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Preface

To our friends and clients:

We’re pleased to present the third edition of A Roadmap to Accounting for Share-Based Payment Awards. This Roadmap provides Deloitte’s insights into and interpretations of the accounting guidance for share-based payment awards, primarily that in ASC 718\(^1\) and ASC 505-50. The accounting framework for share-based payment awards has been in place for many years; however, views on the application of that framework to current transactions continue to evolve, and significant judgment is required. Therefore, use of this Roadmap, though it is intended as a helpful resource, is not a substitute for consultation with Deloitte professionals on complex income tax accounting questions or transactions.

The body of this Roadmap combines the share-based payment accounting rules from ASC 718 and ASC 505-50 (along with relevant guidance from other topics such as ASC 740 and ASC 805) with Deloitte’s interpretations and examples in a comprehensive, reader-friendly format. The Roadmap’s organization mirrors the order of the codification and reflects ASUs issued through the end of December 2014. Each chapter of this publication typically starts with a brief introduction and includes excerpts from ASC 718\(^2\) (for employee awards) or ASC 505 (for nonemployee awards), Deloitte’s interpretations of those excerpts, and examples to illustrate the relevant guidance. Where applicable, we also include cross-references linking to other Roadmap paragraphs (links are in blue; as a reminder, use [alt] and [left arrow] to return to the paragraph you were originally reading).

In addition, this Roadmap includes six appendixes, including one on the accounting for share-based payment awards under IFRSs (Appendix F).

We hope that you find this Roadmap a useful tool when considering the accounting guidance for share-based payment awards.

Sincerely,

Deloitte & Touche LLP

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1 For the full titles of standards, topics, and regulations, see Appendix A.
2 Please note that this Roadmap does not cover the guidance in ASC 718-40 on employee stock ownership plans.
Executive Summary

The following is a brief summary of the Roadmap’s 12 chapters and 6 appendixes:

Chapter 1, “Overview and Scope” — Includes excerpts from the overview and objectives section of ASC 718 and discusses the differences between awards within the scope of ASC 718 (i.e., share-based payments issued to employees) and those within the scope of other sections of the Codification (e.g., nonemployee awards).

Chapter 2, “Recognition” — Contains comprehensive recognition guidance on share-based payment awards issued to employees as well as guidance on determining whether to classify an award as a liability or equity. This chapter also discusses the determination of the grant date and how market, performance, and service conditions affect the recognition of compensation cost for share-based payment awards.

Chapter 3, “Initial Measurement” — Provides guidance on the amount at which an entity should measure the cost associated with an award (i.e., the award’s fair-value-based measure) and explains how certain conditions affect the determination of this fair-value-based measure and the timing of measuring the cost associated with the award.

Chapter 4, “Subsequent Measurement” — Expands on many of the topics in the Initial Measurement chapter. This chapter focuses on measurement of compensation cost after the grant date of the award and includes extensive guidance on modifications of awards, changes in vesting conditions, changes in classification of an award, settlement/cancellation of awards, and equity restructuring.

Chapter 5, “Disclosure,” and Chapter 6, “Other Presentation” — Provide general guidance on disclosure and presentation matters related to the statement of financial position, income statement (including extensive earnings-per-share guidance), statement of cash flows, and footnotes for share-based payment awards. Also see Appendix D, which contains a comprehensive disclosure example (discussed below).

Chapter 7, “Employee Share Purchase Plans” — Discusses background and scope considerations, the determination of whether the plan is compensatory or noncompensatory, the appropriate methods for compensation cost recognition, and measurement guidance specific to ESPPs.

Chapter 8, “Income Taxes” — Provides recognition, measurement, and presentation guidance on the income tax implications of share-based payment awards.

Chapter 9, “Nonemployee Awards” — Addresses scope, recognition, measurement, presentation, and disclosure guidance for awards granted to nonemployees.

Chapter 10, “Business Combinations” — Includes guidance for awards issued or exchanged in a business combination.

Chapter 11, “Implementation Guidance” — Includes excerpts from the implementation guidance in ASC 718, ASC 505, and ASC 805.

Chapter 12, “SEC Staff Guidance” — Includes excerpts from the SEC staff’s guidance on share-based payment awards from various sections of the Codification, including ASC 718 and ASC 505.

Appendix A — Contains the full titles of topics, standards, and regulations used in the Roadmap.

Appendix B — Contains the full forms of acronyms used throughout the Roadmap.

Appendix C — Contains excerpts from the ASC 718 and ASC 505 glossaries of terms that are important to the accounting for share-based payment awards.

Appendix D — Includes a comprehensive example disclosure adapted from ASC 718.
Appendix E — Comprises a sample of recent SEC comments on share-based payment matters, which should be particularly useful for SEC registrants.

Appendix F — Contains a comprehensive discussion of the guidance on share-based payment awards under IFRSs.
Acknowledgments

We are grateful for the contributions of Scott Cerutti, Sandie Kim, Tim Kolber, John Sarno, Aaron Shaw, Mark Strassler, Jiaojiao Tian, and Karen Wiltsie. In addition, we would like to acknowledge the contributions of Teri Asarito, Lynne Campbell, Geri Driscoll, Jeanine Pagliaro, Joseph Renouf, and Lora Spickler-Alot in our Production group. Rob Morris supervised the overall preparation of this Roadmap and extends his deepest appreciation to all professionals that helped in its development.
Chapter 1 — Overview & Scope

The scope of ASC 718 applies to all transactions in which an entity receives employee services in exchange for share-based instruments. The employees are in effect “paying” for the share-based instruments they receive with the services they are providing. Common examples of share-based payment awards include (1) employee share options, (2) share appreciation rights, (3) nonvested shares, and (4) nonvested share units. ASC 718 does not apply to share-based instruments issued in exchange for cash or other assets (i.e., detachable warrants or similar instruments issued in a financing transaction) because the share-based instruments are not issued in exchange for employee services. See Q&A 1-03 for examples of additional share-based transactions, or aspects of those transactions, that are not within the scope of ASC 718.

Share-based payment awards issued to nonemployees in exchange for goods or services are within the scope of ASC 505-50. The recognition and measurement guidance on nonemployee share-based payment awards differs from that on accounting for employee awards under ASC 718. There are three potential differences: (1) the determination of the measurement date (the most significant difference), (2) the recognition of the cost of the award, and (3) the accounting for the award once performance is complete (i.e., determining whether the award is subject to other applicable GAAP). Because of these potential differences, it is important for an entity to consider whether the counterparty is an employee or nonemployee when accounting for share-based payment awards. See Chapter 9 for a discussion of awards granted to nonemployees, including a discussion of ASC 505-50 and the related interpretive guidance.

To be within the scope of ASC 718, share-based awards must, in addition to being issued in exchange for employee services, be either (1) settled by issuing the entity’s equity shares or other equity instruments or (2) indexed, at least in part, to the value of the entity’s equity shares or other equity instruments (see Q&A 1-05). In this context, the word “indexed” indicates that the value the employee receives upon settlement of the award is, at least in part, determined by considering the value of the entity’s equity.

For instance, consider a cash-settled share appreciation right granted to an employee in which the award can only be settled in cash. In such circumstances, the amount of cash the employee receives upon settlement of the award is based on the relationship of the market price of the entity’s equity shares to the exercise price of the award; therefore, the award is considered indexed to the entity’s equity and is within the scope of ASC 718.

Consolidated Financial Statements
Share-based payment awards granted to employees of entities within a consolidated group include, for example, awards that a parent grants to its subsidiary’s employees and that are indexed to or settled in the parent’s equity instruments. In the consolidated financial statements, as long as the individual receiving the award is deemed an employee of the consolidated group, awards indexed to or settled in the equity of any of the entities within the consolidated group are within the scope of ASC 718.

Separate Financial Statements
The accounting for share-based payment transactions in the separate financial statements of each entity within a consolidated group is a bit more difficult. Previously, the accounting for such transactions was discussed in Question 4 of Interpretation 44 and Issues 21 and 22 of EITF Issue 00-23. Although Statement 123(R) (codified in ASC 718) subsequently superseded and nullified Interpretation 44 and Issue 00-23, entities should...
to analogize to their guidance on consolidated-group share-based payment transactions. See Q&A 1-08 through Q&A 1-10 for a discussion of the application of ASC 718 to the accounting in the separate financial statements of entities within a consolidated group.

Other Economic Interest Holders
The scope of ASC 718 also encompasses share-based payment awards that related parties or other economic interest holders in an entity issue to the entity’s employees as compensation for employee services. However, transfers of equity instruments for purposes other than compensation for employee services are outside the scope of ASC 718. When such awards are issued in exchange for employee services, the transaction should be accounted for as a capital contribution from the related party or economic interest holder to the entity and as a grant of share-based payment awards by the entity to its employees. See ASC 718-10-15-4 for additional discussion of awards issued to employees by related parties or other economic interest holders.

Equity Method Investments
Share-based payment awards that are issued to employees of an equity method investee and that are indexed to, or settled in, the equity of the investor are not within the scope of ASC 718. This conclusion is supported by analogy to paragraph 10 of Interpretation 44, which stated that APB Opinion 25 (also superseded by ASC 718) does not apply to the accounting by an investor of an unconsolidated investee for share-based payment awards that the investor grants to the investee’s employees. An entity must therefore account for these awards under other guidance. Such guidance includes ASC 323-10-25-3 through 25-5 and ASC 505-10-25-3, which address the accounting related to the financial statements of the equity method investor, the equity method investee, and the noncontributing investor(s). See Q&A 1-11 and Q&A 1-12 for additional guidance on accounting for these awards.

Other Scope Matters
It is not uncommon for entities to settle share-based payment awards issued to employees with shares of an unrelated entity. However, such transactions are not within the scope of ASC 718. The interpretive guidance below includes examples of such transactions and discusses how an entity should account for them under other GAAP (e.g., ASC 815).

In addition, the scope of ASC 718 does not include awards that are issued as part of the consideration transferred in a business combination. Such awards are accounted for under ASC 805. See Chapter 10 for more information.

**ASC 718-10**

05-1 The Compensation—Stock Compensation Topic provides guidance on share-based payment transactions with employees. This Topic includes the following Subtopics:

- Overall
- Awards Classified as Equity
- Awards Classified as Liabilities
- Employee Stock Ownership Plans
- Employee Stock Purchase Plans
- Income Taxes.

05-2 This Topic does not provide guidance for nonemployee share-based payment transactions. See Subtopic 505-50 for guidance on nonemployee share transactions.

05-3 This Subtopic provides general guidance related to share-based payment arrangements with employees. This Subtopic and Subtopics 718-20 and 718-30 are interrelated and the required guidance may be located in either this Subtopic or one of the other Subtopics. In general, material that relates to both equity and liability instruments is included in this Subtopic, while material more specifically related to either equity or liability instruments is included in their respective Subtopics.
Objectives

ASC 718-10

10-1 The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed. This Topic uses the terms compensation and payment in their broadest senses to refer to the consideration paid for employee services.

10-2 This Topic requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. This Topic establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee stock ownership plans.

1-01 Definition of a Common Law Employee

Question

What are the criteria established by IRS Revenue Ruling 87-41, “Employment Status Under Section 530(D) of the Revenue Act of 1978,” that may aid in the assessment of whether an individual is an employee under common law?

Answer

The IRS developed the criteria (20 factors) on the basis of an examination of cases and rulings that determine whether an individual is an employee under common law. The degree of importance of each criterion varies depending on the factual context in which the services of an individual are performed. In addition, because the criteria are designed as guides in assisting in the determination of whether an individual is an employee, scrutiny is required in applying the criteria to assure that the substance of an arrangement is not obscured by an attempt to achieve a particular employment status. The criteria include the following:

- Instructions — A worker who is required to comply with another person’s instructions about when, where, and how he or she is to work is ordinarily an employee. In addition, the existence of instructions that involve the integration of a worker’s services into the business operations generally demonstrates that the worker is subject to direction and control.

- Continuing relationship — A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. In addition, the worker’s right to terminate the relationship or the employer’s right to discharge the worker indicates an employer-employee relationship.

- Set hours of work — The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.

- Hiring, supervising, and paying assistant — If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job.

- Working on the employer’s premises — If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere.

- Full time required — If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working.

- Payment — Payment by the hour, week, or month generally points to an employer-employee relationship. In addition, if the person or persons for whom the services are performed ordinarily pay the worker’s business expenses, traveling expenses, or both, the worker ordinarily is an employee.

In addition to the foregoing general criteria, refer to IRS Revenue Ruling 87-41 for additional factors that should be considered when assessing if an individual is an employee under common law. For a further discussion of the definition of an employee, refer to ASC 718-10-20.
Question
Under ASC 505, what are the differences between the accounting for share-based payment awards granted to employees and the accounting for such awards issued to nonemployees?

Answer
The provisions of ASC 718 should be applied to all share-based payment awards granted to employees and also, when appropriate, to awards issued to nonemployees. SAB Topic 14.A states, in part:

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in Statement 123R [as codified in ASC 718] would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in Statement 123R [as codified in ASC 718] by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in Statement 123R [as codified in ASC 718] would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement. [Footnote omitted]

Examples of the provisions of ASC 718 that apply equally to employee and nonemployee awards include, but are not limited to, the following:

• The accounting for modifications to the terms of previously issued awards. See Q&A 9-09 for a discussion of the accounting for the modification of share-based payment awards issued to nonemployees.

• The accounting for the income tax effects of awards in the statement of financial position, the statement of operations, and the statement of cash flows.

However, one notable difference between the accounting for nonemployee awards and that for employee awards is related to the award’s measurement date. Entities should refer to ASC 505-50-30 to determine the measurement date for awards issued to nonemployees. ASC 505-50-30-11 concludes that the measurement date of a nonemployee award is the earlier of (1) the performance commitment date or (2) the date on which the counterparty’s performance is complete.

ASC 505-50-30-12 elaborates on the term “performance commitment,” stating, in part:

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.

The determination of whether a performance commitment contains a sufficiently large disincentive for nonperformance depends on the circumstances of the individual arrangement. See Q&A 9-05 for a discussion and example of what is considered a sufficiently large disincentive for nonperformance.

In contrast, the date on which the counterparty’s performance is complete represents the date when the entity receives and the counterparty has delivered or rendered the goods or services in exchange for the award.

The “measurement date” for nonemployee awards is similar to the “grant date” for employee awards because the fair-value-based measure of the award is not fixed until that time. Furthermore, ASC 505-50-30-21 indicates that if it is appropriate for the issuer to recognize some or all of the cost of the award under U.S. GAAP before the measurement date, the issuer would remeasure the award each reporting period at its fair-value-based measure. This is the same accounting as that for an employee award whose service inception date precedes the grant date.

Lastly, while ASC 505-50 does not specifically address either the period(s) or the manner (i.e., capitalize versus expense) in which cost associated with awards issued to nonemployees for goods or services must be recognized, it does state, in ASC 505-50-25-4, that entities are required to use the same period(s) and the same method they would use if the entity issuing the awards (issuer) had paid cash for the goods or services.
Chapter 1 — Overview & Scope
A Roadmap to Accounting for Share-Based Payment Awards

Scope

ASC 718-10

Overall Guidance

15-1 The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Compensation—Stock Compensation Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Compensation—Stock Compensation Topic, with the exception of Subtopic 718-50, which has its own discrete scope.

Entities

15-2 The guidance in the Compensation—Stock Compensation Topic applies to all entities that enter into share-based payment transactions with employees.

Transactions

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.

15-4 Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

15-5 The guidance in this Topic does not apply to the following payment transactions:

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

15-6 Paragraphs 805-30-30-9 through 30-13 provide guidance on determining whether share-based payment awards issued in a business combination are part of the consideration transferred in exchange for the acquiree, and therefore are within the scope of Topic 805, or are for continued service to be recognized in the postcombination period in accordance with this Topic.

15-7 The guidance in the Overall Subtopic does not apply to equity instruments held by an employee stock ownership plan.

1-03 Share-Based Transactions That Are Not Within the Scope of ASC 718

Question

Are certain share-based payment transactions, or aspects of these transactions, not within the scope of ASC 718?

Answer

Yes. Although ASC 718 is a comprehensive source of guidance on accounting for share-based payment transactions, certain share-based transactions, or aspects of these transactions, are not within the scope of ASC 718. Examples include:

- Measurement date for nonemployee share-based payment transactions — Generally, the accounting for share-based payment transactions with nonemployees is within the scope of ASC 718. However, certain aspects of awards granted to nonemployees are within the scope of other authoritative guidance. For example, the measurement date for these awards is described in ASC 505-50-30-10 through 30-19. See Q&A 1-02 for a comparison between the measurement date for nonemployee share-based payment transactions and the grant date for employee share-based payment transactions.

- Equity instruments issued as consideration in a business combination — ASC 718 does not address the accounting for equity instruments issued as consideration in a business combination. The measurement date for equity instruments issued as consideration in a business combination is described in ASC 805-30-30-7.

ASC 805 also provides guidance on determining whether share-based payment awards exchanged in a business combination are (1) part of the consideration transferred and therefore are within the scope of ASC 805 or (2) related to continued service to be recognized in the postcombination period and therefore
are within the scope of ASC 718. ASC 805-20-30-21, ASC 805-30-30-9 through 30-13, ASC 805-30-55-6 through 55-13, ASC 805-740-25-10 and 25-11, ASC 805-740-45-5 and 45-6, and ASC 805-30-55-17 through 55-24 provide guidance on share-based payment awards exchanged in connection with a business combination.

- **Employee share ownership plans (ESOPs)** — ASC 718-10-20 defines an ESOP as “an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.” Entities should continue to account for ESOPs in accordance with ASC 718-40 or SOP 76-3.

- **Options or warrants issued for cash or other than for goods or services** — Financial instruments issued for cash or other financial instruments (i.e., other than for goods or services) are accounted for in accordance with the relevant literature on accounting for and reporting the issuance of financial instruments, such as ASC 815 and ASC 480.

- **Detachable options or warrants issued in a financing transaction** — ASC 470-20 describes how an entity should account for detachable warrants, or similar instruments, issued in a financing transaction.

- **Share-based awards that are granted to employees and settled in shares of an unrelated entity** — ASC 815-10-45-10 describes the accounting for share options that are granted to employees and indexed to and settled in publicly traded shares of an unrelated entity. See Q&A 1-13 for more information about the accounting for share options that are granted to employees and indexed to and settled in non-publicly-traded shares of an unrelated entity. In addition, see Q&A 1-14 for more information about the accounting for nonvested share awards granted to employees in exchange for future service indexed to and settled in shares (publicly and non-publicly-traded) of an unrelated entity. Finally, see Q&A 1-15 for more information about the accounting for forfeitures of share-based awards that are granted to employees and indexed to and settled in shares (publicly and non-publicly-traded) of an unrelated entity.

### 1-04 Scope of Long-Term Incentive Plans

Entity A, a public entity, offers an LTIP to certain of its employees. At the beginning of each year, a target cash bonus based on a specific dollar amount is established for each employee. Each employee in the LTIP will receive a predetermined percentage of his or her target bonus at the end of three years on the basis of the total return on A’s stock price relative to that of its competitors over the three-year performance period. The return on A’s stock price is ranked with that of its competitors from the highest to the lowest performer. On the basis of A’s ranking, each employee will receive a percentage of his or her target bonus that increases or decreases as A’s ranking increases or decreases.

For example, at the beginning of the three-year performance period, A sets a target cash bonus of $100,000 for an employee. Entity A includes nine of its competitors in its peer group to establish a ranking. Depending on the ranking, the employee will receive a percentage that ranges from 0 percent to 200 percent of the target bonus. For instance, if A ranks first in stock price return, the employee will receive 200 percent of $100,000, or $200,000; if A ranks fifth, the employee will receive 100 percent of $100,000, or $100,000; and if A ranks tenth or last, the employee will not receive a bonus.

**Question**

Is A’s LTIP within the scope of ASC 718?

**Answer**

Yes. ASC 718-10-15-3 states, in part, that it:

> [A]pplies 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.)
In the above example, because the bonus is settled only in cash, A’s obligation under the LTIP is classified as a share-based liability. The liability is based, in part, on the price of A’s shares. That is, the share-based liability is based on the return on A’s stock price relative to the returns on the stock prices of A’s competitors. While the bonuses to be paid are not linearly correlated to the return on A’s stock price, the amount of the bonus does depend on the return on A’s stock price relative to that of its competitors. Accordingly, the LTIP is within the scope of, and therefore is accounted for in accordance with, ASC 718. Under ASC 718-30-35-3, A “shall measure a liability award under a share-based payment arrangement based on the award’s fair value remeasured at each reporting date until the date of settlement.”

Before Statement 123(R) (as codified in ASC 718), entities generally used a method consistent with ASC 450 to account for such arrangements. Under ASC 718, the amount of compensation cost recognized must be based on the fair value of the liability; thus, under ASC 718, entities generally must use valuation techniques when measuring this amount.

Informal discussions with the FASB staff support the conclusion that LTIPs can be within the scope of ASC 718.

1-05 Share-Based Payment Awards That Are Settled in a Variable Number of Shares

Question
Are share-based payment awards that offer an employee a fixed monetary amount and that are settled in a variable number of the entity’s shares (e.g., stock-settled debt) within the scope of ASC 718?

Answer
Yes. To be within the scope of ASC 718, a share-based payment award must, in addition to being issued in exchange for goods or services, be either (1) indexed, at least in part, to the value of the entity’s own equity or (2) settled by issuing the entity’s own equity. If an award offers an employee a fixed monetary amount, the amount the employee receives upon settlement of the award is not based on the value of the entity’s equity and therefore is not considered indexed to the entity’s own equity. However, the fixed monetary amount will be settled by issuing a variable number of the entity’s shares. Because the award is settled by issuing the entity’s own equity, the award is within the scope of ASC 718.

Example
An entity sets a bonus of $100,000 for its chief executive if the executive remains employed for a two-year period. The bonus will be settled by issuing enough equity shares whose value equals $100,000. Therefore, if the entity’s share price is $50 at the end of the second year, the entity will settle the bonus by issuing 2,000 ($100,000 bonus ÷ $50 share price) of the entity’s equity shares. This bonus award is within the scope of ASC 718 because it is settled by issuing the entity’s own equity.

1-06 Scope — Awards That Do Not Take the Legal Form of Securities

Question
Are share-based payment awards that are indexed to or settled in something other than an entity’s shares (e.g., partnership interests) within the scope of ASC 718?

Answer
Yes. Share-based payment awards that are indexed to or settled in something other than an entity’s shares may be within the scope of ASC 718. ASC 718-10-20 defines share-based payment arrangements, in part, as follows:

The term shares [in ASC 718-10-15-3] includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity. [Emphasis added]

That is, the legal form of the entity’s award does not preclude it from being within the scope of ASC 718. In this context, the term “shares” broadly represents instruments that entitle the holder to share in the risks and rewards of the entity as an owner.
Example 1 — Trust Unit Rights

Entities may grant their employees trust unit rights to purchase a unit in a unit investment trust at a reduced exercise price. Upon exercise of the unit right, the holder receives publicly traded trust units, which are equal fractional undivided interests in the trust. The trust units are the only voting, participating equity securities of the trust. The trust structure is created to purchase and hold a fixed portfolio of securities or other assets, which represent the "trust portfolio." The trust then distributes the income generated from the portfolio to the holders of the trust units. Therefore, owning a trust unit allows the holder to share in the appreciation of the trust portfolio. Common examples of this type of investment trust structure include mutual funds and real estate investment trusts.

In this example, the entity is offering to issue unit rights, which are not legal securities themselves. However, these unit rights entitle the holder to trust units. Although these trust units are not "shares" in the strictest sense, they provide the holder with the risks and rewards of the entity as an owner (e.g., voting rights). Accordingly, this arrangement is within the scope of ASC 718.

Example 2 — Phantom Stock Plans

Under a typical phantom stock plan, an employee is granted a theoretical number of units that are exercisable into common stock of the entity. These units are not legal securities themselves and usually are issued only on a memorandum basis. The units do not have voting rights with the common stockholders. The value of each phantom unit is based on the value of the entity’s stock and, therefore, appreciates and depreciates on the basis of fluctuations in the value of the entity's stock.

In this example, the phantom stock unit holders do not have the same rights as a common stockholder (i.e., voting rights). However, because the phantom units are indexed to and settled in the entity’s equity, this arrangement is within the scope of ASC 718.

1-07 Deferred Compensation Arrangements in Which the Amounts Earned Are Held in a Rabbi Trust

Many entities provide deferred compensation arrangements that allow employees to defer some or all of their earned compensation (i.e., salary or bonus). Sometimes the employer uses a “rabbi trust” to hold assets from which nonqualified deferred compensation payments will be made. ASC 710 provides guidance on deferred compensation arrangements in which assets equal to compensation amounts earned by employees are placed in a rabbi trust. These arrangements often permit employees to diversify their accounts by investing in cash, the employer’s stock, nonemployer securities, or a combination of these.

Question

Can a deferred compensation arrangement in which the amounts earned are held in a rabbi trust be within the scope of ASC 718?

Answer

Yes. Deferred compensation arrangements in which the amounts earned are indexed to, or can be settled in, an entity’s own stock before being placed into a rabbi trust are within the scope of ASC 718. When the amounts earned in a deferred compensation arrangement (1) are within the scope of ASC 718 before being placed into a rabbi trust and (2) only allow for the settlement of the award in the employer’s stock (i.e., the employee is not allowed to diversify into cash or other assets after the amounts earned are placed into a rabbi trust), the arrangement would be accounted for as an equity award under ASC 718 before the amounts earned are placed into the trust (provided that all other criteria for equity classification have been met). In addition, the deferred compensation arrangement would remain classified in equity and would therefore not need to be remeasured under ASC 710 after the amounts earned are placed into the rabbi trust.

