prevent the employee from bearing the risks and rewards related to stock ownership
- Options or similar instruments that could require a cash or other asset payment to the employee
- Option or similar instrument where the underlying shares are classified as liabilities

There are many different types of liability classified awards, but a similarity they share is that the fair value of the awards are remeasured at each reporting period until the settlement date. The steps for a company with liability classified awards are:

1. Measure the fair value of the award on the grant date
2. Recognize the compensation cost over the service period
3. Remeasure the fair value of the award each reporting period until the settlement date
4. True up compensation cost each reporting period for changes in fair value
5. Once vested, recognize compensation cost for any changes in fair value until settlement

IV. Recognition of Compensation Costs

Determine grant date

In order to establish a grant date, all of the following conditions must be met:

- Grantor and grantee have reached a mutual understanding of the key terms and conditions of the award
- Grantee benefits from or adversely affected by subsequent changes in the price of the share-based award
- All necessary approvals are obtained
- The definition of employee is met by a recipient for employee awards

Typically formal, written agreements provide the best evidence of the terms, but oral arrangements or company history of transactions may also establish terms. If all conditions are met for establishing a grant date, the grant date is established for accounting purposes even if the written terms state a date in the future. On the other hand, if the written terms state a date that has been established but the conditions for establishing a grant date are not met, the grant date is not established for accounting purposes.

Most share-based payment awards require approval before a grant date is established. Also, the key terms and conditions of awards are created by the entity's management and approved by the board.

Vesting

Service and performance conditions can affect the vesting and exercisability of the share-based payment awards. Market and other conditions are not vesting conditions but are subsets of service and performance conditions that can affect the measurement of an award. Examples of each help define what the conditions are. An example of a service condition is an award vests upon the completion of 5 years of continued service. A performance condition example is when an award vests after a specific amount of an entity's product is sold. An example of a market condition is when an award becomes exercisable when the market price reaches a certain level. Service and performance conditions are considered vesting conditions because they must be satisfied for the grantee to earn their award. Market and other conditions are not vesting conditions but are factored in the fair value-based measure of an award.

An important aspect of a service condition is the probability of forfeitures. If a grantee forfeits an award the entity must reverse the compensation cost recognized for the vesting period. A company can adopt a policy to account or estimate forfeitures, for awards that are modified or exchanged in a business combination. The company can base its estimates on historical rates of forfeiture for similar awards, historical rates of employee turnover, volatility of entity's share price, and many others. These estimates should be reassessed throughout the service period for greater accuracy.

When to capitalize?

Compensation costs for share-based payment awards are usually recognized as compensation expense and presented in the income statement of the company's financial statements. However, there are some cases where the compensation costs are capitalized as part of the cost of certain assets. For example, if a company rewarded its manufacturing department employees with share options. The company can determine that the cost of the employees' service is an inventoriable cost, thus capitalizing the cost of the share options during the service period. Subsequently, when the inventory is sold, the company recognizes the cost that was capitalized in the income statement. Other examples of assets that may include capitalized compensation costs are self-constructed fixed assets, capitalized computer software costs, deferred loan origination costs, and others.

V. Modifications

Change in classification

According to ASC 718-10-20 the definition of a modification is a change in terms or conditions of a share-based payment award. The codification lays out the following three criteria that must be met for an entity to not account for the change as a modification:

- Fair value of the modified award is equal to the fair value of the original award immediately before modification
- Classification is the same
- Vesting conditions are the same

In the case of an entity's change in share-based payment not meeting all three criteria, the change must be accounted for as a modification. It is viewed as an exchange of the original award for a new award. Typically, when a modification occurs the new award is of equal or greater value than the original award because the awards are meant to be an incentive.

The accounting for the modification differs when the award's classification changes from equity to liability and vice versa. When an award is modified from equity to liability, an entity would recognize a share-based liability for the portion of the award for which the goods or services have been provided and multiply it by the award's fair value-based measure. If the new fair value-based measure is less than or equal to the original award, the difference would be recorded in APIC. If the new fair value-based measure is greater than the original award, the difference would be recognized as additional compensation cost immediately for vested awards or over the remaining service period for unvested awards.

Example: Increased Fair Value of the Award		
APIC	XX	
COMPENSATION COST	XX	
SHARE BASED PAYMENT LIABILITY		XX

Compensation Cost is recognized for the increase in the fair value of the award.

