STOCK COMPENSATION & RELATED TOPICS

November 14, 2019

Agenda

- **ASC 718, Compensation—Stock Compensation** (Refresher)
- **Profits Interests**
- **ASC 505-50, Equity-Based Payments to Non-Employees** (Refresher)
- **Key Changes under ASU 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting**

ASC 718, Compensation—Stock Compensation

Scope

ASC 718-10-15-3

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

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

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

Separate Financial Statements

Paragraph 14 of Interpretation 44

[A]n exception is made to require the application of Opinion 25 to stock compensation based on stock of the parent company granted to employees of a consolidated subsidiary for purposes of reporting in the separate financial statements of that subsidiary. The exception applies **only to stock compensation based on stock of the parent company** (accounted for under Opinion 25 in the consolidated financial statements) **granted to employees of an entity that is part of the consolidated group**. [Emphasis added]

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Because the controlling entity has the discretion to require entities it controls to enter into a variety of transactions, recognizing the transaction as a dividend more closely mirrors the economics of the arrangement because it will not be clear that the entity granting the stock compensation has received goods or services in return for that grant, and if so, whether the fair value of those goods or services approximates the value of the equity awards.

Liability vs. Equity Classification
General Rule

Awards settled by paying ***cash*** to employees are ***liabilities***.

Awards settled by issuing ***shares*** to employees are ***equity***.

Liability vs. Equity - Accounting

Equity classification

- Measurement date = grant date
- Fair value measured at that date and remains fixed unless the award is modified
- Compensation cost recognized over the award's requisite service period

Liability classification

- Measurement date = settlement date
- Fair value is initially measured at grant date and then re-measured at end of each reporting period until award is settled
- Compensation cost for each reporting period - based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered) in fair value

Classification – Repurchase Features

ASC 718-10-25-9

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

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

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

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

Classification – Repurchase Features (Put)

Types of Repurchase Features

- Noncontingent put option
  - Repurchase price at other than FV → Generally liability-classified
  - Repurchase price at FV → Depends on whether the option is exercisable less than 6 months after the award is vested
- Contingent put option
  - Event solely within employee's control → Evaluate as noncontingent put option
  - Event not solely within employee's control → Depends on repurchase price
    - At FV - if probable that event will occur less than 6 months after the award is vested, liability-classified
    - At other than FV – if probable that event will occur while feature is outstanding, liability-classified

Classification – Repurchase Features (Call)

Types of Repurchase Features

- Noncontingent call option
  - Repurchase price at other than FV → If probable that option will be exercised while feature is outstanding, generally liability-classified
  - Repurchase price at FV → If probable that option will be exercised less than 6 months after the award is vested, liability-classified
- Contingent call option
  - Repurchase price at other than FV → If probable that event will occur while feature is outstanding, evaluate as noncontingent call option at other than FV. If not probable, equity-classified.
  - Repurchase price at FV → If probable that event will occur less than 6 months after the award is vested, evaluate as noncontingent call option at FV. If not probable, equity-classified.

Measurement - Equity

ASC 718-10-30-2

A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Topic, a calculated value or intrinsic value) of the equity instruments issued.

ASC 718-10-30-3

An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this Topic. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled.

ASC 718-10-30-6

The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected volatility, at the grant date.

Measurement – Grant Date

ASC 718-10 Glossary

Grant Date

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

Measurement - Liability

ASC 718-10-30-3 (From Slide 11)

An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this Topic. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled.

ASC 718-10-55-9

The fair value measurement objective for liabilities incurred in a share-based payment transaction with employees is the same as for equity instruments awarded to employees. However, awards classified as liabilities are subsequently remeasured to their fair values (or a portion thereof until the requisite service has been rendered) at the end of each reporting period until the liability is settled.

Recognition - Overview

ASC 718-10-25-2

An entity shall recognize the services received in a share-based payment transaction with an employee as services are received. Employee services themselves are not recognized before they are received. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 718-10-25-6 through 25-19). As the services are consumed, the entity shall recognize the related cost. For example, as services are consumed, the cost usually is recognized in determining net income of that period, for example, as expenses incurred for employee services…

Recognition – Service Condition

ASC 718-10 Glossary

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. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition.

ASC 718-10-35-3

The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

Recognition – Performance Condition

ASC 718-10 Glossary

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. An employee's rendering service for a specified (either explicitly or implicitly) period of time
b. Achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities).

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

Probable

The future events or events are likely to occur.

Recognition – Performance Condition (Cont…)

ASC 718-10-25-20

Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition — compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Example 2 (see paragraph 718-20-55-35) provides an illustration of how to account for awards with multiple performance conditions.

Recognition – Market Condition

ASC 718-10 Glossary

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(ies). The term similar as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

ASC 718-10-30-14

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

Modifications

What is a modification?