For all other deferred compensation arrangements in which amounts earned are placed into a rabbi trust, the accounting depends on the terms of the arrangement and on whether the arrangement can be viewed either as one plan or as substantively consisting of two plans.
**Accounting for the Deferred Compensation Arrangement as Two Plans**

For the arrangement to be viewed as substantively consisting of two plans, the following two criteria must be met:

1. There must be a **reasonable period of time** within which the employee is subjected to the risks and rewards of ownership (i.e., to all the stock price movements of the employer’s stock). ASC 718-10-25-9 defines this period as six months or more. Accordingly, once the share-based payment award is vested, it would need to remain indexed to the employer’s stock for at least six months. After six months, the employee could liquidate the employer’s stock into a diversified account (i.e., a rabbi trust), which would be the beginning of the deferred compensation arrangement.

2. The option to defer the amounts earned under the share-based payment award must be entirely elective. If the employee is forced into a diversified account (i.e., a rabbi trust), the award would most likely be considered mandatorily redeemable under ASC 480. That is, the deferred compensation arrangement would have to be classified as a liability. Therefore, if the employee is “forced” to accept a liability in satisfaction of the share-based payment award, redemption is deemed mandatory. Accordingly, the entire arrangement would be accounted for as a liability from the grant date of the share-based payment award and not just from the beginning of the deferred compensation arrangement.

If the above two criteria are met, the deferred compensation arrangement is viewed as a share-based payment arrangement that is subsequently “converted” into a diversified deferred compensation arrangement. Accordingly, an entity applies the guidance in ASC 718 until the amounts earned are placed into the rabbi trust (“the share-based payment award”) and then applies the guidance in ASC 710 until the deferred amounts are received by the employee (“the deferred compensation arrangement”).

However, if the above two criteria are met and equity classification is achieved from the grant date of the share-based payment award until the amounts earned are placed into the rabbi trust, the entity also must consider the guidance in ASC 480-10-S99-3A. ASC 480-10-S99-3A-12 addresses share-based payment arrangements with employees whose terms may permit redemption of the employer’s shares for cash or other assets. Since the distribution of the amounts earned under the share-based payment award into a diversified account is viewed as settlement in cash or other assets (i.e., because the deferred compensation obligation must be classified as a liability pursuant to ASC 710 once the amounts are placed into the rabbi trust), the share-based payment award would be subject to the guidance in ASC 480-10-S99-3A. The guidance in ASC 480-10-S99-3A requires classification in temporary (mezzanine) equity from the grant date of the share-based payment award until the beginning of the deferred compensation arrangement. At the beginning of the deferred compensation arrangement, the amounts placed into the rabbi trust would be classified as a liability pursuant to ASC 710.

**Accounting for the Deferred Compensation Arrangement as One Plan**

If the above two criteria are not met, the deferred compensation arrangement is viewed as one plan. When the arrangement is viewed as one plan, the diversification option would result in liability classification pursuant to ASC 718 for the share-based payment award from the grant date to the date the amounts earned are placed into the rabbi trust. Under ASC 718, an award that allows the employee to diversify outside of the employer’s stock would result in an award that is indexed to something other than a market, performance, or service condition (i.e., the ultimate value received by the employee also is indexed to the performance of the assets into which they diversified). In accordance with ASC 718-10-25-13, an arrangement that is indexed to an “other” condition is classified as a share-based liability irrespective of whether the employee ultimately receives cash, other assets, or the employer’s stock. (See Q&A 3-35 for more detailed guidance on the accounting treatment of equity versus liability awards.) Accordingly, the deferred compensation arrangement would be classified as a share-based liability from the grant date until the amounts earned are placed into the rabbi trust. Once placed into the rabbi trust, the amounts earned would be classified as a liability pursuant to ASC 710 until the deferred amounts are received by the employee.

**1-08 Share-Based Payment Awards That Are Issued to Employees of a Consolidated Subsidiary and Indexed to and Settled in Parent-Company Equity**

**Question**

In the separate financial statements of a consolidated subsidiary, are share-based payment awards that are issued to employees of that subsidiary, and that are indexed to and settled in equity of the consolidated subsidiary’s parent company, within the scope of ASC 718?
**Answer**

Yes. Although ASC 718 does not specifically address this issue, such awards would be within the scope of ASC 718 by analogy to paragraph 14 of Interpretation 44. While Statement 123(R) (codified in ASC 718) nullified Interpretation 44, the conclusion in paragraph 14 of Interpretation 44 remains applicable by analogy since it is the only available guidance on this issue. Paragraph 14 stated, in part:

> [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]

Under the exception in Interpretation 44, an entity treated the stock of the parent company as though it were the stock of the consolidated subsidiary when reporting in the separate financial statements of the subsidiary. Note that the exception did not, however, extend to share-based payment awards “granted (a) to the subsidiary’s employees based on the stock of another subsidiary in the consolidated group or (b) by the subsidiary to employees of the parent or another subsidiary.” See Q&A 1-09 and Q&A 1-10 for a more detailed discussion of share-based payment awards issued by one subsidiary to the employees of another subsidiary within the same consolidated group and a subsidiary to employees of the parent.

**1-09 Share-Based Payment Awards That Are Issued to Employees of the Parent and Indexed to and Settled in a Consolidated Subsidiary’s Equity**

**Question**

In the separate financial statements of a consolidated subsidiary, are share-based payment awards that are issued to employees of the parent, and that are indexed to and settled in the equity of the consolidated subsidiary, within the scope of ASC 718?

**Answer**

No. Although ASC 718 does not specifically address this issue, such awards would not be within the scope of ASC 718. While the guidance in Interpretation 44 was nullified, the conclusion in paragraph 14 of Interpretation 44 remains applicable by analogy since it is the only available guidance on this issue. Paragraph 14 stated, in part:

> [APB Opinion No. 25] does not apply in the separate financial statements of a subsidiary to the accounting for stock compensation granted (a) to the subsidiary’s employees based on the stock of another subsidiary in the consolidated group or (b) by the subsidiary to employees of the parent or another subsidiary.

However, neither Interpretation 44 nor ASC 718 specifically addresses the accounting for these awards. Such guidance is contained in Issue 21 of EITF Issue 00-23. Although Issue 00-23 has also been nullified, the guidance in Issue 21 of EITF Issue 00-23 remains applicable by analogy since it is the only available guidance on accounting for these awards.

**Accounting in the Separate Financial Statements of the Subsidiary Issuing the Awards**

The Task Force concluded in Issue 21 of EITF Issue 00-23 that the parent organization (controlling entity) can always direct subsidiaries (controlled entities) within the consolidated group to grant share-based payment awards to the parent’s employees and to the employees of other subsidiaries in the consolidated group. Therefore, in its separate financial statements, the subsidiary granting the awards measures the awards at their fair value as of the grant date. That amount is recognized as a dividend from the subsidiary to the parent; a corresponding amount is recognized as equity. The Task Force reasoned that:

> 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.

**Accounting in the Consolidated Financial Statements**

Because the share-based payment awards are issued to employees of the consolidated group and indexed to and settled in equity of the consolidated group, the awards are within the scope of ASC 718. Accordingly, the controlling entity accounts for the awards under ASC 718 when preparing its consolidated financial statements.
Share-Based Payment Awards That Are Issued to Employees of a Subsidiary and Indexed to and Settled in Another Subsidiary’s Equity

Question
In the separate financial statements of individual consolidated subsidiaries, are share-based payment awards that are issued to employees of a subsidiary (Subsidiary A), and that are indexed to and settled in the equity of another consolidated subsidiary (Subsidiary B) in the same consolidated group, within the scope of ASC 718?

Answer
No. Although ASC 718 does not specifically address this issue, such awards would not be within the scope of ASC 718. While the guidance in Interpretation 44 was nullified, the conclusion in paragraph 14 of Interpretation 44 remains applicable by analogy since it is the only available guidance on this issue. Paragraph 14 stated, in part:

[APB Opinion No. 25] does not apply in the separate financial statements of a subsidiary to the accounting for stock compensation granted (a) to the subsidiary’s employees based on the stock of another subsidiary in the consolidated group or (b) by the subsidiary to employees of the parent or another subsidiary.

Accounting in the Separate Financial Statements of the Subsidiary Issuing the Awards
The Task Force concluded in Issue 21 of EITF Issue 00-23 that the parent organization (controlling entity) can always direct subsidiaries (controlled entities) within the consolidated group to grant share-based payment awards to its employees and to the employees of other subsidiaries in the consolidated group. Therefore, in its separate financial statements, the subsidiary issuing the awards (Subsidiary B) measures the awards at their fair value as of the grant date. That amount is recognized as a dividend from the subsidiary to the parent; a corresponding amount is recognized as equity. The Task Force reasoned that:

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.

Accounting in the Separate Financial Statements of the Subsidiary Receiving the Awards
The Task Force concluded in Issue 22 of EITF Issue 00-23 that when preparing its separate financial statements, the subsidiary whose employees are receiving the awards (Subsidiary A) accounts for the awards as compensation cost on the basis of their fair value as of the grant date. In addition, Subsidiary A accounts for the offsetting entry to compensation cost as a credit to equity (i.e., a capital contribution from or on behalf of the parent, since Subsidiary A has no obligation to reimburse the parent for the value of the award).

Share-Based Payment Awards That Are Issued to Employees of an Equity Method Investee and Indexed to and Settled in Equity of an Investor

Question
In the financial statements of an equity method investor, are share-based payment awards that are issued to employees of an equity method investee, and that are indexed to and settled in the equity of the investor, within the scope of ASC 718?

Answer
No. Although ASC 718 does not specifically address this issue, such awards would not be within the scope of ASC 718. While the guidance in Interpretation 44 was nullified, the conclusion in paragraph 10 of Interpretation 44 remains applicable by analogy since it is the only available guidance on this issue. Paragraph 10 stated, in part:

[APB Opinion No. 25] does not apply to the accounting by a grantor for stock compensation granted to nonemployees. For example, Opinion 25 does not apply to the accounting by a corporate investor of an unconsolidated investee (or a joint venture owner) for stock options or awards granted by the investor (owner) to employees of the investee (joint venture) accounted for under the equity method because the grantees are not employees of the grantor.
However, neither Interpretation 44 nor ASC 718 specifically addresses the accounting for these awards. Such guidance is contained in ASC 323-10-25-3 through 25-5 and ASC 505-10-25-3, which addresses the accounting in the financial statements of the equity method investor, the equity method investee, and the noncontributing investor(s).

**Accounting in the Financial Statements of the Investor Issuing the Awards**

ASC 323-10-25-3 and 25-4 indicate that the investor should recognize the entire cost (not just the portion of the cost associated with the investor’s ownership interest) of the share-based payment awards granted to employees of the investee as an expense, with a corresponding amount recognized in the investor’s equity. In addition, the entire cost (and corresponding equity) should be recorded as incurred (i.e., in the same period(s) as if the investor had paid cash to the employees of the investee). The cost of the share-based payment awards is a fair-value-based amount that is consistent with the guidance in ASC 718 and ASC 505-50. In the absence of a performance commitment under ASC 505-50, the awards are remeasured at a fair-value-based amount in each reporting period until performance is complete (i.e., usually the vesting date of the award).

**Accounting in the Financial Statements of the Investee Receiving the Awards**

ASC 505-10-25-3 indicates that the investee should recognize the cost of the share-based payment awards incurred by the investor on the investee’s behalf as compensation cost, with a corresponding amount recognized as a capital contribution. The cost of the share-based payment awards is a fair-value-based amount that is consistent with the guidance in ASC 718 and ASC 505-50. In addition, the compensation cost (and corresponding capital contribution) should be recorded as incurred (i.e., in the same period(s) as if the investor had paid cash to the employees of the investee).

**Accounting in the Financial Statements of the Noncontributing Investors**

ASC 323-10-25-5 states that the noncontributing investors “shall recognize income equal to the amount that their interest in the investee’s net book value has increased (that is, their percentage share of the contributed capital recognized by the investee)” as a result of the capital contribution by the investor issuing the awards. In addition, the noncontributing investors “shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).” That is, the noncontributing investors should recognize their share of the earnings or losses of the investee (inclusive of the compensation cost recognized for the share-based payment awards issued by the equity method investor) in accordance with ASC 323-10. As noted in ASC 323-10-S99-4, “[i]nvestors that are SEC registrants should classify any income or expense resulting from application of this guidance in the same income statement caption as the equity in earnings (or losses) of the investee.”

**1-12 Share-Based Payment Awards That Are Issued to Employees of an Equity Method Investee and Indexed to and Settled in Equity of a Contributing Investor When the Investee Reimburses the Contributing Investor**

**Question**

How are share-based payment awards that are issued to employees of an equity method investee and indexed to and settled in equity of a contributing investor (the “contributing investor”) accounted for in the financial statements of the contributing investor, the equity method investee, and the noncontributing investor(s), if the investee reimburses the contributing investor for the intrinsic value of the awards?

**Answer**

**Accounting in the Financial Statements of the Contributing Investor Receiving the Reimbursement**

If the investee reimburses the contributing investor for the intrinsic value of the share-based payment awards as of the exercise date, the contributing investor records income, with a corresponding amount recorded in equity, in the same amount and in the same periods as the cost that is recognized for issuing the awards. (See Q&A 1-11 for a more detailed discussion of the contributing investor’s accounting (including the measurement and attribution of cost) for the issuance of the awards.) Therefore, the issuance of the awards by the contributing investor and the subsequent reimbursement by the investee will not affect the net income (loss) of the contributing investor. That is, the cost of issuing the awards and the income for the reimbursement of the awards will be equal and offsetting and will be recorded in the same reporting periods in the contributing investor’s income statement.
Accounting in the Financial Statements of the Investee Receiving the Awards and Making the Reimbursement

If the investee reimburses the contributing investor for the intrinsic value of the share-based payment awards as of the exercise date, the investee accrues a dividend to the contributing investor for the amount of the reimbursement in the same amount and in the same periods as the capital contribution from the contributing investor. The recognition of a dividend is appropriate given that the issuance of the awards resulted in a capital contribution from the contributing investor. See Q&A 1-11 for a more detailed discussion of the accounting by the investee for the receipt of the awards.

Accounting in the Financial Statements of the Noncontributing Investors

If the investee reimburses the contributing investor for the intrinsic value of the share-based payment awards as of the exercise date, the noncontributing investor or investors record a capital transaction (debit to equity) for the amount by which their interest in the investee’s net book value has decreased as a result of the dividend distribution to the contributing investor. The recognition of a capital transaction is appropriate given that (1) the reimbursement by the equity method investee to the contributing investor for the value of the awards was contemplated when the awards were issued and (2) the noncontributing investor records a capital transaction (credit to equity) upon issuance of the awards to reflect the disproportionate contribution by the contributing investor to the equity method investee. While this accounting best reflects the substance of this transaction, other views may be acceptable.

See Q&A 1-11 for a more detailed discussion of the accounting by the noncontributing investor(s) for the issuance of the awards when reimbursement to the contributing investor by the equity method investee is not contemplated when the awards are issued.

1-13 Accounting for Share Options in Non-Publicly-Traded Shares of an Unrelated Entity That Are Issued to Employees in Exchange for Future Services

Question

How should an employer account for share options that are indexed to and settled in non-publicly-traded shares of an unrelated entity and that are issued to employees in exchange for future services?

Answer

An employer should first consider whether these options are within the scope of ASC 718. ASC 718 applies if (1) a liability is incurred that is indexed, at least in part, to the value of the employer’s shares or (2) an employer is, or may be, required to settle the liability by issuing its own equity shares or equity instruments (see ASC 718-10-15-3). If the share options are not indexed to or settled in the employer’s shares, ASC 718 would not apply.

Share options that are indexed to and settled in shares of an unrelated entity are outside the scope of ASC 718. Such options are recorded at fair value as liabilities at inception, with changes in fair value recorded in earnings, by analogy to ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48. In addition, EITF Issue 08-8 states, in part:

The SEC Observer reiterated the SEC staff’s longstanding position that written options that do not qualify for equity classification should be reported at fair value and subsequently marked to fair value through earnings.

ASC 815-10-45-10 requires that the entire change in fair value of the share options before vesting be immediately characterized as compensation cost; however, changes in fair value after vesting may be reflected elsewhere in the employer’s income statement. ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 do not provide guidance on accounting for the corresponding debit associated with recognition of the liability that will be recorded as of

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4 Because the share options are not within the scope of ASC 718, “fair value” in this Q&A refers to fair value as determined in accordance with ASC 820, not to fair-value-based measurement under ASC 718.

5 An entity should apply ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 to the share options in this Q&A “by analogy” rather than directly because the share options described in this Q&A involve an underlying that is a non-publicly-traded share of an unrelated entity, while the share options in ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 involve an underlying that is a publicly traded share of an unrelated entity (and that therefore meets the definition of a derivative, since it can be net settled in accordance with ASC 815-10-15-83). Often, option awards on non-publicly-traded shares of an unrelated entity will not meet the net settlement criteria of ASC 815-10-15-83 because of the lack of (1) explicit net settlement, (2) a market mechanism to net settle the options, or (3) delivery of shares that are readily convertible to cash (since the shares are not publicly traded). However, because there is no specific guidance in the accounting literature on accounting for share options that are indexed to and settled in shares of an unrelated nonpublic entity, the fair value accounting in ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 is appropriate by analogy (since the share options are outside the scope of ASC 718, as discussed above), even though they do not meet the definition of a derivative in ASC 815.

6 Issue 08-8 is effective for fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. Issue 08-8 superseded EITF Issue 00-6, which contained similar guidance on written options.
the issuance date of the share options. However, ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 imply that these share options are considered compensation to employees; therefore, the initial debit upon recording the share options at fair value is a prepaid compensation asset, with attribution of the issuance-date fair value recognized over the requisite service period. The prepaid compensation asset is not adjusted for subsequent changes in the fair value of the share options.

### 1-14 Accounting for Nonvested Shares of an Unrelated Entity That Are Issued to Employees in Exchange for Future Services

**Question**

How should an employer account for nonvested shares of an unrelated entity that are issued to employees in exchange for future services if the nonvested shares are not within the scope of ASC 718?

**Answer**

As discussed in Q&A 1-13, an employer should apply the guidance in ASC 815-10-45-10 and ASC 815-10-55-46 through 55-48 to these shares. Nonvested shares (i.e., call options with a zero exercise price) of an unrelated entity are recorded as a liability at fair value\(^7\) at inception, with an offsetting amount recorded as a prepaid compensation asset. Changes in the fair value of the nonvested shares before vesting should be characterized as compensation cost; however, changes in fair value after vesting may be reflected elsewhere in the employer’s income statement. The initial debit upon recording the nonvested shares at fair value is a prepaid compensation asset; attribution of the issuance-date fair value is recognized over the service period. The prepaid compensation asset is not adjusted for subsequent changes in the fair value of the share award.

**Example**

On January 1, 20X1, Entity A issues nonvested shares to an employee. The terms of the award indicate that if the employee remains employed by A for three years, the employee will receive 20 shares of common stock of Entity B, an unrelated publicly traded entity, from A. The fair value of the award on January 1, 20X1, and December 31, 20X1, was $300 and $325, respectively. The following journal entries reflect the accounting for the award:

**Journal Entry: January 1, 20X1**

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<th>Description</th>
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</thead>
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<tr>
<td>Prepaid compensation asset</td>
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<tr>
<td>Derivative liability</td>
<td>300</td>
</tr>
</tbody>
</table>

To record the issuance of the nonvested share award.

**Journal Entries: December 31, 20X1**

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</thead>
<tbody>
<tr>
<td>Compensation cost</td>
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</tr>
<tr>
<td>Prepaid compensation asset</td>
<td>100</td>
</tr>
</tbody>
</table>

To record the amortization of the prepaid compensation asset on a straight-line basis over the three-year service period.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost*</td>
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</tr>
<tr>
<td>Derivative liability</td>
<td>25</td>
</tr>
</tbody>
</table>

To record the change in the derivative instrument’s fair value.

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\* In accordance with ASC 815-10-45-10, changes in the fair value of the award before vesting should be characterized as compensation cost in the employer’s income statement; however, changes in the fair value of the award after vesting may be reflected elsewhere in the employer’s income statement.

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\(7\) Because the nonvested shares are not within the scope of ASC 718, “fair value” in this Q&A refers to fair value as determined in accordance with ASC 820, not to fair-value-based measurement under ASC 718.
A Roadmap to Accounting for Share-Based Payment Awards

1-15 Impact of Forfeitures on Instruments Indexed to and Settled in Shares of an Unrelated Entity

Question

How should an employer account for forfeitures of instruments that are indexed to and settled in shares of an unrelated entity and that are issued to employees in exchange for future services?

Answer

As discussed in Q&A 1-13, instruments that are indexed to and settled in shares of an unrelated entity and that are issued to employees in exchange for future services are not within the scope of ASC 718. Accordingly, entities are not permitted to account for forfeitures of these instruments in accordance with the guidance on share-based payment awards in ASC 718. For instruments that are indexed to and settled in shares of an unrelated entity and that are issued to employees in exchange for future services, the likelihood that the employee will forfeit the award is factored into the fair value measurement of the instrument at the end of each reporting period.

Example

On January 1, 20X1, Entity A issues nonvested shares to an employee. The terms of the award indicate that if the employee remains employed by A for three years, the employee will receive 20 shares of common stock of Entity B, an unrelated publicly traded entity, from A. The fair value of the award on January 1, 20X1, and December 31, 20X1, was $300 and $325, respectively. On January 1, 20X2, the employee resigns and forfeits the award. The following journal entries reflect the accounting for the award:

Journal Entry: January 1, 20X1

Prepaid compensation asset 300
Derivative liability* 300
To record the issuance of the nonvested share award.

Journal Entries: December 31, 20X1

Compensation cost 100
Prepaid compensation asset 100
To record the amortization of the prepaid compensation asset on a straight-line basis over the three-year service period.

Compensation cost** 25
Derivative liability*** 25
To record the change in the derivative instrument’s fair value.

Journal Entries: January 1, 20X2

Compensation cost 200
Prepaid compensation asset 200
To expense the remaining portion of the prepaid compensation asset.

Derivative liability 325
Compensation cost 325
Because the employee has resigned, the fair value of the derivative instrument is $0. This entry is to remove the derivative liability.

* The likelihood that the employee will forfeit the award is factored into the fair measurement of the instrument.

** In accordance with ASC 815-10-45-10, changes in the fair value of the award before vesting should be characterized as compensation cost in the employer’s income statement; however, changes in the fair value of the award after vesting may be reflected elsewhere in the employer’s income statement.

*** See footnote (*).

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8 Because the instruments are not within the scope of ASC 718, “fair value” in this Q&A refers to fair value as determined in accordance with ASC 820, not to fair-value-based measurement under ASC 718.
Chapter 2 — Recognition

A share-based payment arrangement is an exchange between an entity and an employee that provides services. The entity recognizes the effect of that exchange in the balance sheet and income statement as the services are provided. The share-based payment transaction is measured on the basis of the fair value (or sometimes a calculated or intrinsic value) of the equity instrument issued. ASC 718 refers to “fair-value-based” measurement of the value of the share-based payment. Although fair value measurement techniques are used under the fair-value-based measurement method, this method does not take into account the effects of vesting conditions and other types of features that would be included in a true fair value measurement. The objectives of accounting for equity instruments granted to employees are to (1) measure the cost of the employee services received (i.e., compensation cost) in exchange for an award of equity instruments on the basis of the fair-value-based measure of the award on the grant date and (2) recognize that measured compensation cost in the financial statements over the requisite service period.

The classification of the award dictates the corresponding credit in the balance sheet and affects the amount of compensation cost recognized over the requisite service period. If the award is classified as equity, the corresponding credit is recorded in equity — typically as paid-in capital. If the award is classified as a liability, the corresponding credit is recorded as a share-based liability. Equity-classified awards are generally recognized as compensation cost over the requisite service period on the basis of the fair-value-based measure of the award on the grant date. On the other hand, liability-classified awards are remeasured at their fair-value-based measurement in each reporting period until settlement. That is, the changes in the fair-value-based measurement of the liability at the end of each reporting period are recognized as compensation cost, either immediately or over the remaining service period, depending on the vested status of the award. See Q&A 3-35 for a discussion of the differences between the accounting for equity-classified awards and that for liability-classified awards.

Like other compensation costs (e.g., cash compensation), compensation costs associated with share-based payment awards are usually recognized as an expense. In some instances, such costs may be capitalized as part of an asset and later recognized as an expense. For example, if an employee’s compensation is included in the cost of acquiring or constructing an asset, the compensation cost arising from share-based payment awards would be capitalized in the same manner as cash compensation. The capitalized compensation cost would subsequently be recognized as cost of goods sold or as depreciation or amortization expense.

Determining the Grant Date

The exchange between the entity and the employee begins on the service inception date (which is defined as the date on which the requisite service period begins). Generally, the service inception date is the grant date, but it may precede the grant date if certain conditions are met. Accordingly, an entity may begin to recognize compensation cost before the grant date. (See Q&A 4-06 for a discussion of the conditions that must be met for the service inception date to precede the grant date.) For a grant date to have occurred, all of the following conditions must be met:

1. The employer and employee have reached a mutual understanding of the key terms and conditions of the award.
2. The employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares.
3. All necessary approvals have been obtained.
4. The recipient meets the definition of an employee.

See Q&A 2-04 for a further discussion of the conditions that must be met for a grant date to have occurred.
Determining Whether to Classify an Award as a Liability or as Equity

 Generally, the following types of awards (with certain exceptions) must be accounted for as share-based liabilities in accordance with ASC 718-10-25-7 through 25-19 (see Q&A 2-12 for a more detailed discussion of each of these types of awards):

- Awards that would be classified as liabilities under ASC 480. See Q&A 2-13 for a discussion of how the classification criteria in ASC 480 should be applied to share-based payment awards.
- In certain circumstances, awards that become subject to other applicable GAAP. See Q&A 2-14 for guidance on determining when financial instruments subject to ASC 718 become subject to other applicable GAAP.
- Awards subject to repurchase features, when the employee is not subject to the risks and rewards of share ownership for a reasonable period. See Q&A 2-16 for a discussion of the steps an entity should perform in determining the classification of puttable or callable share awards.
- Options or similar instruments for which cash settlement is required or for which the underlying shares are classified as liabilities. See Q&A 2-26 for a discussion of the steps an entity should perform in determining the classification of puttable or callable employee share options.
- Awards with conditions or other features that are indexed to something other than a market, performance, or service condition.
- Awards that are substantive liabilities and awards for which the employer can choose the settlement method but does not have the intent or ability to deliver the shares. See Q&A 2-31 for guidance on factors to evaluate when the employer can choose the method of settlement.