Also, because the award has been reclassified as a liability, it must be remeasured at the fair value-based amount in each reporting period until the settlement date.

On the other hand, the treatment for an award modification from liability to equity is different from most other modifications. This is because the amount of compensation cost recognized is the fair value-based measure of the award on the modification date and not the grant date. Any amounts previously recorded as a share-based compensation liability goes to APIC. The award, now classified as equity, does not have to be remeasured at each reporting period.

Business combination

According to ASC 718-20-35-6, during a business combination or equity restructuring the exchange of share options or other equity instruments or the change in terms or conditions are modifications. When entering a business combination, the acquirer may issue share-based payment awards to replace existing ones. These are referred to as "replacement awards" under ASC 805. The replacement awards may represent the consideration transferred or compensation for future goods or services by the grantees, or both. The acquirer may also assume existing share-based awards. The acquirer may change the terms of these awards to maintain the incentive aspect for the grantees.

Cancellation

When an award is cancelled and accompanied with a replacement award simultaneously, the company will account for it in the same manner as a modification. In the event an award is cancelled and there is no simultaneous grant of a replacement award or offer of a replacement award, the cancellation is treated as a settlement for no consideration.

For cancellations with a replacement award, the company must record the incremental value, if any, for unvested and vested awards. The incremental value is the excess of the fair value-based measure of the replacement award over the fair value-based measure of the cancelled award on the date of cancellation. For vested awards, the incremental value is conveyed as compensation cost on the cancellation date. For unvested awards, the incremental value is conveyed over the remaining service period.

A cancellation for an unvested award without a replacement award requires the entity to recognize the remaining unrecognized compensation cost immediately on the cancellation date. It is important to note that this type of cancellation is different from a forfeiture. A cancellation includes the voluntary surrender of awards. Also, the main difference is that a forfeiture occurs when the services are not rendered, or the goods are not delivered. A cancellation occurs when the service was expected to be rendered or the goods were expected to be provided but cancelled.

VI. Presentation and Disclosure

Income statement presentation

According to ASC 718, there is little guidance on how entities should present compensation cost arising from share-based payments in the financial statements. The guidance is geared more towards the classification of awards (e.g., liability versus equity) and the recognition of the compensation cost (e.g., expensed or capitalized).

However, the SEC staff has provided views on how the compensation expense should be presented. They believe that it should be presented in the same line or lines as cash compensation paid to employees. The presentation in the income statement should not be separated by the form of consideration paid. For more clarity, a disclosure detailing the amount of expense related to share-based payments could be considered.

Statement of cash flows

Since the receipt of goods or services for a share-based payment award is a noncash item, the award is not presented as an outflow in the statement of cash flows. However, the compensation cost recognized in net income is presented as an inflow from operations as a reconciling item, under the indirect method.

Other ways an entity presents other effects of share-based payments are listed below:

1. Cash paid by a grantee to the entity for an award is a cash inflow from financing activities. (e.g., exercise price of a stock option)
2. Cash paid to settle an award classified as equity is a cash outflow for financing activities. If the amount paid exceed the fair-value-based measure of the award, the excess is compensation cost and is a cash outflow for operating activities.

3. Cash paid to settle an award classified as a liability is a cash outflow for operating activities.
4. Per ASC 230-10-45-17, it is required that an entity classifies cash flows related to income taxes, including excess tax benefits as operating activities.

Disclosure requirements

The following disclosure requirements are listed in ASC 718-10-50-1:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders.
b. The effect of compensation cost arising from share-based payment arrangements on the income statement.
c. The method of estimating the fair value of the equity instruments granted, during the period.
d. The cash flow effects resulting from share-based payment arrangements.

The entities must disclose the above information about their share-based payment arrangements in the notes of the financial statements. ASC 718 further breaks down the list of minimum information needed to achieve the four disclosure requirements in ASC 718-10-50-2 and 50-2A.

Non-GAAP financial measures

Any financial measures that exclude compensations costs resulting from share-based payments are considered non-GAAP financial measures. In the case of a non-GAAP financial measure that excludes a recurring item, an entity must provide certain disclosures. The entity must disclose the reason management believes the non-GAAP financial measure provides information to the investors regarding its financial conditions and results of operations.

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For more information on this or other topics please email us at:

info@tbhconsulting.com