A change in any of the terms or conditions of a share-based payment award

Apply modification accounting *unless* all of the following criteria are met:

- Fair value is the same before and after modification
  - Practical expedient - if the modification does not affect any valuation inputs, no requirement to value award immediately before and after modification
- Vesting conditions are the same before and after modification
- Classification as an equity or liability instrument is the same before and after modification

Modifications – Common Examples

- Repricing of underwater stock options whether accomplished directly or through the cancellation of the old options and the grant of new options
- Extension of a stock option’s exercise term
- Adding an acceleration vesting clause in anticipation of an exit event
- Accelerating vesting for an executive who is terminating service

Modifications

How are award modifications treated?

- General rule
  - Treat as the exchange of the original award for a new award (new award usually has higher value)
  - Type I (probable to probable): Incremental compensation recognized as FV of modified award less FV of original award (both FVs measured as of modification date) – i.e. grant-date fair value plus incremental fair value only due to modification
  - Type III (improbable to probable): New fair value measurement if vesting under original terms not considered "probable" on modification date
- Amortize old award and incremental cost of new award over remaining vesting period of modified award, unless vesting accelerated to the current period
- If fully vested prior to modification, amortize incremental cost immediately upon modification (assuming no new vesting terms added)

Modifications

Modifications affecting vesting terms (service/performance conditions)

- Type I - Probable to probable
- Type II - Probable to improbable (not frequent)
- Type III - Improbable to probable (more frequent)
- Type IV - Improbable to improbable

Examples

- Original performance targets set too high
- Change in business plan or restructuring
- Employee assigned new job duties
- Acceleration of vesting for change of control
- Acceleration of vesting for retirement or termination

Profits Interests

What are Profits Interests?

- Defined under the Internal Revenue Service regulations
- Often results in favorable tax consequences
- Partnerships and LLCs increasingly issue profits interests
- Often described in legal agreements as “class x units”, where “X” refers to the class of equity, or referred to as “management units” or “incentive units”
- Legal form of equity but characteristics may be, in substance, more like a performance bonus or a profit-sharing arrangement

Common Characteristics of Profits Interests

- Management's intent is to award the recipient compensation upon a sale, liquidity event (e.g. IPO or change in control) or final liquidation
- Moderately to highly subordinate to other classes of securities or interests
- May have a high distribution hurdle
- Frequently have an explicit performance condition linked to an exit event
- May or may not have an explicit service condition required for vesting
- Forfeiture provisions vary
- Generally includes call options

BDO

Key Indicators

	ASC 718 Indicators	ASC 710 Indicators
Value of the Award	The value of the award is based, at least in part, on the value of the entity's equity	The value of the award is based primarily on a fixed value or one derived from a formula
Settlement Features	Vested awards may survive a change in control, liquidity, or other exit event	Vested awards are contractually required to be settled or terminated upon an exit event
Distribution Rights	Distributions may occur prior to an exit event, even if subject to a distribution threshold, and are based upon pro rata share of ownership	Distributions are contractually or legally limited to an exit event, and/or distributions are not made on a pro rata basis
Separate Cash Bonus Plan	Company offers a separate cash bonus program, and profits interest holders are eligible to participate	Profits interests are issued in lieu of a cash bonus program

ASC 710, Deferred Compensation, vs ASC 718, Stock Compensation – Accounting Differences

	Performance Bonus ASC 710 Accounting Model	Stock Compensation ASC 718 Accounting Model
Recognition	Recognized when payment is both probable and reasonably estimable. Compensation cost may or may not be spread over multiple accounting periods	Generally recognized as employee services are rendered either on a straight-line basis or graded attribution basis
Measurement	Present value and then remeasured at each reporting date	Fair value (FV): ▶ Grant date for equity-classified awards; no remeasurement unless a modification or reclassification occurs ▶ Settlement date (i.e. remeasure FV at each reporting date through settlement) for liability-classified awards
Classification	Liability	Provides a framework for evaluating whether an award should be classified as equity or as a liability
Presentation of distributions to holders	Cash distributions to holders represent compensation cost	Distributions to holders (in cash or additional shares) are treated as capital transactions (e.g., dividends) and generally do not result in additional compensation cost, absent a modification, reclassification, or settlement

ASC 505-50, Equity-Based Payments to Non-Employees

Scope

ASC 505-50-15-2a

All share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to a goods or service provider that is not an employee in amounts based, at least in part, on the price of the entity's shares or other equity instruments or that require or may require settlement by issuing the entity's equity shares or other equity instruments. The phrase at least in part is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

Classification

ASC 505-50-25-10

A grantor shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria established in paragraphs 718-10-25-6 through 25-19. As the goods or services are disposed of or consumed, the grantor shall recognize the related cost.