Market, Performance, and Service Conditions

Share-based payment awards granted to employees may contain the following conditions that affect the vesting, exercisability, or other pertinent factors of the award:

1. Market conditions (e.g., the award becomes exercisable when the market price of the entity’s stock reaches a specified level).
2. Performance conditions (e.g., the award vests when a specified amount of the entity’s product is sold).
3. Service conditions (e.g., the award vests upon the completion of four years of continued service).

Service and performance conditions may be considered vesting conditions. That is, the service or performance condition must be satisfied for an employee to earn (i.e., vest in) an award. Compensation cost is only recognized for awards that are earned or expected to be earned, not for awards that are forfeited or expected to be forfeited because a service or performance condition is not achieved.

Some awards may contain a market condition. Unlike a service or performance condition, a market condition is not a vesting condition. Rather, a market condition is directly factored into the fair-value-based measure of an award. Accordingly, regardless of whether the market condition is satisfied, an entity would still be required to recognize compensation cost for the award if the requisite service period has been completed.

See Chapter 3 for more information about market, performance, and service conditions.

Recognition Principles for Share-Based Payment Transactions

ASC 718-10

25-1 The guidance in this Section is organized as follows:

a. Recognition principle for share-based payment transactions
b. Determining the grant date
c. Determining whether to classify a financial instrument as a liability or as equity
d. Market, performance, and service conditions
e. Subparagraph superseded by Accounting Standards Update No. 2012-04.
f. Payroll taxes.
ASC 718-10 (continued)

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. In some circumstances, the cost of services may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed. This Topic refers to recognizing compensation cost rather than compensation expense because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

25-3 The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options.

25-4 Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

2-01 Impact of Recourse and Nonrecourse Notes

Question
Entities may provide their employees with financing in connection with the purchase of the entity’s shares or the exercise of employee share options. How do such financing transactions affect the entity’s accounting for equity-classified share-based payment awards?

Answer
The measurement and recognition of a share-based payment award should reflect all pertinent factors and substantive terms of the award, including any financing terms. The measurement and recognition of an award depend on whether the financing is a recourse note or a nonrecourse note.

In addition, if (1) an employee is allowed to exercise an option with a note that was not provided for in the terms of the options when the options were granted, (2) the terms of a note (e.g., interest rate) are changed, or (3) the note is forgiven, these changes constitute modifications that should be accounted for in accordance with ASC 718-20-35-3. See Q&A 4-15 for a discussion and examples of the accounting for the modification of a share-based payment award. However, a change in the terms, or forgiveness of, an outstanding recourse note that was not contemplated at the time of exercise would not constitute a modification under ASC 718-20-35-3 if the issued shares are no longer subject to ASC 718. Rather, such a change to the recourse note should be accounted for on the basis of the substance of the transaction in accordance with other appropriate GAAP.

Recourse Notes (Entity’s Recourse Not Limited to the Underlying Stock)
If the consideration received from the employee consists of a recourse note, the transfer of shares is a substantive purchase of stock or an exercise of an option. If the stated interest rate is less than a market rate of interest, the exercise or purchase price is equal to the fair value of the note (i.e., the present value of the principal and interest payments when a discount rate equivalent to a market rate of interest is used). The impact of a below-market rate of interest would be reflected as a reduction of the exercise or purchase price and an increase in compensation cost recognized (see the example below). If the stated interest rate is equal to a market rate of interest, the exercise or purchase price is equal to the principal of the note. That is, the impact of an at-market rate of interest would have no effect on the exercise or purchase price and therefore would not result in an increase in compensation cost recognized. However, see Q&A 2-02 for a discussion of a recourse note that is, in substance, a nonrecourse note.

Nonrecourse Notes (Entity’s Recourse Limited to the Underlying Stock)
If the consideration received from the employee consists of a nonrecourse note, the award is, or continues to be, accounted for as an option until the note is repaid. This is because even after the original options are exercised or the shares are purchased, an employee could decide not to repay the loan if the value of the shares declines below the outstanding loan amount but could instead choose to return the shares in satisfaction of the loan. The result would be similar to an employee’s electing not to exercise an option whose exercise price exceeds the current share price.
When shares are exchanged for a nonrecourse note, the principal and interest are viewed as part of the exercise price of the “option” (therefore, no interest income is recognized). If the note bears interest, the exercise price increases over time by the amount of interest accrued and, accordingly, the option valuation model must incorporate an increasing exercise price. Further, because the shares sold on a nonrecourse basis are accounted for as options, the note and the shares are not recorded. Rather, compensation cost is recognized over the requisite service period, with an offsetting credit to APIC. Periodic principal and interest payments, if any, are treated as deposits. Refundable deposits are recorded as a liability until the note is paid off, at which time the deposit balance is transferred to APIC. Nonrefundable deposits are immediately recorded as a credit to APIC as payments are received. In addition, the shares would be excluded from basic earnings per share and included in diluted earnings per share in accordance with the treasury stock method until the note is repaid.

Example
An entity indirectly reduces the price of an award when it provides an employee with a non-interest-bearing, full-recourse note to cover the purchase price of shares. If an employee purchased shares with a fair value of $20,000 but the entity provided a five-year, non-interest-bearing note (when the market rate of interest was 10 percent), the fair value of the consideration (i.e., the purchase price) is now only $12,418 (the present value of $20,000 in five years, discounted at 10 percent). A reduction in the purchase price results in an increase in the grant-date fair-value-based measure of the award and an increase in the amount of compensation cost recognized. In this example, the entity would record compensation cost of $7,582, equal to the $20,000 fair value of the shares less the $12,418 fair value of the consideration received.

2-02 In-Substance Nonrecourse Notes

Question
Are there situations in which a recourse note is substantively a nonrecourse note?

Answer
Yes. In considering whether a recourse note is, in substance, a nonrecourse note, entities should consider the guidance in Issue 34 of EITF Issue 00-23. Although EITF Issue 00-23 was nullified, the guidance on determining whether a recourse note is substantively a nonrecourse note remains relevant. A recourse note should be considered nonrecourse if any of the following factors are present:

- The employer has legal recourse to the employee’s other assets but does not intend to seek repayment beyond the shares issued.
- The employer has a history of not demanding repayment of loan amounts in excess of the fair value of the shares.
- The employee does not have sufficient assets or other means (beyond the shares) of justifying the recourse nature of the loan.
- The employer has accepted a recourse note upon exercise and subsequently converts the recourse note to a nonrecourse note.

The SEC observer also stated that all other relevant facts and circumstances should be evaluated and that if the note is ultimately forgiven, the SEC will most likely challenge the appropriateness of the conclusion that the note was a recourse note.

An employee may exercise options by using a nonrecourse note for a portion of the exercise price and a recourse note for the remainder. If the respective notes are not aligned with a corresponding percentage of the underlying shares (i.e., in a non-pro-rata structure), both notes should be accounted for together as nonrecourse. A non-pro-rata structure is one in which the exercise price for each share of stock is represented by both the nonrecourse notes and the recourse notes on the basis of their respective percentages of the total exercise price.

See Q&A 2-01 for a discussion of the impact of recourse and nonrecourse notes on the accounting for share-based payment awards.
Determining the Grant Date

**ASC 718-10**

25-5 As a practical accommodation, in determining the grant date of an award subject to this Topic, assuming all other criteria in the grant date definition have been met, a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

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

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

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

2-03 Substantive Plan Terms

Under ASC 718, to establish a grant date for a share-based payment transaction with an employee, the employer and employee must have reached a mutual understanding of the key terms and conditions of the share-based payment award. See Q&A 2-04 for criteria for establishing a grant date and Q&A 2-06 for guidance on reaching a mutual understanding.

**Question**

Do the key terms and conditions of a share-based payment award have to be in writing for an employer and employee to reach a mutual understanding?

**Answer**

Not necessarily. ASC 718-10-55-81 states:

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

a. A formal, written agreement

b. An informal, oral arrangement

c. An entity’s past practice.

Although formal, written agreements provide the best evidence of the key terms of an arrangement, oral arrangements or past practice may also establish key terms and, in some instances, may suggest that the substantive arrangement differs from the written arrangement. For example, if the written terms of a stock option plan provide for settlement in stock but the employer has historically settled options in cash, that past practice may suggest that the arrangement should be accounted for as being settled in cash and should therefore be classified as a liability award, despite the terms established in the written arrangement.

2-04 Conditions for Establishing a Grant Date With an Employee: General

**Question**

What conditions should an employer evaluate in establishing a grant date for a share-based payment transaction with an employee?

**Answer**

Generally, a grant date is considered to be the date on which all of the following conditions have been met:

1. The employer and employee have reached a mutual understanding of the key terms and conditions of the share-based payment award. See the following Q&As for additional discussion of the mutual understanding of key terms and conditions:

   - **Q&A 2-06** — Award in which the approval date precedes the communication date.
   - **Q&A 2-08** — Award in which the vesting conditions are known.
• Q&A 2-10 — Award in which a negative-discretion provision is included in the terms of an award.

2. The employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares. See Q&A 2-07 for a discussion of establishing a grant date in situations in which the exercise price is unknown.

3. All necessary approvals have been obtained. Awards issued under a share-based payment 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 shareholder approval is required but management or the members of the board of directors control enough votes to approve the arrangement, shareholder approval is essentially a formality or perfunctory. Individual awards that are subject to approval by the board of directors, management, or both are not considered granted until all such approvals are obtained. See Q&A 2-05 for a discussion of establishing a grant date in situations in which the awards are subject to approval by the entity’s shareholders, board of directors, or both.

4. The recipient meets the definition of an employee. See ASC 718-10-20 for the definition of an employee and Q&A 1-01 for a discussion of the definition of a common law employee.

Example
On January 1, 20X1, an individual is issued share options upon signing an employment agreement. The options vest at the end of the third year of service on December 31, 20X3 (cliff vesting). However, the individual does not begin to work (i.e., provide service in exchange for the options) for the employer until February 15, 20X1, and therefore does not meet the definition of an employee before this date. Accordingly, provided that all other conditions for establishing a grant date have been met, the grant date does not occur until February 15, 20X1. Compensation cost would be determined on the basis of the fair-value-based measure of the options on February 15, 20X1. Because the service inception date cannot begin before the individual provides service to the employer, compensation cost is recognized ratably over the period from February 15, 20X1, through December 31, 20X3.

2-05 Conditions That Must Be Met to Establish a Grant Date With an Employee: Necessary Approvals

Question
If share-based payment awards are subject to approval by an entity’s shareholders, board of directors, or both, can a grant date be established before such approval is granted?

Answer
Generally, no. Before establishing a grant date for a share-based payment transaction with an employee, an entity generally must obtain all necessary approvals unless such approvals are essentially perfunctory or a formality. (See Q&A 2-04 for additional discussion of the conditions that must be met before a grant date can be established.) Accordingly, unless management (1) controls enough votes to ensure shareholder approval (when shareholder approval is required) or controls the board of directors (when board approval is required) and (2) has approved the awards, a grant date has not been established until the necessary approvals have been obtained and all other grant-date conditions have been met.

Example 1
On January 1, 20X1, Entity A’s management approves the issuance of 1,000 nonvested shares to an executive (all terms are known and communicated to the executive) in accordance with A’s executive share incentive plan. The terms of the plan require A’s board of directors to approve all individual awards, and management does not control the board. However, on the basis of past practice, it is reasonably likely that the board will approve the award.

The board meets on March 1, 20X1, and approves the award. Therefore, if all other conditions for establishing a grant date have been met, the grant date would be March 1, 20X1. Note that, in this example, even though it is likely that approval will be granted, this does not affect the determination of whether an approval is perfunctory and, therefore, of whether a grant date can be established before such approval is obtained. Rather, the approval in this example would not be considered perfunctory because management does not control the outcome of the board’s vote.
Example 2

Entity A’s board of directors has formally delegated to management the right to grant share-based payment awards to employees when certain conditions are met. On February 1, 20X1, A’s management approves and communicates the award of 100 share options to a newly hired employee (all terms are known and the employee begins working for A on February 1, 20X1). Because the board has delegated to management the responsibility of granting awards, the board does not need to provide further approval for the award. However, at its March 1, 20X1, meeting, the board acknowledges, in the minutes to the board meeting, the award that was granted by management on February 1, 20X1.

If all other conditions for establishing a grant date have been met, the grant date would be February 1, 20X1, since board approval is not required (it was merely “acknowledged” in the minutes to the board meeting), and A’s management was given the authority to award the share options. However, caution should be exercised in determining the grant date whenever board approval is subsequently obtained, even when it is not required.

2-06 Conditions for Establishing a Grant Date With an Employee: Approval Date Precedes the Communications Date

A grant date cannot be established until an employer and employee reach a mutual understanding of the key terms and conditions of a share-based payment award. See Q&A 2-04 for a discussion of the conditions that must be met for a grant date to occur. Often, all of the key terms and conditions of awards issued to employees are established on the date the awards are approved in accordance with an entity’s corporate governance provisions (e.g., approval by the board of directors or management). The key terms and conditions of those awards may not be communicated to employees until after the approval date. In addition, the dates on which employees receive formal letters highlighting the key terms and conditions of the awards, or sign formal agreements may not coincide with the approval date or the communication date.

Question

May a grant date be established on the approval date if that date precedes the communication date?

Answer

Yes. ASC 718-10-25-5 acknowledges the difficulties of communicating the key terms and conditions of a share-based payment award to an employee on the approval date. As long as all other criteria for establishing a grant date have been met, a mutual understanding, and therefore a grant date, is presumed to exist on the date the award is approved in accordance with the relevant corporate governance requirements if both of the following conditions are met:

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

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

In most cases, the key terms and conditions of awards granted to employees are determined by the issuing entity’s management and approved by the board of directors (or the compensation committee of the board of directors). However, if employees are in a position to negotiate the key terms and conditions of their awards, a grant date cannot occur until both parties agree on those terms and conditions.

The definition of a “relatively short time period” is a matter of professional judgment and depends on how an entity communicates the terms and conditions of its awards to its employees. For example, if an entity communicates the terms and conditions of its awards via an employee benefits Web site, a relatively short time period may be a few days or the amount of time it would reasonably take to post the information on the Web site and communicate to the employees that the information is available. On the other hand, if the terms and conditions of the awards are usually communicated to each employee individually, the relatively short time period may be a few weeks.

If the approval date is considered to be the grant date pursuant to ASC 718-10-25-5, any change in the terms or conditions of the award between the approval date and the communication date should be accounted for as a modification of the award in accordance with ASC 718-20-35-3 and 35-4. See Q&A 4-15 for examples of the accounting for the modification of a share-based payment award.
2-07 Conditions That Must Be Met to Establish a Grant Date With an Employee: Mutual Understanding of Key Terms — Exercise Price Known

Question
Must the exercise price of an employee share option or similar instrument be known before a grant date can be established?

Answer
Generally, yes. Before a grant date for an employee share option or similar instrument can be established, there must be a mutual understanding of the key terms and conditions of the share option or similar instrument and the employee must begin to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares. (See Q&A 2-04 for additional discussion of the conditions that must be met before a grant date can be established.)

However, if the conditions in ASC 718-10-55-108 are met, the service inception date may precede the grant date. Accordingly, in such situations, an entity may begin recognizing compensation cost before the grant date. (See Q&A 4-06 for a discussion and examples of the conditions that must be met for a service inception date to precede the grant date.)

Example 1
On January 1, 20X1, Entity A issues 1,000 employee share options that vest at the end of one year of service (cliff vesting). All terms of the options are known except for the exercise price, which is set equal to the market price of A’s shares on December 31, 20X1.

In this example, a grant date has been established for December 31, 20X1 (all other conditions for establishing a grant date must also be met). In a manner consistent with ASC 718-10-55-83, a grant date has been established for this date because the employee does not begin to benefit from, or be adversely affected by, changes in the price of A’s shares until December 31, 20X1.

However, if the conditions in ASC 718-10-55-108 are met, the service inception date precedes the grant date. If the service inception date is January 1, 20X1, A must recognize compensation cost on the basis of the proportion of service rendered over the period from January 1, 20X1, to December 31, 20X1. From the service inception date until the grant date (January 1, 20X1, to December 31, 20X1), the entity remeasures the options at their fair-value-based measure at the end of each reporting period on the basis of the assumptions that exist on those dates. Once the grant date is established (December 31, 20X1), the entity discontinues remeasuring the options at the end of each reporting period. That is, the final measure of compensation cost is based on the fair-value-based measure on the grant date. See Q&A 4-07 and Example 6 in ASC 718-10-55-107 through 55-115 for a discussion and examples of the accounting for a share-based payment award in situations in which the service inception date precedes the grant date.

Example 2
On January 1, 20X1, Entity A issues 1,000 employee share options that vest at the end of one year of service (cliff vesting). All terms of the options are known except for the exercise price, which is set equal to the lower of the market price of A’s shares on January 1, 20X1, or its market price on December 31, 20X1 (i.e., the employee is given a look-back option).

In this example, a grant date has been established for January 1, 20X1 (all other conditions for establishing a grant date must also be met). In a manner consistent with ASC 718-10-55-83, while the ultimate exercise price is not known, it cannot be greater than the current market price of A’s shares. In this case, the relationship between the exercise price and the current market price of A’s shares constitutes a sufficient basis for understanding both the compensatory and the equity relationships established by the award. While the employee may not be adversely affected by any decreases in A’s share price, the employee will begin to benefit from subsequent increases in the price of A’s shares.
2-08 Conditions That Must Be Met to Establish a Grant Date With an Employee: Mutual Understanding of Key Terms — Vesting Conditions Known

**Question**
Must vesting conditions of a share-based payment award be known before a grant date can be established?

**Answer**
Generally, yes. Before a grant date can be established for a share-based payment transaction with an employee, there must be a mutual understanding of the key terms and conditions of the share-based payment award. See Q&A 2-04 for a discussion of the conditions that must be met for a grant date to have occurred. Accordingly, all the key terms and conditions of the award must be known, including any vesting conditions (i.e., service or performance conditions). In addition, if the vesting conditions are too subjective, there may be a lack of mutual understanding (see Example 2 below).

**Example 1**
On January 1, 20X1, Entity A issues 1,000 nonvested shares to its employees. The shares will vest in 25 percent increments (tranches) each year over the next four years if A’s actual earnings for each year exceed its annual budgeted earnings by 10 percent (i.e., a graded vesting schedule). Entity A set its annual budget in November of the previous year.

In this example, a grant date has been established for only 250 of the nonvested shares on January 1, 20X1 (all other conditions for establishing a grant date must also be met). A grant date has not been established for the other 750 nonvested shares because the performance conditions for those nonvested shares have not been established yet. The grant dates for those shares will occur once A’s annual budget for the appropriate year has been established and the employee is aware of the performance target (or the performance target is communicated to the employee within a “relatively short time period” thereafter in accordance with ASC 718-10-25-5). Accordingly, the grant dates will most likely be January 1, 20X1, for the first tranche of 250 nonvested shares; November 20X1 for the second tranche of 250 nonvested shares; November 20X2 for the third tranche of 250 nonvested shares; and November 20X3 for the last tranche of 250 nonvested shares.

**Example 2**
On January 1, 20X1, Entity A issues 1,000 employee share options. The options vest at the end of one year of service but only if the employee receives a performance rating of at least 4. Performance ratings are established at the end of the year on a scale of 1 through 5 (with 5 being the highest).

In this example, whether a grant date has been established on January 1, 20X1, depends on the facts and circumstances. Generally, if performance conditions are too subjective, there is a lack of mutual understanding of the key terms and conditions of the award, and therefore no grant date is established. If a performance condition is based on individual performance evaluations, an entity may consider the following items (this list is not all-inclusive) in determining whether the achievement of the performance condition is objectively determined (i.e., whether a mutual understanding of the key terms and conditions has occurred):

- Whether there is a well-established, rigorous system for performance evaluations.
- Whether there are objective goals and specific criteria in place.
- Whether, in addition to determining vesting of share-based payment awards, the evaluations are used for other purposes (e.g., annual raises, promotions).
- Whether overall evaluations are subject to requirements that force a specific distribution (e.g., a rating of 5 is limited to a specified percentage of employees within the group).
- Whether evaluations are completed by direct supervisors.

2-09 Performance Conditions Established on a Future Date

**Question**
Can the grant date for a share-based payment award be established when performance conditions will be established on a future date?
**Chapter 2 — Recognition**  
**A Roadmap to Accounting for Share-Based Payment Awards**

**Answer**

One of the criteria for establishing a grant date for a share-based payment transaction with an employee is that the employer and employee must reach a mutual understanding about the key terms and conditions of the share-based payment award. (See Q&A 2-04 for details about the other criteria for establishing a grant date.) Accordingly, all the key terms and conditions of the share-based payment award, including any vesting conditions (i.e., service, performance, or market conditions), must be known before a grant date can be established. In addition, if the vesting conditions are too subjective, there may be a lack of mutual understanding between the employer and the employee.

**Example 1**

An employee is awarded 400 nonvested shares on January 1, 20X7. Shares vest in equal increments at the end of each year over four years. Each increment will vest if the earnings for each year are equal to or exceed targeted earnings. The award specifies the first-year earnings target for the year ended December 31, 20X7, but not the targets for the remaining three years. Those targets will be established at the beginning of each year in which the performance condition is measured.

If all the other criteria for establishing a grant date have been met, a grant date has been established on January 1, 20X7, for only the 100 shares that vest on December 31, 20X7. A grant date has not been established for the other 300 shares because the performance conditions for those shares have not yet been established. The grant dates for those shares will occur once the earnings target for each respective year has been established and communicated to the employee (or communicated within a relatively short time thereafter in accordance with ASC 718-10-25-5). Accordingly, if the earnings targets are approved on January 1 of each year, the grant dates will be January 1, 20X7, for the first 100 shares; January 1, 20X8, for the next 100 shares; January 1, 20X9, for the next 100 shares; and January 1, 20Y0, for the last 100 shares.

**Example 2**

An employee is awarded 300 nonvested shares on January 1, 20X7. Shares vest in equal increments at the end of each year over three years. Each increment will vest if the earnings for each year exceed annual budgeted earnings by 10 percent. The company sets its annual budget in November of the prior year.

If all the other criteria for establishing a grant date have been met, a grant date has been established on January 1, 20X7, for only the 100 shares that vest on December 31, 20X7. A grant date has not been established for the other 200 shares because the performance conditions for those shares have not yet been established. The grant dates for those shares will occur once the annual budget for each respective year has been established and the employee is aware of the performance target (or the performance target is communicated within a relatively short time thereafter in accordance with ASC 718-10-25-5). Accordingly, the grant dates will most likely be January 1, 20X7, for the first 100 shares; the day the annual budget is set in November 20X7 for the next 100 shares; and the day the annual budget is set in November 20X8 for the last 100 shares.

**Example 3**

An employee is awarded 100 nonvested shares on January 1, 20X7. The shares vest on the basis of a service condition and a performance condition. While both the service and performance conditions have been specified, management retains the discretion to increase or decrease the number of shares that vest by up to 25 percent on the basis of the entity’s performance. Management has not provided guidance on what performance criteria would trigger the use of discretion. Furthermore, management has previously exercised discretion provisions for similar share-based payment awards granted to employees.

The discretion provision will not affect the entity’s ability to achieve a grant date for the 75 percent of shares that are not subject to the discretion provision and, if all the other criteria for establishing a grant date have been met, a grant date has been established on January 1, 20X7, for these 75 shares. However, for the remaining 25 percent of shares that are subject to the discretion provision, these 25 shares do not have the same terms and conditions as the other 75 shares. Thus, the entity should separately evaluate the 25 shares subject to the discretion provision to determine whether the discretion provision for those shares affects the entity’s ability to establish a grant date (a grant date has most likely not been established for the 25 shares).
2-10 Establishing a Grant Date With an Employee When a Negative-Disposition
Provision Is Included in the Terms of a Share-Based Payment Award

A “negative-discretion” provision is a common feature of share-based payment plans that allows management or the compensation committee of the board of directors to reduce the number of awards due to an employee on the basis of objective criteria in the terms of the plan. For example, a plan might state that 100 awards will be issued if EBITDA increases by at least 10 percent each year over a three-year period, with more or fewer awards issued for performance above or below that threshold. A negative-discretion provision would give management or the compensation committee of the board of directors the discretion to reduce the number of awards below the base amount determined by the plan’s stated terms at the end of the performance period.

Question

Does a negative-discretion provision in a share-based payment plan preclude an entity from establishing a grant date under ASC 718 until management or the compensation committee of the board of directors determines the number of awards due to an employee at the end of the performance period?

Answer

It depends. One criterion for establishing a grant date for a share-based payment transaction with an employee is that the employer and employee reach a mutual understanding about the key terms and conditions of the share-based payment award. Entities should consider whether a plan’s negative-discretion provision is a key term or condition that could result in uncertainty in the number of awards to be earned. Factors to consider include the following:

• Management’s intent and the purpose of the provision, including circumstances in which management believes it will exercise its right under the negative-discretion provision.
• Whether, in the past, management has exercised its right under the negative-discretion provision.
• Frequency of use of the negative-discretion provision, including when it was used and the reasons for using it.
• Employees’ awareness of the negative-discretion provision. All communications to employees, including verbal representations, should be considered.

These factors are not intended to be all-inclusive.

2-11 Establishing the Grant Date of a Share-Based Payment Award for a Nonpublic Entity When Valuation Is Not Finalized

A nonpublic entity issues share options to its employees on January 1, 20X1. The terms of the option agreement require that the exercise price of the options equal the fair value of a common share of the entity on the issuance date (January 1, 20X1). The entity has hired an independent expert to perform a valuation of the entity to determine the fair value of the entity’s common shares. The valuation will be based solely on information available as of January 1, 20X1; however, the valuation is not completed until after January 1, 20X1.

Question

Because the valuation is not completed as of the issuance date of the employee share options (January 1, 20X1), has a grant date been established?

Answer

Yes. An entity’s need to finalize the valuation of the underlying common shares as of a specific date (and therefore to set the exercise price of the award) would generally not prevent the entity from establishing a grant date for a share-based payment award with an employee if all other conditions for establishing a grant date have been met. The result of the valuation, based solely on information available as of January 1, 20X1, should be identical, regardless of whether the valuation work is completed on January 1 (i.e., all of the work is hypothetically performed instantaneously) or as of a subsequent date. (See Q&A 2-04 for a discussion of the conditions for establishing a grant date of a share-based payment award with an employee.)

One factor that could prevent an entity from establishing a grant date is the amount of time it takes, after the grant, to complete the valuation. A lengthy period between the purported valuation date and the completion of the valuation work may call into question whether an entity has used hindsight in selecting the underlying
assumptions. Note that even if the final valuation is completed after the grant date, an entity is required to use the information available as of the established grant date (i.e., January 1, 20X1, in the facts above). In other words, to prevent biased estimates, an entity should not factor hindsight into the valuation.

Note also that if an entity were to change the original terms of the award after the established grant date but before completion of the valuation, the entity would account for the changes as a modification. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

**Determining Whether to Classify a Financial Instrument as a Liability or as Equity**

<table>
<thead>
<tr>
<th>ASC 718-10</th>
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<td><strong>25-7</strong></td>
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<td><strong>25-8</strong></td>
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<td><strong>25-9</strong></td>
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<td><strong>25-10</strong></td>
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<td><strong>25-11</strong></td>
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<td><strong>25-12</strong></td>
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<td><strong>25-13</strong></td>
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</tbody>
</table>
### ASC 718-10 (continued)

25-14 For this purpose, an award of equity share options granted to an employee of an entity’s foreign operation that provides for a fixed exercise price denominated either in the foreign operation’s functional currency or in the currency in which the employee’s pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in euros granted to employees of a U.S. entity’s foreign operation whose functional currency is the euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in euros.

25-14A For purposes of applying paragraph 718-10-25-13, a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity’s equity securities trades shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, in accordance with that paragraph, such an award shall not be classified as a liability if it otherwise qualifies for equity classification. For example, a parent entity whose functional currency is the Canadian dollar grants equity share options with an exercise price denominated in U.S. dollars to employees of a Canadian entity with the functional and payroll currency of the Canadian dollar. If a substantial portion of the parent entity’s equity securities trades on a U.S. dollar denominated exchange, the options are not precluded from equity classification.

25-15 The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity’s past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a tandem award under which an employee receives either a stock option or a cash-settled stock appreciation right is obligated to pay cash on demand if the choice is the employee’s, and the entity incurs a liability to the employee. In contrast, if the choice is the entity’s, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an employee has the choice of settling awards by issuing stock predominately settles in cash or if the entity usually settles in stock whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an employee that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether:

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

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

25-16 A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

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

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

25-17 A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

25-18 Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer’s minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee’s discretion, the entire award shall be classified and accounted for as a liability.

25-19 Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee’s share of payroll taxes that are applicable to such supplemental taxable income.

### 2-12 Types of Share-Based Payment Awards Requiring Liability Classification

**Question**

What types of share-based payment awards should be classified as liabilities in accordance with ASC 718?
Generally, the following types of share-based payment awards (with certain exceptions, including those noted below) must be classified as liabilities in accordance with ASC 718-10-25-6 through 25-19:

<table>
<thead>
<tr>
<th>Type of Award</th>
<th>Discussion</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Awards that would be classified as liabilities under ASC 480.</td>
<td>Although share-based payment awards subject to ASC 718 are outside the scope of ASC 480, ASC 718-10-25-7 requires an entity to apply the classification criteria in ASC 480-10-25 and ASC 480-10-15-3 and 15-4 unless ASC 718-10-25-8 through 25-19 require otherwise. See ASC 718-10-25-7 and 25-8 and Q&amp;A 2-13 for a discussion of how the classification criteria in ASC 480 should be applied to share-based payment awards.</td>
<td>In determining the classification of share-based payment awards under ASC 480, entities should take into account the deferral provisions related to ASC 480, as discussed in ASC 718-10-25-8, as well as any specific exceptions in ASC 718-10-25-8 through 25-19.</td>
</tr>
<tr>
<td>An entity may be required to classify awards that become subject to other applicable GAAP as a liability under certain circumstances.</td>
<td>Applies to awards originally accounted for as employee share-based payment awards but that are modified after an individual is no longer an employee. See ASC 718-10-25-7, ASC 718-10-35-9 through 35-14, and Q&amp;A 2-14 for a discussion of when share-based payment awards subject to ASC 718 become subject to other applicable GAAP.</td>
<td>Under ASC 718-10-35-9 through 35-14, certain freestanding instruments issued to employees may never become subject to other GAAP.</td>
</tr>
<tr>
<td>Share-based payment awards subject to repurchase features that do not subject the employee to the risks and rewards of equity share ownership for a reasonable amount of time.</td>
<td>ASC 718-10-25-9 and 25-10 distinguish between repurchase features that are within the control of the issuer and those that are not within the control of the issuer. See Q&amp;A 2-16 for guidance on determining the classification of puttable and callable share-based payment awards.</td>
<td>ASC 718-10-25-9(a) contains an exception for contingent repurchase features that are not within the employee’s control and whose occurrence is not considered probable. ASC 718-10-25-16 through 25-19 exempt from liability classification, under certain circumstances, broker-assisted cashless exercises and repurchases that are used to satisfy the employer’s minimum statutory tax withholding requirements.</td>
</tr>
<tr>
<td>Options or similar instruments on shares for which (1) the underlying shares are classified as liabilities or (2) the options or similar instruments must be settled in cash or other assets.</td>
<td>ASC 718-10-25-11 and 25-12 require that such options or similar instruments be classified as a liability if the (1) underlying shares are classified as a liability or (2) options or similar instruments must be settled in cash or the employee is permitted to elect either cash or share settlement. See Q&amp;A 2-26 for guidance on determining the classification of puttable and callable employee share options.</td>
<td>ASC 718-10-25-11(b) contains an exception for contingent repurchase features that are not within the employee’s control and whose occurrence is not considered probable.</td>
</tr>
<tr>
<td>Awards with conditions or other features that are indexed to something other than a market, performance, or service condition.</td>
<td>Under ASC 718-10-25-13 and ASC 718-10-25-14A, awards indexed to something other than a market, performance, or service condition must be classified as a liability. ASC 718-10-55-65 gives examples of such awards.</td>
<td>ASC 718-10-25-14 and 25-14A exempt awards with a fixed exercise price in a foreign currency from liability classification provided that the exercise price is denominated in the (1) employer’s functional currency, (2) currency in which the employee is paid, or (3) currency of a market in which a substantial portion of the entity’s equity securities trades.</td>
</tr>
<tr>
<td>Awards that are substantive liabilities and awards for which the employer can choose the method of settlement but does not have the intent or ability to settle with shares.</td>
<td>ASC 718-10-25-15 states that an entity should evaluate the substantive terms of the award, past practices of the employer, and ability to deliver shares to determine the award’s classification. See Q&amp;A 2-31 for a discussion of the factors to consider when an employer can choose the method of settlement in determining the classification of an employee share option.</td>
<td>ASC 718-10-25-15(a) states that a requirement to deliver registered shares does not imply, by itself, that an employer does not have the ability to settle the award in shares.</td>
</tr>
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</table>
2-13 Applying the Classification Criteria in ASC 480 to Share-Based Payment Awards

**Question**
How should entities apply the classification criteria in ASC 480 to share-based payment awards accounted for under ASC 718?

**Answer**
Although share-based payment awards subject to ASC 718 are outside the scope of ASC 480, ASC 718-10-25-7 requires entities to apply the classification criteria in ASC 480-10-25 and ASC 480-10-15-3 and 15-4 unless ASC 718-10-25-8 through 25-19 require otherwise. Under ASC 480-10-25 and ASC 480-10-15-3 and 15-4, liability classification is required if an award meets any of the criteria in the table below.

Note that in determining the classification of share-based payment awards under ASC 480, nonpublic entities should consider the deferral provisions related to ASC 480, as discussed in ASC 718-10-25-8.

<table>
<thead>
<tr>
<th>ASC 480 Criteria</th>
<th>Example of Share-Based Payment Award</th>
<th>Comments</th>
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<tbody>
<tr>
<td>Mandatorily redeemable financial instruments described in ASC 480-10-25-4 through 25-7.</td>
<td>An entity issues nonvested shares to employees that must be repurchased by the employer as of specified or determinable dates.</td>
<td>The repurchase feature must be unconditional (i.e., the employee and employer have no choice). In addition, no other features of the instrument’s terms can exist that would cause the shares not to be redeemed. For example, preferred shares that may be converted into common shares before the specified redemption date(s) would not result in liability classification for the preferred shares if the conversion feature is substantive.</td>
</tr>
<tr>
<td>A financial instrument, other than an outstanding share, that embodies (or is indexed to) an obligation to repurchase shares (conditionally or unconditionally) by transferring assets as described in ASC 480-10-25-8 through 25-13.</td>
<td>An entity issues employee share options to an employee. On the same date, the entity issues to the employee a freestanding written put option to sell the entity’s shares back to it at a fixed price.</td>
<td>The guidance in ASC 480 only applies if the repurchase feature is considered “freestanding” (i.e., a legally detachable written put option). Because most employee share repurchase features are embedded and not legally detachable, ASC 718-10-25-11 and 25-12 provide explicit guidance on the impact of repurchase features contained in options or similar instruments issued to employees.</td>
</tr>
<tr>
<td>A financial instrument that embodies certain obligations to issue a variable number of shares when the obligation’s monetary value is based, solely or predominantly, on any one of the following items described in ASC 480-10-25-14:</td>
<td>An entity promises to convey $500,000 in value to an employee for services to be rendered in the upcoming fiscal year. The promise will be settled by issuing to the employee a variable number of the entity’s shares valued at $500,000 on the basis of the entity’s share price at the end of the next fiscal year. See Q&amp;A 2-15 for a discussion and example of share-based payment awards that are indexed to something other than the entity’s shares and settled in a variable number of the entity’s shares.</td>
<td>Awards that are based on monetary values at inception will most likely result in share-settled debt arrangements, accounted for as share-based liabilities.</td>
</tr>
<tr>
<td>1. “A fixed monetary amount known at inception.”</td>
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<td>2. “Variations in something other than the fair value of the issuer’s equity shares.”</td>
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<tr>
<td>3. “Variations inversely related to changes in the fair value of the issuer’s equity shares.”</td>
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Determining When Share-Based Payment Awards Subject to ASC 718 Become Subject to Other Applicable GAAP

Question
When does a share-based payment award that is currently being accounted for under ASC 718 or ASC 505-50 become subject to other applicable GAAP?

Answer
To determine when a share-based payment award becomes subject to other applicable GAAP, an entity should distinguish between (1) awards issued in exchange for employee services and (2) awards issued as consideration for goods or services other than employee services.

Awards Issued in Exchange for Employee Services Only
ASC 718-10-35-9 through 35-11 indicate that a share-based payment award that is issued to an employee and is subject to ASC 718 does not become subject to other applicable GAAP unless the award is modified when the individual is no longer an employee. ASC 718-10-35-9 through 35-11 only apply to awards issued to employees in exchange for past or future employee services. Modifications to the award when the holder is no longer an employee should be accounted for under ASC 718-10-35-14. After the modification, the award will become subject to other applicable GAAP (e.g., ASC 815 and ASC 480). Note that once the award becomes subject to other applicable GAAP, any of ASC 718’s exceptions to liability classification are no longer applicable.

Further, ASC 718-10-35-10 states, in part:

[A] modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

Other Awards
Awards issued in whole or in part as consideration for goods or services other than employee services generally become subject to other applicable GAAP once performance is complete and the awards are no longer subject to ASC 505-50. In particular, issuers must consider whether such an award must be accounted for as a derivative instrument under ASC 815. ASC 815-10-55-49 states, in part:

[E]quity instruments (including stock options) that are granted to nonemployees as compensation for goods and services in share-based payment transactions are subject to [ASC 815-10] once performance has occurred . . . . Any equity instrument granted in a share-based payment transaction subject to Subtopic 505-50 for the reporting entity is not considered to be a derivative instrument subject to [ASC 815-10] by that entity during the period that the equity instrument is subject to [ASC 505-50].

As a result, an issuer may have determined that a nonemployee award is equity-classified during the performance period. However, because of the requirements in ASC 815, once performance is complete, an issuer may be required to reclassify the award from equity to a derivative liability.

Classifying Share-Based Payment Awards That Are Indexed to Something Other Than the Issuer’s Equity Shares and Settled in a Variable Number of the Entity’s Shares

Question
Is a share-based payment award classified as a share-based liability if (1) the monetary value of the obligation is indexed solely to variations in an entity’s operating performance measure (e.g., EBITDA) and (2) the award is settled in a variable number of the entity’s shares?
**Answer**

Yes. Under ASC 718-10-25-6, an entity would apply ASC 718-10-25-6 through 25-19 to determine whether such awards are classified as a liability. Awards not specifically discussed in those paragraphs are subject to the guidance in U.S. GAAP on financial instruments issued in transactions that do not involve share-based payments. Although share-based payment awards subject to ASC 718 are excluded from the scope of ASC 480, ASC 718-10-25-7 specifically requires an entity to apply the classification criteria in ASC 480-10-25 and ASC 480-10-15-3 and 15-4 unless ASC 718-10-25-8 through 25-19 require otherwise (see Q&A 2-13 for a discussion of applying the classification criteria in ASC 480 to share-based payment awards). The awards in this example are subject to the classification criteria in ASC 480 since ASC 718-10-25-7 through 25-19 do not require otherwise. Because the awards represent an obligation to issue a variable number of the entity’s shares indexed solely to variations in an operating performance measure of the entity (and not indexed to variations in the fair value of the entity’s shares), they are considered a share-based liability in accordance with ASC 480-10-25-14. ASC 480-10-25-14 states, in part:

>A financial instrument that embodies an unconditional obligation . . . that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability . . . if, at inception, the monetary value of the obligation is based solely or predominately on . . . [v]ariations in something other than the fair value of an issuer’s equity shares. [Emphasis added]

**Example**

Entity A grants employee share options with an exercise price established on the grant date equal to a fixed multiple of an operating performance measure of A (e.g., trailing 12 months EBITDA). It is assumed that the EBITDA multiple does not represent a reasonable approximation of the fair value of A’s equity shares. The settlement price of the options as of the vesting date is also established according to a fixed multiple of the same operating performance measure of A. Any excess of the options’ settlement price as of the vesting date over the options’ exercise price as of the grant date is paid to the employees in a variable number of A’s shares on the basis of the fair value of A’s shares on the vesting date. Because the monetary value of the options (1) is indexed solely to variations in an operating performance measure of A (i.e., EBITDA) and (2) will be settled in a variable number of A’s shares, the options will be classified as a share-based liability.

**2-16 Determining the Classification of Puttable and Callable Share Awards Subject to ASC 718**

**Question**

What steps should an entity follow in determining the classification of a puttable or callable share award subject to ASC 718?

**Answer**

The steps outlined below are only applicable to share awards subject to ASC 718 that contain conditional obligations (e.g., put or call rights) to transfer cash or other assets at settlement and should not be applied to the following awards:

- Share awards subject to ASC 718 that contain unconditional obligations to transfer cash or other assets. These awards must be classified as share-based liabilities pursuant to ASC 718-10-25-7. See Q&A 2-13 for a discussion of applying the classification criteria in ASC 480 to share-based payment awards.

- Share-based payment awards of puttable or callable employee share options subject to ASC 718. These awards must be classified pursuant to the guidance in ASC 718-10-25-11 and 25-12. See Q&A 2-26 for a discussion of the steps to follow in determining the classification of puttable and callable employee share options.
Chapter 2 — Recognition
A Roadmap to Accounting for Share-Based Payment Awards

**Step 1**
Does the employee’s repurchase feature (i.e., put option) permit the employee to avoid bearing the risks and rewards normally associated with share ownership for a reasonable period (six or more months) after the date the requisite service is rendered and the share is issued?

If yes, classify the share award as a share-based liability. If no, proceed to step 2.

See Q&A 2-17 and Q&A 2-18 for a discussion of the effect of noncontingent and contingent repurchase features on the classification of puttable share awards. A repurchase feature enabling employers to satisfy their minimum statutory tax withholding requirements upon vesting of the share award will not give rise to liability classification provided that no repurchases in excess of the minimum statutory withholding requirements occur. See ASC 718-10-25-18 and 25-19, Q&A 2-32, and Q&A 2-33 for discussion of the effect of minimum statutory tax withholding amounts on the classification of share-based payment awards.

**Step 2**
Is it probable that the employer, through its repurchase feature (i.e., call option), would prevent the employee from bearing the risks and rewards of share ownership for a reasonable period (six or more months) after the requisite service is rendered and the share is issued?

If yes, classify the share award as a share-based liability. If no, proceed to step 3.

See Q&A 2-19 for a discussion of the effect of noncontingent and contingent repurchase features on the classification of callable share awards.

**Step 3**
Is the share award modified when the holder is no longer an employee of the entity?

If no, proceed to step 4. If yes, follow the guidance under ASC 718-10-35-9 through 35-14 to determine whether the share award becomes subject to other applicable GAAP. Proceed to step 4 if liability classification is not required.

See Q&A 2-14 for a discussion of when share-based payment awards subject to ASC 718 become subject to other applicable GAAP.

**Step 4**
Is temporary equity classification of the share award required under SAB Topic 14.E? This step should be followed by all SEC registrants. Non-SEC registrants may elect not to follow step 4.

If yes, classify the share award outside of permanent equity as temporary (or “mezzanine”) equity.

See Q&A 2-21 and Q&A 2-22 for discussion and an example of the application of ASR 268 and ASC 480-10-S99-3A to share-based payment awards with repurchase features.

**2-17 Impact of Noncontingent Repurchase Features on the Classification of Puttable Share Awards**

**Question**
How does a noncontingent repurchase feature affect the classification of puttable share awards issued to employees?

**Answer**
Liability classification is required if the noncontingent repurchase feature (e.g., a put option) permits the employee to avoid bearing the risks and rewards normally associated with share ownership for a reasonable period from the date the requisite service is rendered and the share is issued. To avoid liability classification, an employee must bear the risks and rewards of share ownership for at least a period of six months from the date the requisite service is rendered and the share is issued. A noncontingent put option (the exercise of which is in the employee’s control) that allows the employee to exercise the put option within six months of the vesting of the share award results in liability classification of the share award, even if the employee is unlikely to exercise the put option. Note that if the repurchase price is not measured at fair value as of the repurchase date (e.g., repurchase at a formula price), the employee would generally not be subject to the risks and rewards of share ownership, regardless of whether the repurchase feature can only be exercised six months after the share vests. See Q&A 2-18 for a discussion of the effect of contingent repurchase features on the classification of puttable share awards.
An exception to this requirement is a repurchase feature that enables employers to satisfy their minimum statutory tax withholding requirements (see Example 2 below). See ASC 718-10-25-18 and 25-19, Q&A 2-32, and Q&A 2-33 for discussion of the effect of minimum statutory tax withholding amounts on the classification of share-based payment awards.

Entities must continually assess share awards to ensure that they are appropriately classified. Awards that are initially classified as liability awards may subsequently be classified as equity awards if, for example, the repurchase feature expires or the shares are held for at least six months from the date the share awards vested for fair value repurchase features (i.e., the shares are no longer immature).

Note that SEC registrants must consider the requirements of ASR 268 (FRR Section 211) and ASC 480-10-S99-3A, as discussed under SAB Topic 14.E. SAB Topic 14.E requires that an SEC registrant present share awards (otherwise classified as equity) subject to redemption features not solely within the control of the issuer as temporary (or “mezzanine”) equity. Temporary equity classification is required even if the share awards qualified for equity classification under the requirements of ASC 718 (e.g., a share award that is puttable by the employee more than six months after vesting). Noncontingently puttable share awards classified as temporary equity should be carried at redemption value. See Q&A 2-21 and Q&A 2-22 for discussion and an example of the application of ASR 268 and ASC 480-10-S99-3A to share-based payment awards with repurchase features.

The examples below illustrate noncontingent repurchase features commonly found in share-based payment arrangements.

**Repurchase at Fair Value**

*Example 1*

Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The share awards give the employee the right to require A to buy back its shares at their then-current fair value 12 months from the date the share awards are fully vested.

The repurchase feature will *not result in liability classification* of the share awards since the employee is required to bear the risks and rewards of share ownership for more than six months (12 months) after the share awards have vested. However, if A is an SEC registrant, it must apply the requirements in ASR 268 and ASC 480-10-S99-3A.

*Example 2*

Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). When the awards vest, the employee can require A to repurchase a portion of its shares at their then-current fair value to meet A’s minimum statutory tax withholding requirements.

The repurchase feature will *not result in liability classification* of the share awards pursuant to ASC 718-10-25-18 and 25-19 provided that the employee cannot require A to repurchase its shares in an amount that exceeds A’s minimum statutory tax withholding requirements. A repurchase feature giving the employee the right to require withholdings in excess of the employer’s minimum statutory tax withholding requirements as of the vesting date will *result in liability classification* for the entire award.

**Repurchase at a Fixed Price**

*Example*

Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The share awards give the employee the right to require A to buy back its shares *at a fixed amount* 12 months from the date the share awards are fully vested.

The repurchase feature will *result in liability classification* of the share awards since the employee would not ever be subject to the risks and rewards of share ownership, regardless of whether the repurchase feature can only be exercised six months after the share vests. That is, the repurchase price is fixed at the inception of the arrangement. The share award would be accounted for as an award with a liability and equity component in a manner similar to a tandem award, as described in ASC 718-10-55-120 through 55-130.
Repurchase at a Fixed Amount Over Fair Value

Example
Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The share awards give the employee the right to require A to buy back its shares 12 months from the date the share awards are fully vested. The repurchase amount will be based on the fair value of A’s shares on the date the employee exercises the put option plus $100 per share.

The repurchase feature will not result in liability classification of the share awards since the employee is required to bear the risks and rewards of share ownership for more than six months (12 months) after the share awards have vested. However, if A is an SEC registrant, it must apply the requirements in ASR 268 and ASC 480-10-S99-3A. In addition, ASC 718-20-35-7 and ASC 718-10-55-85 require the recognition of additional compensation cost for the excess of the repurchase price over the fair-value-based measure of an award (i.e., $100 per share in this example). The additional compensation cost is recognized over the requisite service period of the share awards (i.e., two years), with a corresponding amount recognized as a share-based liability.

Repurchase at a Formula Price

Example
Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The share awards give the employee the right to require A to buy back its shares 12 months from the date the share awards are fully vested. The repurchase amount will be based on a multiple of A’s earnings.

The repurchase feature will result in liability classification of the share awards since the repurchase amount is not indexed to A’s share price; therefore the employee would not be subject to the risks and rewards of share ownership regardless of whether the repurchase feature can only be exercised six months after the shares vest.

2-18 Impact of Contingent Repurchase Features on the Classification of Puttable Share Awards

Question
How does a contingent repurchase feature affect the classification of puttable share awards issued to employees?

Answer
An entity should analyze a put option that becomes exercisable only upon the occurrence of a specified future event (i.e., the triggering event) to determine whether the triggering event is within the control of the employee (i.e., the party that can exercise the put option). An entity should ignore triggering events within the control of the employee and analyze the repurchase feature as if it is noncontingent (i.e., as if the triggering event already occurred) to determine whether it permits the employee to avoid bearing the risks and rewards normally associated with share ownership for a reasonable period from the date the requisite service is rendered and the share is issued. To avoid liability classification, an employee must bear the risks and rewards of share ownership for at least six months from the date the requisite service is rendered and the share is issued. See Q&A 2-17 for a discussion of the effect of noncontingent repurchase features on the classification of puttable share awards.

If the triggering event is not within the control of the employee, the entity should assess, on an individual-employee basis, the probability that the triggering event will occur. Liability classification is required for fair value repurchase features if it is probable that (1) the triggering event will occur within six months of the date the share awards vest and (2) the repurchase feature will permit the employee to avoid bearing the risks and rewards normally associated with share ownership for six or more months after the date the requisite service is rendered and the share is issued.

Equity classification is appropriate for share awards in which occurrence of the triggering event is (1) not within the control of the employee and (2) not probable or only probable after the employee has been subject to the risks and rewards normally associated with share ownership for six or more months from the date the requisite service is rendered and the share is issued. However, a repurchase feature that is not measured at fair value as of the repurchase date (e.g., repurchase at a formula price) would generally not subject the employee to the risks and rewards normally associated with share ownership, irrespective of the holding period (see Q&A 2-17 for further discussion). If repurchase features are not measured at fair value, equity classification would generally only be appropriate for share awards in which occurrence of the triggering event is (1) not within the control of the employee and (2) not probable while the repurchase feature is outstanding.
Entities must continually assess share awards to ensure that they are appropriately classified. Awards that are initially classified as equity awards may be subsequently classified as liability awards as a result of a change in probability assessment. Likewise, awards that are initially classified as liability awards may subsequently be classified as equity awards if, for example, there is a change in probability assessment, the repurchase feature expires, or the shares are held for at least six months from the date the share awards vested for fair value repurchase features (that is, the shares are no longer immature).

Note that SEC registrants must consider the requirements of ASR 268 (FRR Section 211) and ASC 480-10-S99-3A, as discussed in SAB Topic 14.E. SAB Topic 14.E requires that an SEC registrant present share awards (otherwise classified as equity) subject to redemption features not solely within the control of the issuer as temporary (or “mezzanine”) equity. Temporary equity classification is required even if the share awards qualified for equity classification under ASC 718 (e.g., a share award that is contingently puttable by the employee at fair value on the repurchase date more than six months after vesting). See Q&A 2-21 and Q&A 2-22 for discussion and an example of the application of ASR 268 and ASC 480-10-S99-3A to share-based payment awards with repurchase features.