**** Once performance is complete, entities must apply other GAAP (e.g. ASC 815) to determine the classification of nonemployee awards.***

Measurement - Overview

ASC 505-50-30-2

Paragraph 505-50-30-6 establishes that share-based payment transactions with nonemployees shall be measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

ASC 505-50-30-6

If the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction. In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued.

Measurement Date

ASC 505-50-30-11

An entity (the issuer, grantor, or purchaser) may enter into transactions with nonemployees in which equity instruments are issued in exchange for the receipt of goods or services or to provide a sales incentive. The issuer shall measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions as of the earlier of the following dates, referred to as the measurement date:

a. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a performance commitment)
b. The date at which the counterparty's performance is complete.

Measurement Date – Performance Commitment

ASC 505-50-30-12

A performance commitment is a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the issuer and the counterparty. Forfeiture of the equity instruments as the sole remedy in the event of the counterparty's nonperformance is not considered a sufficiently large disincentive for purposes of applying this guidance. In addition, the ability to sue for nonperformance, in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable. (An entity may always be able to sue for nonperformance but it is not always clear whether any significant damages would result.)

Recognition

ASC 505-50-25-4:

This guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an entity granting the equity instrument (the purchaser or grantor) shall recognize the fair value of the equity instruments that will be issued, other than to require that an asset, expense, or sales discount be recognized (or previous recognition reversed) in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with or using the equity instruments.

ASC 505-50-25-6:

Grantor shall recognize the goods acquired or services received in a share-based payment transaction when it obtains the goods or as services are received. A grantor may need to recognize an asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nevertheless, the goods or services themselves are not recognized before they are received.

ASC 505-50-25-9:

A recognized asset, expense, or sales discount shall not be reversed if a stock option that the counterparty has the right to exercise expires unexercised.

ASC 505-50-25-10:

A grantor shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria established in paragraphs 718-10-25-6 through 25-19. As the goods or services are disposed of or consumed, the grantor shall recognize the related cost.

ASU 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

Scope

- Issued in June 2018
- Superseded ASC 505-50
- Expanded ASC 718 to include both nonemployee and employee share-based payment arrangements
- Excludes share-based payments issued as sales incentives to customers

Classification

- Pre-ASU 2018-07: Upon performance completion, awards subject to other guidance in U.S. GAAP like ASC 815.
- Post-ASU 2018-07: Awards generally remain within ASC 718 unless modified and nonemployee no longer provides goods or services.

Measurement Date

- Concept of “performance commitment” eliminated
- No remeasurement of awards until performance is complete
- Aligns measurement date with employee share-based payment arrangements (that is, measurement date = grant date for equity-based awards)

Measurement – Fair Value

- Measurement method is always based on Fair Value
- Expected term: Elect on an award-by-award basis to use the contractual term
- Similar to employee awards, certain practical expedients are available for nonpublic entities

Recognition

- No change under ASU on manner and period of cost recognition
- Nonemployee share-based payment arrangements would be recognized "in the same period(s) and in the same manner as if the grantor had paid cash for the goods or services."
- Judgment in determining the attribution of costs (i.e. services or goods provided may not directly correlate with vesting of awards)
- Accounting policy on straight-line recognition limited to employee awards only
- Similar to employee awards, accounting policy election permitted for nonemployee awards on either (1) estimating forfeiture or (2) recognizing forfeitures when they occur
  - Policy election independent of entity's policy election for employee awards

Vesting Conditions

- ASC 718 guidance on service and performance conditions extended to nonemployee awards
- Service condition: "nonemployee delivering goods or rendering services to the grantor over a vesting period"
- Performance condition: "performance of the grantee if such performance is in accordance with the terms of the award and solely relates to the grantor's own operations (or activities"
  - Probability now considered under new ASU
  - Concept of "then-current lowest aggregate fair value" no longer exists under new ASU
- Judgment remains under new ASU when determining whether a vesting condition is a service or performance condition

Transition

- PBEs → Effective for fiscal years beginning after December 15, 2018, including interim periods within that year
- Other entities → Effective for fiscal years beginning after December 15, 2019; Interim periods within fiscal years beginning after December 15, 2020
- Early adoption permitted but no earlier than adoption date of ASC 606
  - If early adoption is elected in an interim period, adjustments should be reflected as of the beginning of the fiscal year that includes that interim period

Transition (cont'd)

- Modified retrospective transition approach with cumulative-effect adjustment to retained earnings for all (1) liability awards not settled as of adoption date and (2) equity awards for which a measurement date has not been established
  - Excludes equity awards for which a measurement date was previously established under ASC 505-50
  - Equity awards for which a measurement date was not previously established would be remeasured based on FV on adoption date

THANK YOU!