Example

Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The share awards give the employee the right to require A to buy back its shares once an IPO occurs. The repurchase amount will be based on the fair value of A’s shares on the date the employee exercises the put option.

The repurchase feature will not result in liability classification of the share awards but may result in liability classification when it becomes probable that an IPO will occur. As discussed in Q&A 3-31, it is generally not considered probable that an IPO will occur until the IPO is effective.

If the IPO becomes effective six months after the share awards vest, equity classification will remain appropriate since the employee would have been subject to the risks and rewards normally associated with share ownership for at least a period of six months from the date the share awards vested. However, once A becomes an SEC registrant, it must apply the requirements in ASR 268 and ASC 480-10-S99-3A.

2-19 Impact of Noncontingent Repurchase Features Triggered by an Employer Call Option on the Classification of Share Awards

Question

How does a noncontingent repurchase feature that can be triggered by an employer call option affect the classification of share awards issued to employees?

Answer

ASC 718-10-25-9(b) requires liability classification of share awards when (1) the issuer (employer) has the ability to call the shares upon the vesting of the award and (2) it is probable that the call option will be exercised before the employee has been subject to the risks and rewards normally associated with share ownership for at least six months from the date the share awards vest.

This requirement to assess the probability that an employer’s call option will be exercised is different from the requirement under ASC 718-10-25-9(a), which does not permit an assessment of the employee’s probability of exercising a noncontingent put option. That is, a repurchase feature allowing employees to exercise a noncontingent put option within six months of the vesting of the share awards will always result in liability classification of the share award, even if the employee is unlikely to exercise the put option.

The probability assessment under ASC 718-10-25-9(b) should be based on (1) the employer’s stated representations that it has the positive intent not to call the shares while they are immature (i.e., within six months of vesting) and (2) all other relevant facts and circumstances. In considering all other relevant facts and circumstances, it is appropriate to analogize to the guidance in superseded Issue 23(a) of EITF Issue 00-23. Issue 23(a) identifies the following additional relevant factors to consider:

- The frequency with which the employer has called immature shares in the past.
- The circumstances under which the employer has called immature shares in the past.
- The existence of any legal, regulatory, or contractual limitations on the employer’s ability to repurchase shares.
- Whether the employer is a closely held, private company.
In addition, if the noncontingent call feature is not measured at fair value as of the repurchase date, whether the shares are immature or mature is generally not relevant to the probability assessment mentioned above since the employee would generally not be subject to the risks and rewards of share ownership if the repurchase feature is exercised, regardless of whether the repurchase feature is exercised six months after the share vests. Accordingly, the probability assessment should be performed for all periods for which the repurchase feature is outstanding. One exception to this rule is if the repurchase price is at a fixed amount over the fair value on the repurchase date. In this case, if it is not probable that the call option will be exercised for at least six months from the date the share awards vest but it is still probable that the call option will be exercised when the repurchase feature is outstanding, only the fixed amount in excess of fair value would be classified as a liability award.

Further, it is generally probable that a noncontingent call feature that allows the employer to repurchase shares at a price that is below fair value or potentially below fair value on the repurchase date will be exercised irrespective of the holding period. However, an entity should evaluate that repurchase provision to determine whether, in substance, it represents a forfeiture provision (see Q&A 2-24 for further discussion).

Entities must continually assess share awards to ensure that they are appropriately classified. Awards may initially be classified as equity awards but, as a result of a change in probability assessment, may subsequently be classified as liability awards. Likewise, awards that are initially classified as liability awards may subsequently be classified as equity awards if, for example, (1) there is a change in the probability assessment, (2) the repurchase feature expires, or (3) the shares are held for at least six months after the share awards vest for fair value repurchase features (i.e., the shares are no longer immature).

It is not necessary for an entity to consider the requirements in ASC 480-10-S99-3A when analyzing a repurchase feature triggered by an employer call option because the redemption feature is solely within the control of the employer. ASC 480-10-S99-3A only applies to awards with redemption features not solely within the control of the issuer (employer). That is, a share award with terms that only permit the employer to repurchase the shares will never be classified as temporary equity.

**Example**

Entity A grants 1,000 nonvested share awards to an employee that vest at the end of the second year of service (cliff vesting). The employee is restricted from selling A’s shares to a third party for 12 months after they vest. During this 12-month period, A has the right to call its shares at their then-current fair value. The employer should assess the probability that it will call the shares within six months of the vesting of the share awards. Liability classification is required if it is probable that the shares will be called within six months from the date the share awards vest.

If A is an SEC registrant, temporary equity classification of the share awards will not be required under ASC 480-10-S99-3A because the guidance does not apply to share awards with redemption features that are solely within the control of the issuer (employer).

### 2-20 Impact of Contingent Repurchase Features Triggered by an Employer Call Option on the Classification of Share Awards

**Question**

How does a contingent repurchase feature affect the classification of callable share awards issued to employees?

**Answer**

ASC 718-10-25-9(b) requires liability classification of share awards when (1) the issuer (employer) has the ability to call the shares upon the vesting of the awards and (2) it is probable that the call option will be exercised before the employee has been subject to the risks and rewards normally associated with share ownership for at least six months from the date the share awards vest.

An entity should first analyze a contingent call option that becomes exercisable only upon the occurrence of a specified future event (i.e., the triggering event) to determine whether it is probable that the triggering event will occur on an individual-employee basis. For repurchase features that are measured at fair value as of the repurchase date, this probability assessment should cover the period during which the shares are immature (i.e., within six months of vesting). For repurchase features that are not measured at fair value as of the repurchase date, this
probability assessment should generally cover the period during which the repurchase feature is outstanding. In this latter situation, whether the shares are immature or mature is generally not relevant to the probability assessment since the employee would generally not be subject to the risks and rewards of share ownership if the non-fair-value repurchase feature is exercised, regardless of whether the repurchase feature is exercised six months after the share vests. In addition, this probability assessment may be performed regardless of whether the occurrence of the triggering event is in the control of the party that can exercise the repurchase feature (i.e., the employer). If it is not probable that the triggering event will occur while the shares are immature (for fair value repurchase features) or at any time before the repurchase feature expires (for non-fair-value repurchase features), the repurchase feature will not result in liability classification. If it is probable that the triggering event will occur while the shares are immature (for fair value repurchase features) or at any time before the repurchase feature expires (for non-fair-value repurchase features), an entity should analyze the repurchase feature as if it is noncontingent (that is, as if the triggering event already occurred). See Q&A 2-19 for a discussion of the accounting for noncontingent repurchase features triggered by an employer call option.

Entities must continually assess share awards to ensure that they are appropriately classified. Awards may initially be classified as equity awards but, as a result of a change in probability assessment, may subsequently be classified as liability awards. Likewise, awards that are initially classified as liability awards may subsequently be classified as equity awards if, for example, (1) there is a change in the probability assessment, (2) the repurchase feature expires, or (3) the shares are held for at least six months after share awards vest for fair value repurchase features (i.e., the shares are no longer immature).

It is not necessary for an entity to consider the requirements in ASC 480-10-S99-3A for a repurchase feature triggered by an employer call option because the redemption feature is solely within the control of the employer. ASC 480-10-S99-3A only applies to awards with redemption features not solely within the control of the issuer (employer). That is, a share award with terms that allow the employer to repurchase the shares will never be classified as temporary equity.

2-21 Applying ASR 268 and ASC 480-10-S99-3A to Share-Based Payment Awards With Repurchase Features

Repurchase features may not result in liability classification of share-based payment awards subject to ASC 718. See Q&A 2-16 for guidance on determining the classification of puttable and callable share awards and Q&A 2-26 for guidance on determining the classification of puttable and callable employee share options.

Question

Are SEC registrants required to apply the SEC’s guidance in ASR 268 (FRR Section 211) and ASC 480-10-S99-3A on redeemable securities in determining the classification of share-based payment awards if the award is otherwise classified as an equity award under ASC 718?

Answer

Yes. SEC registrants must consider the requirements of ASR 268 and ASC 480-10-S99-3A, as discussed in SAB Topic 14.E. SAB Topic 14.E requires an SEC registrant to present share-based payment awards (otherwise classified as equity) subject to redemption features not solely within the control of the issuer outside of permanent equity (i.e., as “temporary” or “mezzanine” equity). Temporary equity classification may be required even if the share-based payment awards otherwise qualify for equity classification under ASC 718 (e.g., a share award that is contingently puttable by the employee more than six months after vesting at the then-current fair value). Exceptions include the following:

- The award does not require redemption for cash or other assets, and cash settlement would be possible only upon the issuer’s inability to deliver registered shares (as described in ASC 815-40-25-11 through 25-16).
- The award permits direct or indirect share repurchases only to satisfy the employer’s minimum statutory tax withholding requirements (as described in ASC 718-10-25-18 and 25-19).

ASC 480-10-S99-3A requires that SEC registrants recognize and measure awards with redemption features not solely within the control of the issuer in temporary equity as follows:

- At issuance, the carrying value should be based on the redemption value of the award and the proportion attributed to the requisite service rendered to date.
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A Roadmap to Accounting for Share-Based Payment Awards

• Until settlement, the award should be remeasured at the end of the reporting period on the basis of the redemption value of the award and the proportion attributed to the requisite services rendered to date. Note that remeasurement is not required for awards issued with contingent repurchase features if it is not considered probable that the contingency would be satisfied. The assessment of probability is generally performed on an employee-by-employee basis.

• The amount of compensation cost recognized should be based on the grant-date fair-value-based measure of the award. Changes in the redemption value after the award is granted are recorded in equity and not as compensation cost recognized in earnings.

The redemption value at issuance is based on the redemption feature of the award. For example, the redemption value of an award that is redeemable at intrinsic value is the intrinsic value of the award. Thus, if an employee share option is granted “at the money,” its initial redemption value is zero. For a share award with a repurchase feature that is classified in temporary equity, the redemption value on the grant date will typically be the fair value of the issuer’s shares on the grant date since the employee is typically not required to pay an exercise price.

Subsequent remeasurement (if required under ASC 480-10-S99-3A) will be based on the fair value of the issuer’s shares in each period, less the exercise price of the award, if any. See Q&A 2-22 for an example of the application of ASR 268 and ASC 480-10-S99-3A to share awards with repurchase features and Q&A 2-28 for an example of the application of ASR 268 and ASC 480-10-S99-3A to employee share options with a contingent cash settlement feature.

2-22 Applying ASR 268 and ASC 480-10-S99-3A to Share Awards With Repurchase Features — Example

On January 1, 20X1, Entity A, an SEC registrant, grants 100,000 nonvested share awards to an employee. The share awards vest at the end of the fourth year of service (cliff vesting). The share awards give the employee the right to require A to buy back A’s shares at their then-current fair value any time after six months from the date the share awards are fully vested. The fair value of the shares is as follows:

- $10 on January 1, 20X1.
- $12 on December 31, 20X1.
- $7 on December 31, 20X2.
- $11 on December 31, 20X3.
- $14 on December 31, 20X4.

The repurchase feature will not result in liability classification of the share awards since the employee will bear the risks and rewards of share ownership for a period of more than six months after the share awards have vested. However, as an SEC registrant, A must apply ASR 268 (FRR Section 211) and ASC 480-10-S99-3A. ASR 268 and ASC 480-10-S99-3A require an SEC registrant to present share-based payment awards (otherwise classified as equity) that are subject to redemption features not solely within the control of the issuer outside of permanent equity (i.e., as “temporary” or “mezzanine” equity). See Q&A 2-21 for a discussion of the application of ASR 268 and ASC 480-10-S99-3A to share awards with repurchase features.

Entity A should record the journal entries below. For simplicity, the effects of forfeitures and income taxes have been ignored.

**Journal Entries: December 31, 20X1**

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>250,000</td>
</tr>
<tr>
<td>Temporary equity</td>
<td>250,000</td>
</tr>
</tbody>
</table>

To recognize compensation cost on the basis of the grant-date fair-value-based measure of the share awards (100,000 share awards × $10 grant-date fair-value-based measure × 25 percent for one of four years of services rendered).
Chapter 2 — Recognition
A Roadmap to Accounting for Share-Based Payment Awards

Retained earnings 50,000
Temporary equity 50,000
To remeasure the share awards at their redemption value as of December 31, 20X1
[(100,000 share awards × $12 fair value of A’s shares × 25 percent for one of four years of services rendered) – $250,000 carrying value of the share awards].

Journal Entries: December 31, 20X2

Compensation cost 250,000
Temporary equity 250,000
To recognize compensation cost on the basis of the grant-date fair-value-based measure of the share awards [(100,000 share awards × $10 grant-date fair-value-based measure × 50 percent for two of four years of services rendered) – $250,000 compensation cost previously recognized].

Temporary equity 200,000
Retained earnings 200,000
To remeasure the share awards at their redemption value as of December 31, 20X2
[(100,000 share awards × $7 fair value of A’s shares × 50 percent for two of four years of services rendered) – $550,000 carrying value of the share awards].

Journal Entries: December 31, 20X3

Compensation cost 250,000
Temporary equity 250,000
To recognize compensation cost on the basis of the grant-date fair-value-based measure of the share awards [(100,000 share awards × $10 grant-date fair-value-based measure × 75 percent for three of four years of services rendered) – $500,000 compensation cost previously recognized].

Retained earnings 225,000
Temporary equity 225,000
To remeasure the share awards at their redemption value as of December 31, 20X3
[(100,000 share awards × $11 fair value of A’s shares × 75 percent for three of four years of services rendered) – $600,000 carrying value of the share awards].

Journal Entries: December 31, 20X4

Compensation cost 250,000
Temporary equity 250,000
To recognize compensation cost on the basis of the grant-date fair-value-based measure of the share awards [(100,000 share awards × $10 grant-date fair-value-based measure × 100 percent for four of four years of services rendered) – $750,000 compensation cost previously recognized].

Retained earnings 325,000
Temporary equity 325,000
To remeasure the share awards at their redemption value as of December 31, 20X4
[(100,000 share awards × $14 fair value of A’s shares × 100 percent for four of four years of services rendered) – $1,075,000 carrying value of the share awards].
Early Exercise of an Option or Similar Instrument

Question
What is an “early exercise” of an option or similar instrument?

Answer
An early exercise refers to an employee’s ability to change his or her tax position by exercising an option or similar instrument and receiving shares before the completion of the award’s requisite service period (i.e., before the award is vested). The early exercise of an award results in the employee’s deemed ownership of the shares for U.S. federal income tax purposes, which in turn results in the commencement of the share’s holding period (under the tax law). Once the shares are held by the employee for the required holding period, any gain realized upon the sale of those shares is taxed at a capital gains tax rate rather than an ordinary income tax rate.

Because the awards are exercised before completion of the requisite service period, if the employee terminates employment before the end of this period, the entity issuing the shares usually can repurchase the shares for either of the following:

- The lesser of the fair value of the shares on the repurchase date or the exercise price of the award.
- The exercise price of the award.

The purpose of the repurchase feature is effectively to require the employee to remain through the requisite service period to receive any economic benefit from the award. See Q&A 2-24 for a discussion of the accounting for such a repurchase feature.

Repurchase Feature of an Early-Exercised Share-Based Payment Option or Similar Instrument

ASC 718-10-25-9 and 25-10 discuss the appropriate classification (i.e., liability versus equity) of options or similar instruments with certain share-associated repurchase features. Specifically, these paragraphs discuss awards that contain (1) an employee’s right to require the entity to repurchase the share (a put option) or (2) an entity’s right to repurchase the share from the employee (a call option).

Question
Should a repurchase feature associated with an entity’s right to repurchase the underlying shares (at either the exercise price or the lesser of the fair value of the shares on the repurchase date or the exercise price) that is included in the terms of a share option or similar instrument capable of being “early exercised” (see Q&A 2-23) be assessed under the provisions of ASC 718-10-25-9 and 25-10?

Answer
No. The fact that the employee was able to exercise the award early does not indicate that the vesting condition was satisfied, since the repurchase feature prevents the employee from receiving any economic benefit from the award until the entity’s call option expires upon completion of the award’s requisite service period. ASC 718-10-55-31(a) confirms this conclusion, stating, in part:

Under some share option arrangements, an option holder may exercise an option prior to vesting (usually to obtain a specific tax treatment); however, such arrangements generally require that any shares received upon exercise be returned to the entity (with or without a return of the exercise price to the holder) if the vesting conditions are not satisfied. Such an exercise is not substantive for accounting purposes.

In effect, the repurchase feature functions as a forfeiture provision rather than a cash settlement feature. That is, if the employee remains in the employment of the entity for the requisite service period of the award, the award will vest and the restriction (the repurchase feature) will be removed. In contrast, if the employee terminates employment before the completion of the requisite service period, the entity will repurchase the shares (in effect, as though the shares were never issued).
2-25 Modification of an Early-Exercised Option or Similar Instrument

**Question**
The repurchase feature associated with an “early-exercised” option or similar instrument is discussed in Q&A 2-24. However, if an entity elects not to repurchase the outstanding shares in the event of an employee termination before the completion of the requisite service period of the award, how does the entity account for its decision not to repurchase?

**Answer**
The entity’s election not to repurchase a share issued as a result of an early exercise is accounted for as a modification that, in effect, accelerates the vesting of the award. The modification is accounted for as a Type III improbable-to-probable modification. That is, on the date of the employee termination, the original award is not expected to vest. Accordingly, no compensation cost is recognized for the original award and any previously recognized compensation cost is reversed. On the date the entity decides not to repurchase the shares (which generally is contemporaneous with the employee’s termination), the entity would determine the fair-value-based measure of the modified award (i.e., the award that is fully vested). The fair-value-based measure of the modified award is recorded over the remaining service period of the award, which generally would be immediate, since the award’s vesting is effectively accelerated upon termination. See Q&A 4-22 for a discussion of the accounting for a modification of share-based payment awards with performance and service vesting conditions, and see Q&A 4-24 for an example illustrating an improbable-to-probable modification.

2-26 Determining the Classification of Puttable or Callable Employee Share Options Subject to ASC 718

**Question**
What steps should an entity take to determine the classification of puttable or callable employee share options or similar instruments subject to ASC 718?

**Answer**
The entity should take the steps indicated in the table below. Note that these steps only apply to employee share options or similar instruments subject to ASC 718 that contain conditional obligations to transfer cash or other assets upon settlement and do not apply to the following awards:

- Employee share options or similar instruments subject to ASC 718 that contain unconditional obligations to transfer cash or other assets. These options or similar instruments must be classified as liabilities pursuant to ASC 718-10-25-11(b). See Q&A 2-27 for a discussion of the classification of employee share options that are required to be settled in cash or other assets upon the occurrence of a contingent event.

- Employee share options or similar instruments that will be settled upon the issuance of shares that themselves must be classified as liabilities under ASC 718-10-25-11 and 25-12.

- Share-based payment awards of puttable or callable shares subject to ASC 718. These awards must be classified pursuant to ASC 718-10-25-9 and 25-10. See Q&A 2-16 for guidance on determining the classification of puttable and callable share awards. ASC 718-10-25-9 and 25-10 also apply to employee share options or similar instruments in which the underlying shares are puttable or callable. In these circumstances, the employee does not begin to bear the risks and rewards normally associated with share ownership until the options or similar instruments are exercised.
### Determining the Classification of Puttable or Callable Employee Share Options or Similar Instruments Subject to ASC 718

<table>
<thead>
<tr>
<th>Step</th>
<th>Question</th>
<th>Answer</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Can the employee elect either cash or share settlement of the share option or similar instrument (i.e., is the method of settlement within the employee’s control)?</td>
<td>If yes, classify the employee share option or similar instrument as a share-based liability. If no, proceed to step 2.</td>
<td>See Q&amp;A 2-27 for a discussion of the effect of contingent repurchase features on the classification of puttable employee share options.</td>
</tr>
<tr>
<td>2</td>
<td>If the employer can choose the method of settlement (i.e., cash or share settlement), does the employer have the intent and ability to settle the employee share option or similar instrument in the employer’s shares?</td>
<td>If no, classify the employee share option or similar instrument as a share-based liability. If yes or not applicable, proceed to step 3.</td>
<td>See Q&amp;A 2-31 for a discussion of the factors to consider when an employer can choose the method of settlement in determining the classification of an employee share option. See Q&amp;A 2-27 for a discussion of the effect of contingent repurchase features on the classification of callable employee share options.</td>
</tr>
<tr>
<td>3</td>
<td>Is the share option or similar instrument modified when the holder is no longer an employee of the entity?</td>
<td>If no, proceed to step 4. If yes, apply ASC 718-10-25-7 to determine whether the employee share option or similar instrument is subject to other applicable GAAP. Proceed to step 4 if liability classification is not required.</td>
<td>See Q&amp;A 2-14 for a discussion of when share-based payment awards subject to ASC 718 are subject to other applicable GAAP.</td>
</tr>
<tr>
<td>4</td>
<td>Is temporary equity classification of the employee share option or similar instrument required under SAB Topic 14.E? This step applies to SEC registrants; non-SEC registrants may elect not to apply it.</td>
<td>If yes, classify the employee share option or similar instrument outside of permanent equity as temporary (or “mezzanine”) equity.</td>
<td>See Q&amp;A 2-21 and Q&amp;A 2-28 for a discussion and example of the application of ASR 268 (FRR Section 211) and ASC 480-10-S99-3A to employee share options with contingent cash settlement features.</td>
</tr>
</tbody>
</table>

### 2-27 Impact of Contingent Cash Settlement Features on the Classification of Employee Share Options

**Question**
How does a contingent cash settlement feature affect the classification of employee share options or similar instruments?

**Answer**
An entity should analyze a contingent cash settlement feature that becomes exercisable only upon the occurrence of a specified future event (i.e., the triggering event) to determine whether the triggering event is within the control of the employee. Triggering events within the control of the employee should be ignored, and the options or similar instruments should be analyzed as if the triggering event has already occurred. Options or similar instruments that require or permit the employee to cash settle the options or similar instruments must be classified as liabilities.

ASC 718-10-25-11 states that if a contingent cash settlement feature becomes exercisable upon a triggering event that is not within the control of the employee and the employee can choose the method of settlement or settlement in cash or other assets is required, the share option or similar instrument will not result in liability classification if it is not probable that the triggering event will occur. The assessment of probability is generally performed on an employee-by-employee basis. For example, a share option that can require cash settlement or net cash settlement upon a change in control should not be classified as a liability unless a change in control is considered probable. Generally, a change in control is not considered probable until the event that triggers it has occurred (e.g., when a business combination has been consummated).

Note that SEC registrants must consider the requirements of ASR 268 (FRR Section 211) and ASC 480-10-S99-3A, as discussed in SAB Topic 14.E. SAB Topic 14.E requires an SEC registrant to present options and similar instruments (otherwise classified as equity) subject to cash settlement features not solely within the control of the issuer outside...
of permanent equity (i.e., as “temporary” or “mezzanine” equity). Temporary equity classification is required even if the options or similar instruments otherwise qualify for equity classification under ASC 718 (e.g., an option that can be cash settled upon a change in control). See Q&A 2-21 and Q&A 2-28 for a discussion and example of the application of ASR 268 and ASC 480-10-S99-3A to employee share options with a contingent cash settlement feature.

The redemption value at issuance is based on the cash settlement feature of the option or similar instrument. For example, the redemption value of an option that can be cash settled at intrinsic value is the intrinsic value of the option. Thus, if an employee share option is granted “at the money,” its initial carrying value would be zero. Subsequent remeasurement in temporary equity is not required under ASC 480-10-S99-3A unless it is probable that the triggering event will occur, in which case the option or similar instrument would be reclassified as a liability under ASC 718. As indicated in ASC 718-10-35-15, an entity would account for a reclassified share option or similar instrument in essentially the same way it would account for a modification that changes the award’s classification from equity to liability. See Q&A 4-18 for a discussion and examples of the accounting for the modification of an award that changes the award’s classification from equity to liability.

If a contingent cash settlement feature becomes exercisable upon a triggering event that is not within the control of the employee and the employer can determine the method of settlement, the share option or similar instrument will not result in liability classification if it is not probable that the event will occur. The probability assessment is generally performed on an employee-by-employee basis. If it becomes probable that the triggering event will occur, the entity must consider the substantive terms of the option or similar instrument, including the entity’s intent and ability to settle the option or similar instrument in cash or shares and the entity’s past practices of settling options or similar instruments, in determining the appropriate classification of the options or similar instruments. See Q&A 2-31 for the factors to consider when an employer can choose the method of settlement in determining the classification of an employee share option.

ASC 480-10-S99-3A does not need to be considered if the employer can choose the method of settlement (i.e., cash or share settlement) since that guidance only applies to awards with redemption features not solely within the control of the issuer (employer). An option or similar instrument with terms that allow the employer to choose the method of settlement will never be classified as temporary equity.

2-28 Applying ASR 268 and ASC 480-10-S99-3A to Employee Share Options With a Contingent Cash Settlement Feature — Example

On January 1, 20X1, Entity A, an SEC registrant, grants 100,000 share options to an employee, each with a grant-date fair-value-based measure of $8. The options are granted with a $10 exercise price when A’s share price is $15 (i.e., the options have an intrinsic value of $5 per share on the grant date). The options vest at the end of the second year of service (cliff vesting) and give the employee the right to require A to net cash settle the options upon a change of control. On February 1, 20X3, when the fair-value-based measure of the options was $15, a change of control became probable. Note that in accordance with ASC 805-20-55-50 and 55-51, which discuss liabilities that are triggered upon the consummation of a business combination, a change in control is generally not probable until it occurs.

From the date of issuance, January 1, 20X1, to January 31, 20X3, the cash settlement feature will not result in liability classification of the options since the change in control is not considered probable. However, on February 1, 20X3, when the change of control becomes probable (i.e., the date it occurs), the options must be reclassified as a share-based liability. The reclassification is accounted for similarly to a modification that changes the awards’ classification from equity to liability. That is, on the date the change in control becomes probable and occurs, A recognizes a share-based liability for the portion of the options that are related to prior service, multiplied by the options’ fair-value-based measure on that date. If the amount recognized as a share-based liability is less than or equal to the amount previously recognized in equity, the offsetting amount is recorded to APIC (i.e., final compensation cost cannot be less than the grant-date fair-value-based measure). If, on the other hand, the amount recognized as a share-based liability is greater than the amount previously recognized in equity, the excess is recognized as compensation cost either immediately (for vested options) or over the remaining service (vesting) period (for unvested options). Because the options are now classified as a liability, they are remeasured at a fair-value-based measure each reporting period.

In addition, as an SEC registrant, A must apply ASR 268 (FRR Section 211) and ASC 480-10-S99-3A. See Q&A 2-21 for a discussion of the application of ASR 268 and ASC 480-10-S99-3A to employee share options with cash settlement features. As a result, from the date of issuance, January 1, 20X1, to January 31, 20X3, A must classify any grant-date intrinsic value outside of permanent equity (i.e., as “temporary” or “mezzanine” equity). Subsequent
Remeasurement in temporary equity is not required under ASC 480-10-S99-3A unless it is probable that the triggering event will occur. However, as noted above, on February 1, 20X3, when the change in control becomes probable, the options must be reclassified as a share-based liability.

Entity A should record the journal entries below. For simplicity, the effects of forfeitures and income taxes have been ignored.

**Journal Entries: December 31, 20X1**

```
Compensation cost 400,000
   APIC 400,000
To recognize compensation cost on the basis of the grant-date fair-value-based measure of the options (100,000 options × $8 grant-date fair-value-based measure × 50 percent for one of two years of services rendered).
```

```
Equity — APIC 250,000
   Temporary equity 250,000
To reclassify a portion of the grant-date intrinsic value of the options to temporary equity in accordance with ASC 480-10-S99-3A (100,000 options × $5 grant-date intrinsic value × 50 percent for one of two years of services rendered).
```

**Journal Entries: December 31, 20X2**

```
Compensation cost 400,000
   APIC 400,000
To recognize compensation cost on the basis of the grant-date fair-value-based measure of the options [(100,000 options × $8 grant-date fair-value-based measure × 100 percent for two of two years of services rendered) – $400,000 compensation cost previously recognized].
```

```
Equity — APIC 250,000
   Temporary equity 250,000
To reclassify a portion of the grant-date intrinsic value of the options to temporary equity in accordance with ASC 480-10-S99-3A [(100,000 options × $5 grant-date intrinsic value × 100 percent for two of two years of services rendered) – $250,000 amount previously reclassified].
```

**Journal Entries: February 1, 20X3**

```
Temporary equity 500,000
   APIC 500,000
To reverse the amount previously recognized in temporary equity in accordance with ASC 480-10-S99-3A once the change in control becomes probable.
```

```
Equity — APIC 800,000
Compensation cost 700,000
   Share-based compensation liability 1,500,000
To recognize (1) a share-based liability on the basis of the fair-value-based measure of the options on the date the change in control becomes probable and (2) compensation cost for the excess of the share-based liability over the amount previously recognized in equity. Because the options are now classified as a liability, A must remeasure the options at a fair-value-based measure each reporting period until settlement.
```
2-29  Impact of Net Share Settlement Features on the Classification of Employee Share Options

Many share-based payment arrangements contain provisions allowing employees to net share settle vested options. These features, which are sometimes referred to as stock option pyramiding, phantom stock-for-stock exercises, and immaculate cashless exercises, allow the employee to exercise an option without having to pay the exercise price in cash.

**Question**

Does a net share settlement feature result in liability classification of an employee share option?

**Answer**

No. A net share settlement feature in and of itself does not result in liability classification of an option. An option that can be net share settled is no different from a share-settled SAR and is not required to be classified as a share-based liability. However, an option may include other features that result in liability classification. See Q&A 2-26 for guidance on determining the classification of puttable and callable employee share options.

However, under the grant-date fair-value-based measurement approach in ASC 718, compensation cost for a net-share-settled option or share-settled SAR is not remeasured (1) unless the option or SAR is modified or (2) other features in the option or SAR result in liability classification.

2-30  Impact of Features Linked to the Consumer Price Index on the Classification of Share-Based Payment Awards

Entities may link the exercise price of an employee share option to the change in the CPI or another similar index (such as the retail price index in the United Kingdom) to eliminate the effect of inflation on the option’s value.

**Question**

How does linking the exercise price of an option to the change in the CPI affect the classification of an employee share option?

**Answer**

ASC 718-10-25-13 indicates that when an award is indexed to a factor in addition to the entity’s share price and that factor is not a market, performance, or service condition, the award must be classified as a liability. A feature that adjusts the exercise price of an option for changes in the CPI does not meet the definition of a market, performance, or service condition. Accordingly, such an award must be classified as a liability.

In contrast, an entity may (1) estimate the change in the CPI (or another similar index) over an option’s requisite service period or its expected life and (2) set a fixed exercise price that is adjusted for that estimate. Because the exercise price is established as of the grant date and not linked to the actual change in the CPI (or another similar index), the option is not considered to be indexed to a factor other than a market, performance, or service condition. Accordingly, such an award, if it otherwise meets the criteria for equity classification, is classified as equity.

**Example 1 — Liability-Classified Award**

Entity A grants employee share options with a grant-date exercise price equal to the market price of A’s shares that increases monthly for inflation (on the basis of changes in the CPI) through the date of exercise.

Because the options’ value is indexed to the CPI and the change in CPI is a factor that is not considered a market, performance, or service condition, the options must be classified as a liability. Entity A must remeasure the options at their fair-value-based measure each reporting period until settlement.

Alternatively, if the options’ terms only require monthly adjustments to the exercise price for changes in CPI through the vesting date, the options would be classified as a liability only until the vesting date. That is, A only must remeasure the options at their fair-value-based measure each reporting period until the vesting date. On the vesting date, the options’ value no longer is indexed to the CPI; therefore, as long as all the other criteria for equity classification have been met, the award would be reclassified as equity.
Example 2 — Equity-Classified Award

Entity A grants employee share options with a grant-date exercise price equal to the grant-date market price of A’s shares that increases annually by 3 percent (on the basis of A’s estimate of annual inflation) through the date of exercise. Before considering the effects of the 3 percent annual increase to the exercise price, A determines that the options should be classified as equity.

Because the options’ value is not indexed to a factor other than a market, performance, or service condition (e.g., a change in the CPI), the options would be classified as equity. Accordingly, the fair-value-based measure of the options is fixed on the grant date, and the increasing exercise price is incorporated into the fair-value-based measure of the options.

2-31 Factors to Consider When an Employer Can Choose the Method of Settlement in Determining the Classification of Employee Share Options (or Similar Instruments)

Question

What factors must an entity consider in determining the classification of employee share options when an employer has the ability to choose the method of settlement (i.e., cash or share settlement)?

Answer

An entity must consider the employer’s intent and ability to settle the options in cash or shares in determining whether the options must be classified as equity or as a liability. An employer’s past practices related to the following may indicate that some or all of the options must be classified as a liability:

- Repurchasing, for cash, options or shares issued upon exercise of the options.
- Net cash settling options.
- Repurchasing, for cash, options or shares issued upon exercise of the options whenever requested by an employee.

The entity must also consider the employer’s ability to deliver shares upon the exercise of options. The employer must have a sufficient number of unissued and authorized shares to settle the options. ASC 718-10-25-15(a) states that a requirement to provide registered shares does not, by itself, imply that the employer does not have the ability to deliver shares. However, if the employer does not have a sufficient number of unissued and authorized shares to settle the options in shares, liability classification of the options may be required.

If the employer can choose the method of settlement (i.e., cash or share settlement), ASC 480-10-S99-3A does not need to be considered since that guidance only applies to awards with redemption features not solely within the control of the issuer (employer). An option (or similar instrument) with terms that allow the employer to choose the method of settlement will never be classified as temporary equity.

2-32 Impact of the Cash Settlement of Fractional Shares as a Result of an Employer’s Minimum Statutory Withholding Obligations on the Classification of Share-Based Payment Awards

Many share-based payment awards permit entities to repurchase a portion of the shares that would otherwise be issued to employees (e.g., upon share option exercise or vesting of nonvested shares), either directly or indirectly through a net settlement feature, to provide payment in connection with the employer’s minimum statutory tax withholding requirements. ASC 718-10-25-18 contains an exception from liability classification for this share repurchase feature. However, it also states:

- If an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee’s discretion, the entire award shall be classified and accounted for as a liability.

Because a whole number of shares is typically withheld from employees (the issuance of fractional shares is typically precluded), the value of a fractional share may be paid in cash directly to the employee. For example, if 24.3 shares must be withheld to satisfy the employer’s minimum statutory withholding tax obligation, the entity typically withholds 25 shares and pays the difference (value of a fractional 0.7 share) in cash directly to the employee.
Question
Does the cash settlement of the fractional share paid directly to the employee result in liability classification of the share-based payment award?

Answer
Generally, no. ASC 718-10-25-18 does not appear to require that an award be classified as a liability as a result of a policy of requiring cash settlement of fractional shares. Therefore, if the cash-settled portion is considered de minimis to the employee, rounding up shares to meet the minimum statutory tax withholding obligation is not considered a violation of ASC 718-10-25-18. However, an entity should evaluate each arrangement to ensure that its substance does not create a liability and to determine that the cash settlement of the fractional share is, in fact, de minimis to the employee.

An entity should evaluate each share-based payment award individually on the basis of the facts and circumstances. However, the following two scenarios may indicate that the arrangement is a liability in substance: (1) there are multiple exercises in small increments (thus increasing the number of fractional shares that are cash-settled, which increases the amount of cash paid to a single employee) and (2) the entity’s stock has a high per-share price such that the cash paid for a fractional share could be significant.

2-33 Impact of Changes in the Amount Withheld to Meet the Employer’s Minimum Statutory Withholding Requirement on the Classification of Share-Based Payment Awards

Assume that the tax authorities allow an entity to calculate the amount of taxes due for a restricted stock award on any date from the vesting date of an award to the entity’s year-end. For administrative ease, on the vesting date, the entity (1) withholds, on the basis of the fair value of the shares on that date, the amount of shares whose fair value is equal to the amount under the employer’s minimum statutory withholding requirement and (2) remits that amount to the tax authorities. At year-end, the entity decides to recalculate the statutory tax withholding amount, which results in a decreased withholding obligation because of a decrease in the fair value of the entity’s shares from the vesting date.

Question
Are there any accounting consequences if the entity (1) requests a refund from the tax authorities for the overpayment and (2) remits the overpayment to the employee?

Answer
It depends on how the tax savings are remitted to the employee. We believe that if the overpayment is remitted to the employee in cash, the transaction substantively represents the withholding of an amount in excess of that under the minimum statutory tax requirement. As a result, in such circumstances, the entire award would have to be classified as a liability in accordance with ASC 718-10-25-18. Alternatively, if the tax savings are remitted to the employee in shares, we believe that the entity should, to avoid any accounting consequences, determine the number of shares remitted to the employee by using the fair value of the shares on the vesting date. In essence, the entity would calculate, on the newly determined date, the minimum statutory tax required (on the basis of the fair value of the shares on that date) and would divide that amount by the fair value of the shares as of the vesting date to determine the amount that would have been withheld as of the vesting date if the entity had known the minimum tax withholding requirement at that time. The excess number of shares between the new calculation and initial calculation would then be remitted to the employee.
Chapter 2 — Recognition
A Roadmap to Accounting for Share-Based Payment Awards

Market, Performance, and Service Conditions

ASC 718-10

Exceptions to Liability Classification

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.

25-21  If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no compensation cost shall be recognized if the requisite service is not rendered. Paragraphs 718-10-55-60 through 55-63 provide guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).

Service and performance conditions are considered vesting conditions. That is, the service or performance condition must be satisfied for an employee to earn (i.e., vest in) an award. Compensation cost only is recognized for awards that are earned or expected to be earned. Compensation cost is not recognized for awards that are forfeited or expected to be forfeited because a service or performance condition is not achieved.

Unlike a service or performance condition, a market condition is not a vesting condition. Rather, a market condition is factored into the grant-date fair-value-based measure of an award. Accordingly, regardless of whether the market condition is satisfied an entity may still be required to recognize compensation cost for the award.

See Chapter 3 for detailed guidance and a discussion of market, performance, and service conditions.

Payroll Taxes

ASC 718-10

25-22  A liability for employee payroll taxes on employee stock compensation shall be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualified option in the United States, generally the exercise date).

25-23  Payroll taxes, even though directly related to the appreciation on stock options, are operating expenses and shall be reflected as such in the statement of operations.
Chapter 3 — Initial Measurement

The cost of the employee services rendered in exchange for share-based payment awards should be measured at the fair-value-based measure of the equity instruments exchanged or the liabilities incurred. The most significant difference between the terms “fair value” (as defined in ASC 820) and “fair-value-based” (as used in ASC 718) is the exclusion of the effects of (1) service and performance conditions that apply only to vesting or exercisability during the requisite service period, (2) reload features, and (3) certain contingent features. Although ASC 718 uses both fair value and fair-value-based when referring to the measurement objective for share-based payment transactions, this publication only uses “fair-value-based.”

For nonpublic entities, there are two exceptions to fair-value-based measurement. (See Q&A 3-29 for a discussion of how the valuation requirements in ASC 718 for nonpublic entities differ from those for public entities.) The first exception is available to nonpublic entities that cannot reasonably estimate the expected volatility of their share price for options or similar instruments. Such entities may substitute the historical volatility of an appropriate industry sector index in lieu of their expected volatility. This measure is referred to as a calculated value rather than as a fair-value-based measure. See Q&A 3-27 for a discussion of when to use the historical volatility of an appropriate industry sector index and Q&A 3-28 for guidance on selecting and computing the historical volatility of an appropriate industry sector index.

The second exception available to nonpublic entities involves the valuation of liability-classified awards. Nonpublic entities can elect, as a policy decision, to measure all liability-classified awards at intrinsic value instead of a fair-value-based measure (or calculated value if a fair-value-based measure is not reasonably practicable) at the end of each reporting period until the award is settled.

Impact of Service, Performance, and Market Conditions on the Fair-Value-Based Measure
An entity should inventory all relevant terms and conditions of a share-based payment award. Each of these terms and conditions may have a direct or indirect effect on the fair-value-based measure of the award. A service or performance condition that affects either the vesting or the exercisability of an award is considered a vesting condition. Vesting conditions are not directly incorporated into the fair-value-based measure of an award. Rather, as discussed in the Recognition chapter, an entity uses vesting conditions to determine whether an award has been earned and therefore whether to record compensation cost for the award. However, a vesting condition can have an indirect impact on the fair-value-based measure by affecting the expected term of an option or similar instrument. Because the expected term of an award cannot be shorter than the vesting period, the longer the vesting period, the longer the expected term of an award. (See the Estimating the Fair-Value-Based Measure subsection below for a discussion of how the required inputs into a valuation technique or model (including expected term) affect the fair-value-based measure of an award. See Q&A 3-34 for a discussion of the effects of service and performance conditions on the fair-value-based measure of an award.)

In contrast, a service or performance condition that affects a factor other than vesting or exercisability (e.g., exercise price, contractual term, quantity, conversion ratio) will be incorporated into an award’s fair-value-based measure. See Q&A 3-23 for a discussion of how service and performance conditions that affect factors other than vesting or exercisability are incorporated into the grant-date fair-value-based measure of an award.

As discussed in the Recognition chapter, a market condition is not a vesting condition. Therefore, a market condition will be directly incorporated into the fair-value-based measure of an award and will not be used to determine (other than indirectly to derive the service period) whether compensation cost will be recorded. To incorporate a market condition into the fair-value-based measure, an entity must use a valuation technique that takes into account all possible outcomes of the market condition. That is, the valuation technique must be able to estimate the value of path-dependent options. One such valuation technique is a Monte Carlo simulation.
See the Estimating the Fair-Value-Based Measure subsection below for a discussion of valuation techniques used to estimate the fair-value-based measure of an award. See Q&A 3-34 for a discussion of the effects of market conditions on the fair-value-based measure of an award.

**Measurement Date**

For equity-classified awards granted to employees, the measurement date is the grant date. That is, the grant date is the date on which the measurement of the award is fixed. As discussed in the Recognition chapter, the service inception date may precede the grant date. As a result, even though an entity may begin to record compensation cost before the grant date, the fair-value-based measure of an equity-classified award is not fixed until the grant date. In periods before the grant date, compensation cost is remeasured on the basis of the award’s estimated fair-value-based measure at the end of each reporting period to the extent that service has been rendered in proportion to the total requisite service period. See Q&A 4-07 for guidance on accounting for a share-based payment award when the service inception date precedes the grant date.

For liability-classified awards granted to employees, the ultimate measurement date is the settlement date. That is, unlike equity-classified awards, liability-classified awards are remeasured at their fair-value-based measure in each reporting period until settlement. The changes in the fair-value-based measure of the liability-classified award at the end of each reporting period are recognized as compensation cost either immediately or over the remaining service period (or both), depending on the vested status of the award. See Q&A 3-35 for a discussion of the difference between the accounting for equity-classified awards and that for liability-classified awards.

**Estimating the Fair-Value-Based Measure**

To determine the fair-value-based measure of a share-based payment award, an entity must use the observable market price of an instrument with the same or similar terms if such an instrument is available. (See Q&A 3-05 for a discussion of what constitutes an observable market price and Q&A 3-04 for the SEC’s views on the use of “market instruments” to measure the fair-value-based measure of share-based payment awards.) Because market instruments with terms that are the same as or similar to those of employee share options and similar instruments are generally unavailable, an entity must use a valuation technique (e.g., an option pricing model) to estimate the fair-value-based measure of employee share options and similar instruments. For nonvested shares, an entity must generally use the fair value of its equity shares to estimate the fair-value-based measure of the nonvested shares. See Q&A 3-25 for a discussion of the valuation of nonvested shares. The valuation technique that an entity uses to estimate the fair-value-based measure of an employee share option or a similar instrument must:

1. Be applied in a manner consistent with the fair-value-based measurement objective of ASC 718.
2. Be based on established principles of financial economic theory and generally applied in the valuation field.
3. Reflect all substantive characteristics of the instrument (except for items that are specifically excluded from the fair-value-based measurement objective, such as vesting conditions, reload features, and certain contingent features).

Two of the most common valuation techniques that meet these criteria are (1) lattice models (e.g., binomial models) and (2) closed-form models (e.g., the Black-Scholes-Merton formula). With a lattice model, an entity estimates the fair-value-based measure by considering the assumed changes in prices of the instrument over successive periods and by incorporating assumptions about (1) employee exercise behavior over the life of each share option grant and (2) changes in expected stock-price volatility. With a closed-form model, an entity employs an equation to estimate the fair-value-based measure by using key determinants of a share option’s price, such as the current market price of the underlying share, exercise price, expected volatility of the underlying share, time to expiration (i.e., expected term), and a risk-free interest rate for the expected term of the award.

ASC 718 does not prescribe the use of a particular valuation technique or model. As long as the valuation technique or model is consistent with the fair-value-based measurement objective and meets the other criteria outlined above, the selection of such a technique or model will depend on the substantive characteristics of the employee share option or similar instrument (e.g., whether it contains a market condition). See Q&A 3-01 for more information about selecting a valuation technique or model.
An entity must, at a minimum, take the following inputs into account when using a valuation technique or model to estimate the fair-value-based measure of an employee share option or similar instrument:

1. Exercise price.
2. Expected term.
3. Current market price of the underlying share.
4. Expected volatility of the underlying share.
5. Expected dividends on the underlying share.
6. Risk-free interest rate for the expected term.

ASC 718-10-55-13 through 55-50 provide additional guidance on determining the assumptions used in the valuation model. In addition, SAB Topics 14.C and 14.D contain the SEC’s views on the valuation of share-based payments. See Q&A 3-06 for a discussion of the impact of each of the above inputs on the fair-value-based measure of an employee share option or similar instrument.

An entity may subsequently change the valuation technique or model used to estimate the fair-value-based measure of an option or similar instrument. See Q&A 3-03 for guidance on when an entity can subsequently change a valuation technique or model.

### Fair-Value-Based

<table>
<thead>
<tr>
<th>ASC 718-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-1</strong> While some of the material in this Section was written in terms of awards classified as equity, it applies equally to awards classified as liabilities.</td>
</tr>
<tr>
<td><strong>30-2</strong> 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.</td>
</tr>
<tr>
<td><strong>30-3</strong> An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this Topic. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.</td>
</tr>
<tr>
<td><strong>30-4</strong> However, this Topic provides certain exceptions (see paragraph 718-10-30-21) to that measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date. A nonpublic entity also may choose to measure its liabilities under share-based payment arrangements at intrinsic value (see paragraphs 718-10-30-20 and 718-30-30-2).</td>
</tr>
<tr>
<td><strong>Terms of the Award Affect Fair Value</strong></td>
</tr>
<tr>
<td><strong>30-5</strong> The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note.</td>
</tr>
</tbody>
</table>
Measurement Objective — Fair Value at Grant Date

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.

30-7 The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (see paragraph 718-10-55-10).

30-8 Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future.

30-9 As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not. Paragraphs 718-10-55-4 through 55-47 provide additional guidance on estimating the fair value of equity instruments, including the factors to be taken into account in estimating the fair value of equity share options or similar instruments as described in paragraphs 718-10-55-21 through 55-22.

3-01 Selecting a Valuation Technique to Value Share-Based Payment Awards

Question
What considerations should an entity take into account when selecting a valuation technique to value its share-based payment awards?

Answer
ASC 718 generally requires the use of a fair-value-based measurement method. Fair value is described as the amount at which market participants would be willing to conduct transactions. In the absence of an observable market price, an entity should use a valuation technique to estimate the fair-value-based measure. Currently, the Black-Scholes-Merton (closed-form) and binomial (lattice or open-form) models are the most commonly used valuation techniques for options and similar instruments. While ASC 718 does not prescribe a particular valuation technique, it does require that the technique selected be consistent with the fair-value-based measurement objective.\(^1\) To meet the fair-value-based measurement objective, a valuation technique should be (1) applied in a manner consistent with the fair-value-based measurement objective, (2) based on established principles of financial theory and generally applied in the field, and (3) capable of incorporating all of the substantive characteristics unique to employee share options. ASC 718-10-55-21 states that the selected valuation technique should, at a minimum, incorporate the following inputs:

- The award’s exercise price.
- The award’s expected term.
- The current market price of the underlying share.
- The expected volatility of the underlying share price.
- The expected dividends on the underlying share.
- The risk-free interest rate for the expected term of the award.

See Q&A 3-06 for a discussion of the impact that the various inputs used in valuation techniques have on estimating the fair-value-based measure of a share-based payment award.

Entities are generally required to use the same groups of inputs under the Black-Scholes-Merton model as they do under the lattice model. The key difference is that the lattice model allows entities to assume variations to these inputs during the contractual term of the award. The selection of an appropriate valuation technique will therefore depend on the substantive characteristics of the award being valued. For example, the lattice model produces, as an output, the expected term of the award, which will depend on the employees’ exercise and post-vesting

\(^1\) The fair-value-based measurement objective requires that assumptions reflect information that is (or would be) available to form the basis for an amount at which the instruments being valued would be exchanged. In the estimation of the fair-value-based measure, the assumptions used should not represent the biases of a particular party.
termination behavior. The lattice model also allows entities to vary the volatility of the underlying share price, the risk-free interest rate, and the expected dividends on the underlying shares, since changes in these factors are expected to occur over the contractual term of the option. The lattice approach can be used to directly model the effect of different expected periods before exercise on the fair-value-based measure of the option, whereas the Black-Scholes-Merton model assumes that exercise occurs at the end of the option’s expected term.

The lattice model may therefore be better suited to capture and reflect the substantive characteristics of a particular share-based payment award. It would generally not be appropriate for an entity to use the Black-Scholes-Merton model to value a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares (i.e., a market condition). This is because the Black-Scholes-Merton model is not designed to take into account this type of market condition and therefore does not incorporate all of the substantive characteristics unique to the share option being valued. However, the lattice model can be used to determine the fair-value-based measure of an award containing a market condition since this model can incorporate multiple estimates of when the market condition will be achieved and can thereby reflect all substantive characteristics of the share option being valued. Whether it is practical to use a lattice model is based on a variety of factors, including the availability of reliable data to support the variations in the inputs. Entities should develop reasonable and supportable estimates for each of the inputs and the underlying assumptions, regardless of the valuation technique applied.

The SEC also stated in Question 2 of SAB Topic 14.C that the SEC staff understands that an entity may consider multiple techniques or models that meet the fair-value-based measurement objective before selecting the appropriate technique or model. The SEC staff would not object to an entity’s choice of a technique or model that meets the fair-value-based measurement objective. For example, an entity is not required to use a lattice model simply because that model was the most complex of the models the entity considered.

3-02 Using Multiple Valuation Techniques to Estimate the Fair-Value-Based Measure of Share-Based Payment Awards

Question
Can entities use more than one valuation technique to estimate the fair-value-based measure of their share-based payment awards?

Answer
Yes. Entities may use different valuation techniques to estimate the fair-value-based measure of different types of share-based payment awards. However, they should use the selected model consistently for similar types of awards with similar characteristics. For example, an entity may use a lattice model to estimate the fair-value-based measure of awards with a market condition and use the Black-Scholes-Merton formula to estimate the fair-value-based measure of awards that contain only a service or performance condition. Alternatively, an entity may use a lattice model to estimate the fair-value-based measure of employee share options and the Black-Scholes-Merton formula to estimate the fair-value-based measure of awards in an ESPP.

Entities are not expected to change valuation techniques or models frequently for similar types of share-based payment awards from period to period. See Q&A 3-03 for a discussion of changing valuation techniques or models to value share-based payment awards.

If an entity changes its valuation technique or model for a certain type of award, the entity should apply the new valuation technique or model to all of the corresponding newly issued awards. A change in valuation method will not affect the fair-value-based measures of previously issued awards; awards issued before the adoption of the new technique should not be remeasured or revalued unless they are modified.

3-03 Changing Valuation Techniques Used to Value Share-Based Payment Awards

Under ASC 718-10-55-27, entities must consistently apply a valuation technique and the technique should not be changed “unless a different valuation technique is expected to produce a better estimate” of the fair-value-based measure. A change in valuation technique should be accounted for as a change in accounting estimate and should be applied prospectively to new awards.

Question
In subsequent periods, may an entity change the valuation technique or model previously used to value a specific type of award?
Answer

Question 3 of SAB Topic 14.C states that an entity may change its valuation technique or model as long as the new technique or model meets the fair-value-based measurement objective in ASC 718. See Q&A 3-01 for more information on selecting a valuation technique to value a share-based payment award. However, the SEC also stated that it would not expect an entity to frequently switch between valuation techniques or models, particularly when there is no significant variation in the type of award being valued. An entity should generally only change its valuation technique or model to improve the estimate of the fair-value-based measure, not simply to reduce the amount of compensation cost recognized.

3-04 SEC’s Views on Using Market Instruments in the Fair-Value-Based Measurement of Employee Share Options

Question

The fair-value-based measure of an employee share option should be based on an observable market price of similar options, if available. What are the SEC’s views on designing instruments to sell in the market and using the instruments’ transaction prices as the fair-value-based measure of employee share options?

Answer

The SEC’s Office of Economic Analysis (OEA) has indicated that any market-based approach must contain the following three elements:

- An instrument design that meets the fair value measurement objectives of ASC 718.
- An information plan to help investors properly value the instrument.
- A market pricing mechanism through which an instrument can be traded to generate a price.

Regarding instrument design, then SEC Chief Accountant Donald Nicolaisen indicated in a September 9, 2005, statement that entities should be able to design instruments with transaction prices that reasonably estimate the fair value of underlying employee stock options by using a “tracking approach.” Under the tracking approach, an entity issues an instrument that incorporates rights to future payouts that are identical to the future flows of net receipts by employees or net obligations of the entity under the grant. When willing buyers and sellers trade a tracking instrument, they devote resources to estimating the value of the instrument and reveal this information through the market price. For the fair-value-based measure of an employee share option to be replicated, the holder’s ability to trade or hedge the instrument cannot be restricted, even though employees are likely to face such restrictions.

Mr. Nicolaisen also stated that entities must be able to sufficiently resolve questions about significant differences in the expected price (determined on the basis of widely used modeling techniques) and actual transaction price of the market instrument.

The SEC indicated that instruments designed under a “terms and conditions approach,” with which an entity tries to replicate the terms of an employee share option (such as nontransferability) and impose them on a market instrument, do not produce values that are consistent with ASC 718.

In an October 17, 2007, letter to Zions Bancorporation, then SEC Chief Accountant Conrad Hewitt commented on the use of employee stock option appreciation rights securities (ESOARS) to determine the fair value of employee share-based payment awards. The letter indicated that, subject to certain conditions, ESOARS are sufficiently designed to meet the measurement objective of ASC 718 and may be used as a market-based approach to value employee share options. That is, if certain conditions are met, entities that issue employee share options may use ESOARS (or an acceptably designed alternative) in lieu of existing valuation techniques (e.g., the Black-Scholes-Merton formula or a binomial model) to determine the grant-date fair value of an employee share option.

3-05 Observable Market Price of a Share-Based Payment Award

Question

What constitutes an observable market price of a share-based payment award?

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3 ESOARS are derivative securities that are sold to investors. They are designed to (1) track the value of a referenced pool of employee share options (i.e., there is no one-to-one correlation between the issuance of an employee share option and ESOARS), (2) pay investors as employee share options are exercised, (3) make payments to their investors on the basis of a pro rata share of the intrinsic value realized by employees upon exercise of their share options in the referenced pool, and (4) be priced, upon issuance, through a modified Dutch auction.
Answer

An observable market price is the price that buyers are paying for a liability or equity instrument (with the same or similar terms) in an active market. Entities should exercise judgment to determine whether an instrument is being traded in an active market and whether the instrument being traded is similar to the instrument being valued. Factors to consider include, but are not limited to:

- The volume of trading.
- The number of instruments available for trading.
- The purchaser of the instruments (e.g., related parties).
- Whether the terms of the instrument incorporate adjustments to mirror employee termination behavior.
- Indications that the buyer did not pay market price.
- Potential effects of dilution.

For example, a price established through an isolated transaction in which a broker sells options that are identical to options issued to employees might not be considered an observable market price. Similarly, an active market for traded options may not provide an appropriate basis for entities to determine the fair-value-based measure of options issued to employees if traded options are not similar to employee share options, which will most likely be the case for exchange traded options. Employee share options generally differ from traded options in that (1) the employees cannot sell their share options — they can only exercise them and (2) the term of most employee share options truncates upon termination of the option holder’s employment contract. In addition, some employee share options prohibit the exercising of options during blackout periods. This inability to sell an employee share option can effectively reduce the option’s value and differentiates it from traded options.

3-06 Effects of Inputs Used in Estimating the Fair-Value-Based Measure of a Share-Based Payment Award

While ASC 718 does not require the use of a particular valuation model for determining the fair-value-based measure of a share-based payment award, ASC 718-10-55-21 does require, at a minimum, that the valuation model used incorporate the following inputs:

- The exercise price of the award.
- The expected term of the award.
- The current market price of the underlying share.
- The expected volatility of the underlying share price.
- The expected dividends on the underlying share.
- The risk-free interest rate for the expected term of the award.

Question

How does a change in each of the aforementioned inputs affect the fair-value-based measure of a share-based payment award?

Answer

When an individual option pricing model input fluctuates, it will generally affect the other inputs. For example, as volatility increases, more option holders will take advantage of the fluctuation in share prices by exercising their options. The increase in the number of exercises will affect the expected term, which in turn will require an adjustment to the expected dividend and risk-free interest rates. Therefore, as long as all other variables are held constant, the effects of a change in each individual input factor on the fair-value-based measure of a share-based payment award (e.g., an employee share option) are as follows:

- Exercise price of the award and current market price of the underlying share — These inputs are generally defined in the terms of each award. That is, the current market price of the underlying share for an award granted by a public entity is usually the quoted market price of the entity’s common stock on the grant.
date and the exercise price is the amount of cash an employee is required to pay to exercise the award. An increase in the exercise price will decrease the fair-value-based measure of an award, whereas an increase in the current market price will increase the fair-value-based measure of an award. Accordingly, the relationship between the exercise price of an award and the current market price of the entity’s common stock will affect the fair-value-based measure of an award. That is, on the grant date, an option that is issued “in-the-money” (i.e., the exercise price is less than the current market price of the entity’s common stock) will have a greater fair-value-based measure than an option issued “at the money” or “out of the money.” At-the-money options are awards with an exercise price equal to the current market price of the entity’s common stock, whereas out-of-the-money options are awards with an exercise price that exceeds the current market price of the entity’s common stock.

• **Expected term of the award** — The expected term of an award is the period for which the award is expected to be outstanding (i.e., the period from the service inception date, which is usually the grant date, to the date of expected exercise or settlement). The fair-value-based measure of an award increases as the expected term of the award increases as a result of the increase in its time value. The time value of an award is the portion of an award’s fair-value-based measure that is based on (1) the amount of time remaining until the expiration date of the award and (2) the notion that the underlying components that determine the value of the award may change during that time. See Q&A 3-11 for a discussion of factors to consider in estimating the expected term of an award.

• **Expected volatility of the underlying share price** — Expected volatility of the underlying share price is a probability-weighted measure of the expected dispersion of share prices about the mean share price over the expected term of the award. The fair value of a traded option increases with an increase in volatility. A high volatility indicates that the share price fluctuates more (up or down from the mean share price), which gives the option holder more potential benefit. For example, if an option is issued at the money, the holder of an option with a share price that is highly volatile has a greater chance of being able to exercise the option when the share price fluctuates to a higher value, and sell that share for a profit, than a holder of a similar option with an underlying share price that is less volatile. See Q&A 3-07 for a discussion of the factors to consider in estimating the expected volatility of the underlying share price and Q&A 3-08, Q&A 3-09, and Q&A 3-10 for a discussion of the SEC staff’s views on estimating the expected volatility of the underlying share price in valuing a share-based payment award.

• **Expected dividends on the underlying share** — The expected dividends on the underlying share represent the expected dividends or dividend rate that will be paid out on the underlying shares during the expected term of the award. Expected dividends should only be included in the valuation model to the extent that the award holders are not entitled to receive those dividends. Consequently, as expected dividends increase, the fair-value-based measure of the award decreases. See Q&A 3-15 for a discussion of how dividends paid on employee share options during the service (vesting) period affect the valuation of such awards.

• **Risk-free interest rate for the expected term of the award** — Higher interest rates will increase the fair-value-based measure of an award by increasing the award’s time value. The risk-free rate is a theoretical interest rate at which an investment earns interest without incurring any risk. The notion is used extensively in option pricing theory, under which all assets may be assumed to have expected returns equal to the risk-free rate. The risk-free rate in the United States is assumed to be a treasury rate with a remaining term equal to the expected term of the award (e.g., United States Treasury zero-coupon issues).

### 3-07 Factors to Consider in Estimating Expected Volatility of the Underlying Share Price in Valuing a Share-Based Payment Award

ASC 718-10-20 defines volatility, in part, as follows:

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.

**Question**

When valuing a share-based payment award, which factors should entities consider in estimating the expected volatility of the underlying share price?
Answer

ASC 718-10-55-24 states that “[h]istorical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience shall be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past.”

ASC 718 does not specify a method for estimating the expected volatility of the underlying share price; rather, ASC 718-10-55-35 clarifies that the objective in estimating the expected volatility of the underlying share price is to ascertain the “assumption about expected volatility of the underlying share price that marketplace participants would be likely to use in determining an exchange price for an option.” ASC 718-10-55-37 provides a list of factors that entities are required to consider in estimating the expected volatility of the underlying share price. The method for estimating the volatility of the underlying share price on the basis of these factors should be applied consistently from period to period. Entities should only adjust the factors or assign more weight to an individual factor on the basis of objective information that support such adjustments. Entities should incorporate any relevant new or different information that would be useful in estimating expected volatility of the underlying share price.

Question 1 of SAB Topic 14.D.1 states that entities should make good-faith efforts to identify and use sufficient information to determine whether historical volatility, implied volatility, or a combination of both will result in the best estimate of expected volatility of the underlying share price. See Q&A 3-08, Q&A 3-09, and Q&A 3-10 for the SEC staff’s views on estimating the expected volatility of an underlying share price. Entities are required to consider the following factors in estimating expected volatility:

1. Historical Volatility of the Underlying Share Price

Entities typically value employee share options by using the historical volatility of the underlying share price. The historical volatility of the underlying share price is based on the most recent volatility of the share price over the expected term of the option when a closed-form model is being used and the contractual term when a lattice model is being used. ASC 718-10-55-37(a) states that entities may disregard the volatility of the share price for an identifiable period if the volatility of the share price resulted from a condition (e.g., failed takeover bid) specific to the entity and the condition is not expected to recur during the expected or contractual term. However, for a condition not specific to the entity (e.g., general market declines), an entity would generally not be allowed to exclude or place less weight on the volatility of its share price during that period unless objectively verifiable evidence supports the expectation that market volatility will revert to a mean that will differ materially from the volatility during the specified period. See Q&A 3-08 for a discussion of the SEC staff’s views on the computation of historical volatility.

2. Implied Volatility of the Underlying Share Price

The implied volatility of the underlying share price is not the same as the historical volatility of the underlying share price. The implied volatility of the underlying share price is derived from the price of traded options or traded financial instruments other than the entity’s own shares. Implied volatility can be calculated with the Black-Scholes-Merton formula by including the fair value of the option (i.e., the market price of the traded option) and other inputs (stock price, exercise price, dividend rate, and interest rate) and solving for volatility. When valuing employee share options, entities should carefully consider whether the implied volatility of a traded option is an appropriate basis for expected volatility of the underlying share price. For example, traded options usually have much shorter terms than employee share options and the calculated implied volatility does not take into account the possibility of mean reversion.4 To compensate for mean reversion, entities could calculate a long-term implied volatility with statistical tools. For example, entities with traded options with terms ranging from 2 to 12 months can plot the volatility of these options on a volatility curve and use statistical tools to plot a long-term implied volatility for a traded option with an expected or contractual term equal to an employee share option.

Generally, entities that can observe sufficiently extensive trading of options and can therefore plot an accurate long-term implied volatility curve should place greater weight on implied volatility than the historical volatility of their own share price. That is, traded option price volatility is more informative in the determination of expected volatility of an entity’s stock price than historical stock price volatility, since option prices take into account the option trader’s forecasts of future stock price volatility. In contrast to traded options, stock prices take into account the equity trader’s forecast of future cash flows payable to the stock holders. Refer to Q&A 3-09 for a discussion of the SEC staff’s views on the extent of reliance on implied volatility.

4 ASC 718-10-55-37(a) states, in part, “Mean reversion refers to the tendency of a financial variable, such as volatility, to revert to some long-run average level. Statistical models have been developed that take into account the mean-reverting tendency of volatility.”
3. Limitations on Availability of Historical Data

Public entities should compare the length of time an entity’s shares have been publicly traded with the expected or contractual term of the option. A newly public entity may also consider the expected volatility of the share prices of similar public entities. Entities can consider factors such as industry, stage of life cycle, size, and financial leverage to determine similar entities.

Nonpublic entities may base the expected volatility of their share prices on that of similar publicly traded entities. When a nonpublic entity is unable to reasonably estimate its entity-specific volatility or that of a similar publicly traded entity, it may use calculated value. Refer to Q&A 3-27 and Q&A 3-28 for a discussion of when a nonpublic entity may use the historical volatility of an appropriate industry sector index and what a nonpublic entity should consider in selecting and computing the historical volatility of an appropriate industry sector index when valuing share-based payment awards.

4. Data Intervals

If an entity considers the historical volatility of its share price in estimating the expected volatility of its share price, then the entity should use intervals for price observations that (1) are appropriate on the basis of the circumstances and (2) provide the basis for a reasonable estimate of a fair-value-based measure. See Q&A 3-08 for a discussion of the SEC staff’s views on frequency of price observations.

5. Changes in Corporate and Capital Structure

An entity’s corporate and capital structure could impact the expected volatility of its share price (e.g., highly leveraged entities tend to have higher volatilities of their share prices). Entities should take changes in the corporate and capital structure into account since the historical volatility of a share price for a period when the entity was, for example, highly leveraged may not be representative of future periods when the entity is not expected to be highly leveraged.

3-08 SEC Staff’s Views on the Computation of Historical Volatility of the Underlying Share Price in Valuing a Share-Based Payment Award

**Question**

What are the SEC staff’s views on factors an entity should consider in the computation of historical volatility of the underlying share price in valuing a share-based payment award?

**Answer**

Question 2 of SAB Topic 14.D.1 and the response state:

> Question 2: What should Company B consider if computing historical volatility?

> Interpretive Response: The following should be considered in the computation of historical volatility:

1. **Method of Computing Historical Volatility**

   The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B’s expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B’s historical volatility much more heavily than earlier periods. For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history.

   2. **Amount of Historical Data**

   FASB ASC subparagraph 718-10-55-37(a) indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.
3. Frequency of Price Observations

FASB ASC subparagraph 718-10-55-37(d) indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate. Company B should select a consistent point in time within each interval when selecting data points.

4. Consideration of Future Events

The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option. Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

5. Exclusion of Periods of Historical Data

In some instances, due to a company’s particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility. In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff believes these situations would be rare.

3-09 SEC Staff’s Views on the Extent of Reliance on Implied Volatility of the Underlying Share Price in Valuing a Share-Based Payment Option

Question

What are the SEC staff’s views on factors an entity should consider when evaluating the extent of its reliance on the implied volatility of the underlying share price derived from its traded options in valuing a share-based payment award?

Answer

Question 3 of SAB Topic 14.D.1 and the response state:

Question 3: What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

Interpretive Response: To achieve the objective of estimating expected volatility as stated in FASB ASC paragraphs 718-10-55-35 through 718-10-55-41, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to
Chapter 3 — Initial Measurement
A Roadmap to Accounting for Share-Based Payment Awards

synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and 4) the similarity of the length of the term of the traded and employee share options.46

1. Volume of Market Activity

The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect a marketplace participant’s expectations regarding expected volatility.

2. Synchronization of the Variables

Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. Similarity of the Exercise Prices

The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant.47 If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.48

4. Similarity of Length of Terms

The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share option’s contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater.49 However, when using traded options with a term of less than one year,50 the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option. The staff believes Company B’s evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the market’s expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.


47 Implied volatilities of options differ systematically over the “moneyness” of the option. This pattern of implied volatilities across exercise prices is known as the “volatility smile” or “volatility skew.” Studies such as “Implied Volatility” by Stewart Mayhew, Financial Analysts Journal, July-August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

48 The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of $52, but the only traded options available have exercise prices of $50 and $55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of $55 and a 60% weight on the option with an exercise price of $50.

49 The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.

50 The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.
3-10 SEC Staff’s Views on Relying Exclusively on Either Implied or Historical Volatility in Estimating Expected Volatility of the Underlying Share Price

Question
What are the SEC staff’s views on entities’ exclusive reliance on either implied volatility or historical volatility when estimating expected volatility of the underlying share price in valuing a share-based payment award?

Answer
Question 4 of SAB Topic 14.D.1 and the response state:

Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?

Interpretive Response: As stated above, FASB ASC Topic 718 does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity’s estimate of expected volatility be reasonable and supportable. Many of the factors listed in FASB ASC Topic 718 are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in FASB ASC Topic 718, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option. The staff believes that a company, after considering the factors listed in FASB ASC Topic 718, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

The staff would not object to Company B placing exclusive reliance on implied volatility [or historical volatility] when the following factors are present, as long as the methodology is consistently applied:

<table>
<thead>
<tr>
<th>[Implied Volatility]</th>
<th>[Historical Volatility]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options; 53</td>
<td>Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past; 55</td>
</tr>
<tr>
<td>The implied volatility is derived from options that are actively traded;</td>
<td>The computation of historical volatility uses a simple average calculation method;</td>
</tr>
<tr>
<td>The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;</td>
<td>A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and</td>
</tr>
<tr>
<td>The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options; 54</td>
<td>A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period; 56</td>
</tr>
<tr>
<td>The remaining maturities of the traded options on which the estimate is based are at least one year.</td>
<td></td>
</tr>
</tbody>
</table>

51 FASB ASC paragraphs 718-10-55-36 through 718-10-55-37.
52 FASB ASC paragraph 718-10-55-35.
53 FASB ASC paragraphs 718-10-55-18 and 718-10-55-39 discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the option’s contractual term should consider the factors listed in FASB ASC Topic 718, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.
54 When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.
55 See FASB ASC paragraph 718-10-55-38. A change in a company’s business model that results in a material alteration to the company’s risk profile is an example of a circumstance in which the company’s future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company’s business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.
56 If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.
3-11  Estimating the Expected Term of an Award in Valuing a Share-Based Payment Option

ASC 718-10-55-30 states, in part:

The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement).

Question

What factors should entities consider in estimating the expected term of an award in valuing an option or similar instrument?

Answer

The SEC has given entities the option to use a simplified method to estimate the expected term of “plain vanilla” employee share options in certain cases. See Q&A 3-12 for an example of an entity’s use of the simplified method for estimating the expected term of an employee share option.

ASC 718-10-55-24 states, in part, that “[h]istorical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience shall be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past.”

ASC 718 does not specify a method of estimating the expected term of an award; rather, ASC 718-10-55-31 provides certain factors an entity may consider in estimating the expected term of an award. The method for estimating the term of an award must be objectively supportable, and any adjustments to historical observations should be supported by objective data. Similarly, historical observations should be accompanied by information on why future observations are not expected to change. ASC 718-10-55-31 provides the following factors an entity may consider in estimating the expected term of an award:

• The vesting period of the award — Options generally cannot be exercised before vesting; thus, the expected term of an option cannot be less than the vesting period of the option.

• Employees’ historical exercise and postvesting employment termination behavior for similar grants — Under ASC 718-10-55-24, expectations of future employee exercise and postvesting termination behavior should be based on historical experience. Historical exercise patterns should be modified when current information suggests that future behavior will differ from past behavior. For example, rapid increases in an entity’s stock price in the past after a release of a new product could have caused more employees to exercise their options as soon as the options vested. If a similar increase in the entity’s stock price is not expected, an entity should consider whether adjusting the historical exercise patterns is appropriate.

• Expected volatility of the underlying share price — An increase in the volatility of the underlying share price tends to result in an increase in exercise activity because more employees take advantage of the volatility in an entity’s share price to realize potential gains on the exercise of the option and subsequent sale of the underlying shares. ASC 718-10-55-31(c) states, “An entity also might consider whether the evolution of the share price affects an employee’s exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time).” The exercise behavior based on the evolution of an entity’s share price can be more easily incorporated into a lattice model than into a closed-form model.

• Blackout periods — A blackout period is a period during which exercise of an option is contractually or legally prohibited. Blackout periods and other arrangements that affect exercise behavior for options can be included in a lattice model. Unlike a closed-form model, a lattice model can be used to calculate the expected term of an option by taking restrictions on exercises and other postvesting exercise behavior into account.

• Employees’ ages, lengths of service, and home jurisdictions — Historical exercise information could have been affected by the profile of the employee group. For example, during a bull market, entities are more likely to have greater turnover of employees since more opportunities are available. Many of these employees will exercise their options as early as possible. These historical exercise patterns should be adjusted if similar turnover rates are not expected to recur in the future.
• Other relevant information — ASC 718-10-55-32 states that the “expected term [of an award] 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.” When entities take external peer group information into account, evidence should be available to support that the data has been sourced from entities with comparable facts and circumstances.

• Aggregation of awards into homogeneous groups — Individual awards should be aggregated into relatively homogeneous groups if identifiable groups of employees display or are expected to display significantly different exercise behaviors. For example, hourly employees will tend to exercise their options for a smaller percentage gain than salaried employees. For employee groupings, the response to Question 4 of SAB Topic 14.D.2 states that the SEC staff believes that an entity may generally make a reasonable fair-value-based estimate with as few as one or two groupings. The SEC staff believes that the focus should be on groups of employees with significantly different exercise behavior, such as executives and nonexecutives.

3-12 Simplified Method for Estimating the Expected Term of an Employee Share Option

Question
What are the SEC staff’s views on an entity’s use of a simplified method for estimating the expected term of an employee share option?

Answer
Before it was amended by SAB 110, Question 6 of SAB Topic 14.D.2 outlined a simplified method of estimating the expected term of “plain-vanilla” employee share options. SAB 110 permits entities, under certain circumstances, to continue to use the simplified method even after the December 31, 2007, sunset date established by the preamended version of Question 6.

Before Question 6 was amended, an entity was permitted, through December 31, 2007, to avail itself of the safe harbor under the simplified method regardless of whether the entity had enough information to refine its estimate of the expected term. In contrast, under the amended version, an entity must exercise professional judgment and may use the simplified method only if it concludes that it is not reasonable to base its estimate of the expected term on its historical employee share option exercise experience. Therefore, the simplified method will no longer be permitted in many cases.

SAB 110 provides the following examples of situations in which it may be appropriate for an entity to use the simplified method:

• A company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time its equity shares have been publicly traded.
• A company significantly changes the terms of its share option grants or the types of employees that receive share option grants such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.
• A company 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 expected term.

SAB 110 also states that an entity may use the simplified method for some, but not all, of its employee share option grants. That is, the SEC staff will accept the use of the simplified method for grants when an entity does not have sufficient historical exercise data. An entity should not consider using a lattice model before determining whether it is eligible to use the simplified method.

The SEC staff also indicates in SAB 110 that entities may use the simplified method before they become public. In addition, at the September 13, 2005, meeting of the FASB Statement 123(R) Resource Group, the FASB and SEC staffs stated that they would not object to a nonpublic entity’s use of the simplified method described in the preamended version of Question 6 as long as the requirements of SAB Topic 14 were met. Therefore, a nonpublic entity should be able to avail itself of the provisions in the amended version of Question 6.

5 SAB Topic 14 describes a plain vanilla award as an award with the following basic characteristics:
• The share options are granted at the money;
• Exercisability is conditional only on performing service through the vesting date [i.e., the requisite service period equals the vesting period];
• If an employee terminates service prior to vesting, the employee would forfeit the share options;
• If an employee terminates service after vesting, the employee would have limited time to exercise the share options (typically 30–90 days); and
• The share options are nontransferable and nonhedgeable.
Finally, an entity that uses the simplified method should disclose the following information in the notes to its financial statements:

- That the simplified method was used.
- The reason the method was used.
- The types of share option grants for which the simplified method was used, if it was not used for all share option grants.
- The period(s) for which the simplified method was used, if it was not used in all periods presented.

SAB 110 does not specify when the use of the simplified method will be discontinued; however, entities should be aware that the SEC staff believes that when more detailed external information about exercise behavior becomes available, the simplified method will no longer be used for share option grants.

Note that for an entity’s employee share options to qualify as plain-vanilla, which would allow the entity to use the simplified method, the share options must have only the basic characteristics of a share-based payment award that are detailed in Question 6 of SAB Topic 14.D.2. See Q&A 3-13 for examples of awards that would not qualify as plain-vanilla options.

Example
An entity grants “at-the-money” employee share options, each with a contractual term of 10 years. The options meet the criteria for plain-vanilla options outlined in Question 6 of SAB Topic 14.D.2. The options vest in 25 percent increments (tranches) each year over the next four years (a graded vesting schedule). Therefore, under the simplified method, the expected term of the options would be 6.25 years, calculated as follows:

\[
\begin{align*}
1\text{-year vesting term} \times \text{first 25% vested} & = 0.25 \\
+ 2\text{-year vesting term} \times \text{second 25% vested} & = 0.50 \\
+ 3\text{-year vesting term} \times \text{third 25% vested} & = 0.75 \\
+ 4\text{-year vesting term} \times \text{last 25% vested} & = 1.00 \\
10\text{-year contractual term} & + 10.00 \\
Divide by 2 (average) & \div 2.00 \\
6.25 \text{ years}
\end{align*}
\]

Or, \(((1 + 2 + 3 + 4) \div 4) + 10) \div 2 = 6.25 \text{ years.}\)

Alternatively, an entity grants at-the-money employee share options, each with a contractual term of 10 years. The options meet the criteria for plain-vanilla options outlined in Question 6 of SAB Topic 14.D.2. The options vest at the end of the fourth year of service (cliff vesting). Therefore, under the simplified method, the expected term of the awards would be 7 years \((4\text{-year vesting term} + 10\text{ year contractual life}) \div 2\).

3-13 Share-Based Payment Awards That Do Not Qualify as “Plain-Vanilla” Employee Share Options

The expected term of an award factors into an entity’s determination of the fair-value-based measure of a share-based payment award. See Q&A 3-11 for a discussion of how to estimate the expected term of an award. SAB Topic 14 advocates the use of a simplified method to estimate the expected term of “plain-vanilla” employee share options in certain circumstances. See Q&A 3-12.

SAB Topic 14 describes a plain-vanilla option as an award with the following characteristics:

- The options are granted at the money;
- Exercisability is conditional only on [the employee’s] performing service through the vesting date [i.e., the requisite service period equals the vesting period];
• If an employee terminates service prior to vesting, the employee would forfeit the share options;
• If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
• The share options are nontransferable and nonhedgeable.

Question
What types of share-based payment awards do not qualify as plain-vanilla options?

Answer
To qualify as a plain-vanilla option, a share-based payment award must possess all of the characteristics listed above. The following examples illustrate awards that do not qualify as plain-vanilla options and therefore would not be eligible for the simplified method for estimating the expected term of an award:

• In 20X1, an entity granted employee share options and used the simplified method to estimate the options’ expected term. After the original grant date, the entity established that it had incorrectly determined the grant date for its options granted in 20X1 and that the options were actually granted “in the money.” Because the options were not granted “at the money,” they do not qualify as plain-vanilla options.

• In 20X1, an entity granted employee share options that either (1) vest at the end of the seventh year of service or (2) accelerate vesting if certain defined EBITDA targets are met before that date. Because the options’ exercisability depends on a performance condition as well as a service condition, they do not qualify as plain-vanilla options.

• In 20X1, an entity granted employee share options and used the simplified method to estimate the options’ expected term. In 20X2, the entity decided to modify the options, and as of the modification date, the options were in the money. Because the options no longer qualify as plain-vanilla options on the modification date, the entity cannot use the simplified method to determine the fair-value-based measure of the modified options and of the incremental compensation cost resulting from the modification.

The examples above do not illustrate every type of award that does not qualify as a plain-vanilla option. Each award should be evaluated to determine whether it qualifies as a plain-vanilla option.

Factors or Restrictions That Affect the Determination of Fair Value at Grant Date

ASC 718-10

Vesting Versus Nontransferability
30-10 To satisfy the measurement objective in paragraph 718-10-30-6, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees’ expected exercise and postvesting employment termination behavior in estimating fair value (referred to as an option’s expected term).

Forfeitability
30-11 A restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

Performance or Service Conditions
30-12 Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered). Examples 1 through 2 (see paragraphs 718-20-55-4 through 55-40) and Example 1 (see paragraph 718-30-55-1) provide illustrations of how compensation cost is recognized for awards with service and performance conditions.
### ASC 718-10 (continued)

**30-13** The fair-value-based method described in paragraphs 718-10-30-6 and 718-10-30-10 through 30-14 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. This Topic refers to the required measure as fair value.

**Market Conditions**

**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.

**Market, Performance, and Service Conditions that Affect Factors Other than Vesting or Exercisability**

**30-15** Market, performance, and service conditions (or any combination thereof) may affect an award’s exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award’s grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied. Paragraphs 718-10-55-64 through 55-66 provide additional guidance on the effects of market, performance, and service conditions that affect factors other than vesting or exercisability. Examples 2 (see paragraph 718-20-55-35); 3 (see paragraph 718-20-55-41); 4 (see paragraph 718-20-55-47); 5 (see paragraph 718-20-55-51); and 7 (see paragraph 718-20-55-68) provide illustrations of accounting for awards with such conditions.

**30-16** Paragraph Not Used

**Nonvested or Restricted Shares**

**30-17** A nonvested equity share or nonvested equity share unit awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date.

**30-18** Nonvested shares granted to employees usually are referred to as restricted shares, but this Topic reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

**30-19** A restricted share awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties. Example 8 (see paragraph 718-20-55-71) provides an illustration of accounting for an award of nonvested shares.

### 3-14 Effect of Postvesting Restrictions on the Fair-Value-Based Measure of Employee Share Options

ASC 718-10-30-10 states, in part:

A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date.

**Question**

How are postvesting restrictions taken into account in a closed-form option-pricing model like the Black-Scholes-Merton formula?

**Answer**

The effect of postvesting restrictions can be taken into account by reducing the current market price of the underlying shares used as an input factor in the Black-Scholes-Merton formula. For example, assume that an entity issues an option with a four-year service (vesting) condition and a postvesting restriction that prohibits the employee from selling the shares obtained upon exercising the option for another two years. If the entity estimates the fair-value-based measure of the option by using a Black-Scholes-Merton formula, the input used for the current market price of the underlying shares generally will not be the quoted market price of the entity’s common stock since the option being valued contains a postvesting restriction. Rather, it is more appropriate for the entity to use the fair value of a similar share as the input for the current market price (i.e., the market price of a share containing similar restrictions on transferability for a period of two years). If similar shares are not traded in an active market, the fair value should be determined by using the same valuation technique that would be used to estimate the fair value of a traded instrument. The current market price of a restricted share generally should be lower than the current market price of a similar share without any restrictions. Therefore, using the current market price of a restricted share in the Black-Scholes-Merton formula will result in an estimated grant-date fair-value-based measure.
of the option that is lower than that of an option without any postvesting restrictions (if all other inputs remain
equal). However, to use a value that incorporates a discount from the value of an unrestricted share (in valuing a
restricted share), the entity must be able to provide objective and verifiable evidence supporting the amount of the
discount.

3-15 Impact of Dividends Paid on Employee Share Options During the Vesting Period

Question

How should the measurement of employee share options be adjusted, and how is compensation cost affected if
the employee receives the dividends paid on the underlying shares during the vesting period or if dividends paid on
the underlying shares reduce the exercise price of the option (i.e., the award is a dividend-protected option)?

Answer

In using an option-pricing model to estimate the fair-value-based measure of an employee share option, an entity
usually takes expected dividends into account because dividends paid on the underlying shares are part of the fair
value of those shares and option holders generally are not entitled to receive those dividends. However, an award
of share options may be structured to protect option holders from that effect through dividend rights that take
various forms. An entity should appropriately reflect that dividend protection in estimating the fair-value-based
measure of a share option. For example, an entity could appropriately reflect the effect of the dividend protection
by using an expected dividend yield input of zero if all dividends paid to shareholders are applied to reduce the
exercise price of the options being valued.

In addition, ASC 718-10-55-45 states, in part:

Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity
instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends
or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments
that do not vest shall be recognized as additional compensation cost. The estimate of compensation cost for
dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an
entity’s estimates of forfeitures.

See Q&A 6-11 for a discussion of the impact that dividend-paying share-based payment awards have on the
computation of EPS. Also see ASC 718-740-45-8 through 45-12 for a discussion of the treatment of the tax benefit
for dividends paid on share-based payment options issued to employees.

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-
value-based measure of $100. The options vest at the end of one year of service (cliff vesting). The option holders
will receive a cash amount per option that is equal to the dividends paid per share to common shareholders during
the vesting period. Employees are not required to return the dividends received if they forfeit their options. On July
1, 20X1, A declares a dividend of $1 per share. Further assume that A has estimated a forfeiture rate of 10 percent.
See the journal entries below. For simplicity purposes, the effects of income taxes have been ignored.

Journal Entry: March 31, 20X1

Compensation cost 22,500
APIC 22,500
To record compensation cost for the quarter ended March 31, 20X1 (1,000 options × $100
fair-value-based measure × 25% services rendered × 90% of options expected to vest).

Journal Entry: June 30, 20X1

Compensation cost 22,500
APIC 22,500
To record compensation cost for the quarter ended June 30, 20X1 (1,000 awards × $100
fair-value-based measure × 25% services rendered × 90% of options expected to vest).
Journal Entry: Date of Dividend Declaration
Retained earnings 900
Compensation cost 100
Dividends payable 1,000
To record the declaration of dividends and the related compensation cost on options not expected to vest (1,000 options × $1 dividend × 10% of dividends paid on options not expected to vest).

Journal Entry: September 30, 20X1
Compensation cost 22,500
APIC 22,500
To record compensation cost for the quarter ended September 30, 20X1 (1,000 options × $100 fair-value-based measure × 25% services rendered × 90% of options expected to vest).

In the fourth quarter, A experiences lower turnover than expected. On December 31, 20X1, 980 of the 1,000 options that were granted become vested. On that date, A would record the journal entries below.

Journal Entries: December 31, 20X1
Compensation cost 30,500
APIC 30,500
To record compensation cost for the quarter ended December 31, 20X1 [(980 options vested × $100 fair-value-based measure) – $67,500 compensation cost previously recognized].
Retained earnings 80
Compensation cost 80
To adjust compensation cost for dividends paid on awards that the company believed would be forfeited but vested.

3-16 Accounting for Dividends Paid on Awards During Vesting
The terms of some share-based payment awards offer award holders dividend protection (nonvested shares and options). In such cases, award holders are entitled to receive a dividend during the vesting period and, in some instances, to retain the dividend even if the award fails to vest. Such awards are commonly referred to as “dividend-protected awards.”

Question
How should an entity account for dividend-protected awards?

Answer
In a manner consistent with the forfeiture estimate an entity uses to measure the compensation cost of an award, the dividend payment for dividend-protected awards should be charged to retained earnings to the extent that the award is expected to vest. If an employee is entitled to retain dividends paid on shares that fail to vest, these amounts should be charged to compensation cost and will then be periodically adjusted on the basis of any revisions to the forfeiture estimate, with a final true-up based on actual forfeitures.

ASC 718-10-55-45 states, in part:

Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost. The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity’s estimates of forfeitures.
ASC 718-740-45-8 indicates that if the relevant tax authority allows for a deduction for the dividends paid:

- Any realized tax benefit related to dividends charged to retained earnings is credited to APIC.
- The tax benefit recognized on the amount charged to compensation expense should be credited to income tax expense.

In addition, ASC 718-740-45-9 through 45-12 provide guidance on how the tax benefits of dividends for dividend-protected awards “shall be included in the pool of excess tax benefits.”

**Example**

On January 1, 20X6, an entity grants 1,000 nonvested shares, each with a grant-date fair value of $100. The awards vest at the end of one year of service (cliff vesting). The award holders will receive an amount equal to dividends paid to normal shareholders during the vesting period. Employees are not required to return the dividends or dividend equivalents received if they forfeit their awards. On July 1, 20X6, the entity declares a dividend of $1 per share. Further assume that the entity has estimated a forfeiture rate of 10 percent of the awards. The entity’s tax rate is 40 percent. See the journal entries below.

**Journal Entries: March 31, 20X6**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>22,500</td>
</tr>
<tr>
<td>APIC</td>
<td>22,500</td>
</tr>
<tr>
<td>To record compensation cost for the equity award for the quarter ended (1,000 awards × 90% options expected to vest × $100 fair value × 25% services rendered).</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>9,000</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>9,000</td>
</tr>
<tr>
<td>To record the related tax effect for the quarter ended ($22,500 compensation expense × 40% tax rate).</td>
<td></td>
</tr>
</tbody>
</table>

**Journal Entries: June 30, 20X6**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>22,500</td>
</tr>
<tr>
<td>APIC</td>
<td>22,500</td>
</tr>
<tr>
<td>To record compensation cost for the equity award for the quarter ended (1,000 awards × 0.90 forfeiture rate × $100 fair value × 25% services rendered).</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>9,000</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>9,000</td>
</tr>
<tr>
<td>To record the related tax effect for the quarter ended ($22,500 compensation expense × 40% tax rate).</td>
<td></td>
</tr>
</tbody>
</table>

**Journal Entries: Date of Dividend Declaration**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>900</td>
</tr>
<tr>
<td>Compensation cost</td>
<td>100</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>1,000</td>
</tr>
<tr>
<td>To record the declaration of dividends for the awards expected to vest and the related compensation cost for awards not expected to vest [(1,000 awards × 90% options expected to vest × $1 dividend) and (1,000 awards × $1 dividend × 10%)].</td>
<td></td>
</tr>
<tr>
<td>Current taxes payable</td>
<td>400</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>40</td>
</tr>
<tr>
<td>APIC</td>
<td>360</td>
</tr>
<tr>
<td>To record the tax effect of the dividend declared [(900 × 40%) and (100 × 40%)].</td>
<td></td>
</tr>
</tbody>
</table>
Journal Entries: September 30, 20X6

- Compensation cost 22,500
- APIC 22,500
  
To record compensation cost for the equity award for the quarter ended (1,000 awards × 0.90 forfeiture rate × $100 fair value × 25% services rendered).

- DTA 9,000
- Deferred tax expense 9,000
  
To record the related tax effect for the quarter ended ($22,500 compensation expense × 40% tax rate).

On December 31, 20X6, 980 of the 1,000 options that were granted become vested. On that date, the entity would record the following amounts in its journal entries:

Journal Entries: December 31, 20X6

- Compensation cost 30,500
- APIC 30,500
  
To record compensation cost for the quarter ended, excluding the effects of the dividend in July (980 awards × $100 fair value) – $67,500 compensation cost previously recognized).

- DTA 12,200
- Deferred tax expense 12,200
  
To record the related tax effect for the quarter ended ($30,500 compensation expense × 40% tax rate).

- Retained earnings
- Compensation cost 80
  
To adjust compensation cost related to the dividend paid for actual shares vested ($100 compensation cost previously recognized – (20 actual awards forfeited × $1 dividend)].

- Income tax expense 32
- APIC 32
  
To adjust the tax effect for actual shares vested related to the dividend paid (80 × 40%).

3-17 Service Condition

**Question**

What is a service condition, and how does an entity account for a share-based payment award under ASC 718 when the award contains only a service condition?

**Answer**

ASC 718-10-20 defines a service condition, in part, as the following:

> 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.

To satisfy an award’s service condition, the employee must provide service to (i.e., remain employed by) the entity for a specified period. A service condition is included explicitly in the terms of an award and is usually in the form of a vesting condition.
For service conditions that affect vesting and exercisability, if an employee forfeits the award (i.e., does not satisfy the service condition), the employee does not vest in (i.e., has not earned) the award. Entities are required to estimate forfeitures; that is, accruals of compensation cost should be based on the number of awards for which the requisite service is expected to be rendered. If the employee does not provide the necessary service and therefore fails to earn the award, the entity would reverse any compensation cost previously recognized during the service period. Ultimately, compensation cost is not recognized for awards that do not vest. See Q&A 4-01 for an example illustrating the accounting for forfeitures and Q&A 4-02 for factors to consider in estimating forfeitures.

Since the service condition affects the employee’s ability to earn (i.e., vest in) the award, it is not directly factored into the grant-date fair-value-based measure of the award. However, a service condition can indirectly affect the grant-date fair-value-based measure by affecting the expected term of an award. Because the expected term of an award cannot be shorter than the vesting period, a longer vesting period would result in a longer expected term of an award. See Q&A 3-23 and Q&A 3-34 for a discussion of how a service condition affects the valuation of share-based payment awards.

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest at the end of the third year of service (cliff vesting).

For A’s employee to earn the award (i.e., for the employee’s right to the award to vest and become exercisable), the employee must provide three years of continuous service to A. At the end of the third year of service, the employee will have earned all of the rights to the options; the employee’s ability to exercise the options is no longer contingent on whether the employee provides additional service. The accrual of compensation cost is based on the number of options for which the requisite service period of three years is expected to be rendered. If the employee fails to provide the three years of service (i.e., forfeits the options), A ceases to accrue any future compensation cost and reverses any previously recognized compensation cost.

3-18 Performance Conditions

Question

What is a performance condition, and how does an entity account for a share-based payment award under ASC 718 when the award contains only a performance condition?

Answer

ASC 718-10-20 defines a performance condition, in part, as the following:

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).

To satisfy an award’s performance condition, the employee must provide service to (i.e., remain employed by the entity) for a specified period. The employee’s ability to earn the award depends on the operations or activities of the employer or the activities of the employee. Operations or activities of the employer could include the attainment of specified financial performance targets (e.g., revenue, EPS), operating metrics (e.g., number of items produced), or other specific actions (e.g., IPO). Activities of the employee could include volume of goods or services provided or sales by the employee. The service period for such conditions can be either explicitly stated or implied (e.g., the period it will take for the performance condition to be achieved).

If (1) an employee does not provide the necessary service or (2) the entity or the employee does not attain the specified performance target, the employee has not earned (i.e., vested in) the award. If the employee does not earn the award, the entity would reverse any compensation cost accrued during the service period. Ultimately, compensation cost is not recognized for awards that do not vest. During the service (vesting) period, an entity must assess the probability that the performance condition will be achieved (i.e., the probability that the employee will earn the award). If it is not probable that the performance condition will be achieved, an entity should not record any compensation cost. ASC 718-10-25-20 states, in part:

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.
Since the performance condition affects the employee’s ability to earn (i.e., vest in) the award, it is not directly factored into the grant-date fair-value-based measure of the award. However, a performance condition can indirectly affect the grant-date fair-value-based measure by affecting the expected term of an award. Because the expected term of an award cannot be shorter than the vesting period, a longer vesting period would result in a longer expected term of an award. See Q&A 3-34 for a discussion of how a performance condition affects the valuation of share-based payment awards.

Compensation cost is usually recognized ratably over the requisite service period of an award with only a performance condition. Although ASC 718-20-55-40 suggests that compensation cost could be recognized on the basis of “the relative satisfaction of the performance condition,” the FASB staff believes that it would be rare to recognize compensation cost in a manner other than ratably over the requisite service period of an award with only a performance condition.

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest only if cumulative net income over the next three annual reporting periods exceeds $1 million and the employee is still in the employment of A.

The service period is explicitly stated in the terms of the options. The employee must provide three years of continuous service to A to earn the options. In addition, A must meet the specified performance target of cumulative net income in excess of $1 million over the next three annual reporting periods. If either (1) the employee does not remain in the employment of A for the specified period or (2) A does not attain the performance target, the options will be forfeited and any compensation cost previously recognized by A will be reversed. Compensation cost would be recognized on a straight-line basis (i.e., one-third for each year of service) over the three-year service period if it is probable that the performance condition will be achieved.

3-19 Accounting for Share-Based Payment Awards With a Performance Condition That Are Granted to Retirement-Eligible Employees

An entity grants its employees share-based payment awards that contain a performance condition. That is, an employee’s ability to earn (i.e., vest in) the award is conditioned not only on the employee’s providing the required service but also on the entity’s attaining specified performance targets (e.g., revenue, EPS). In addition, such awards may contain a clause that allows an employee who is retirement-eligible (or who becomes retirement-eligible) to retain the award and allow it to become exercisable if the performance target is achieved even after the employee retires. See ASC 718-10-55-87 and 55-88 for a discussion of the accounting for awards granted to retirement-eligible employees.

Question

How should an entity account for a performance-based award that is granted to an employee who is retirement-eligible (or who becomes retirement-eligible)?

Answer

It depends. When a performance-based award is granted to a retirement-eligible employee, it is possible that the award becomes exercisable because of the entity’s achieving a performance target during a period when the individual is no longer employed. It is unclear whether ASC 718 accounts for cases in which an individual is not employed or providing service to earn the award throughout the relevant performance period. The FASB Statement 123(R) Resource Group discussed this scenario during its September 13, 2005, meeting. The Resource Group members discussed various answers to the question but were unable to reach a unanimous conclusion on any one alternative. Therefore, unless the FASB provides further guidance on this issue, an entity may elect as an accounting policy any of the alternatives outlined below. As with any accounting policy, the entity should disclose its election and apply it consistently.
Editor’s Note: On June 19, 2014, the FASB issued ASU 2014-12, which addresses diversity in practice related to entities’ accounting for performance targets that affect vesting of share-based payment arrangements that could be achieved after the requisite service period. Performance targets that affect vesting and that can be achieved after the requisite service period should be treated as performance conditions in accordance with ASC 718 and should not be reflected in the award’s grant-date fair-value-based measure (see ASC 718-10-30-28). The guidance in ASU 2014-12 is effective for all entities (i.e., public business entities and all other entities) for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. Entities may apply the amendments in ASU 2014-12 either (1) prospectively to all awards granted or modified after the effective date or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter.

Upon the adoption of ASU 2014-12, Alternative 2 would be the only acceptable method for an entity to use in accounting for a performance-based award that is granted to an employee who is (or becomes) retirement-eligible as well as other types of performance-based awards that can vest after the requisite service period (e.g., an award that vests upon an IPO even if the IPO occurs after the employee’s requisite service period). As a result, Alternative 1 and Alternative 3 would no longer be acceptable approaches.

Alternative 1 — Award Terms Are Considered an “Other Condition”

Under this alternative, the performance target of the award is considered a condition other than a service, performance, or market condition (i.e., an “other condition”). In accordance with ASC 718-10-25-13, the award is classified as a share-based liability and the other condition is reflected in the entity’s estimate of the fair-value-based measure of the award. Proponents of this alternative reject the argument that the performance target of the award is a performance condition because they believe that for an award to contain a performance condition, the employee must remain employed for the duration of the performance period. Because, in this case, the employee may leave before the end of the performance period and retain the award, the performance target of the award cannot be viewed as a performance condition.

In accordance with ASC 718-10-55-87 and 55-88, the requisite service period will either be (1) immediate (for retirement-eligible employees) or (2) the time from the grant date until the employee becomes retirement-eligible. The concept of an implicit service period is not relevant under this alternative because the performance target is treated as an other condition and factored into the fair-value-based measure of the award. Because the award will be classified as a share-based liability, it will be remeasured at a fair-value-based amount (inclusive of the effect of the other condition) as of each reporting period until settlement.

Note that if the period leading up to the retirement-eligible date is equal to or longer than the performance period, the performance target of the award meets the definition of a performance condition and should be accounted for accordingly (i.e., not pursuant to the guidance in this Q&A). See Q&A 3-18 for a discussion of how performance conditions affect the recognition of compensation cost.

Alternative 2 — Award Terms Are Considered a Performance Condition

Under this alternative, the performance target of the award is considered a performance condition; however, the performance condition will not be factored into the determination of the requisite service period if the period associated with the performance target falls after the retirement eligibility date. Proponents of this alternative do not believe that the terms of an award containing a performance condition require the employee to remain employed or provide service to earn the award for the duration of the performance period. Therefore, if the employee leaves before the end of the performance period, the entity is not precluded from determining that the performance target of the award is a performance condition.

In accordance with ASC 718-10-55-87 and 55-88, the requisite service period will either be (1) immediate (for retirement-eligible employees) or (2) the shorter of (a) the time from the grant date until the employee becomes retirement-eligible or (b) the implicit service period provided by the performance target. Because the performance target of the award is viewed as a performance condition, an entity must assess the probability that the performance condition will be achieved. If achievement of the performance condition is not probable, an entity should not record any compensation cost. See Q&A 3-18 for a discussion of how performance conditions affect the recognition of compensation cost.
If an entity recorded compensation cost (because achievement of the performance target was deemed probable) and the performance target was not achieved, the entity would reverse any previously recognized compensation cost, even if the holder of the award was no longer an employee (i.e., the employee had retired). Conversely, if the entity did not record compensation cost (because achievement of the performance target was not deemed probable) and the performance target was met (or meeting it became probable), the entity would record compensation cost on the date the performance target was met (or meeting it became probable) even if the holder of the award was no longer an employee.

**Alternative 3 — Award Terms Are Considered a Postvesting Restriction**

Under this alternative, the performance target of an award is treated as a postvesting restriction. Accordingly, the likelihood of the entity’s achieving the performance target is factored into the grant-date fair-value-based measure of the award rather than into the determination of whether the awards will be earned (i.e., vest). This alternative is based on the view that the grant-date fair-value-based measure should reflect restrictions inherent in the instrument, including restrictions that stem from requirements that remain in effect after the requisite service period. Therefore, compensation cost is recorded over the requisite service period and is not reversed if the requisite service is provided, regardless of whether the performance target of the award is achieved.

In accordance with ASC 718-10-55-87 and 55-88, the requisite service period will either be (1) immediate (for retirement-eligible employees) or (2) the time from the grant date until the employee becomes retirement-eligible. The concept of an implicit service period is not relevant under this alternative since the performance target is treated as a postvesting condition and factored into the fair-value-based measure of the award.

Note that if the period leading up to the retirement-eligible date is equal to or longer than the performance period, the award meets the definition of a performance-based share-based payment award and should be accounted for accordingly (i.e., not pursuant to the guidance in this Q&A). See Q&A 3-18 for a discussion of how performance conditions affect the recognition of compensation cost.

**Example — Alternative 1**

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $6 (inclusive of the effect of the “other condition”), to employees who are currently retirement-eligible. The options legally vest and become exercisable only if cumulative net income over the next three annual reporting periods exceeds $1 million. The employees can retain the options for the remaining contractual life of the options even if the employees elect to retire. However, the options only become exercisable upon the achievement of the cumulative net income target.

In this example, the three-year service period is nonsubstantive. That is, even though the legal vesting of the options implies a service period of three years, the employees could retire the next day and retain the options. As a result, A records the $6,000 ($6 grant-date fair-value-based measure × 1,000 options) of compensation cost immediately on the grant date. However, because the terms of the options are considered an “other condition,” the options will be (1) classified as a share-based liability and (2) remeasured at a fair-value-based amount (inclusive of the impact of the other condition) each reporting period until settlement. If the net income target is never achieved, the fair-value-based measure of the award will be reduced to zero.

**Example — Alternative 2**

On January 1, 20X1, Entity A grants 1,000 at-the-money employee share options, each with a grant-date fair-value-based measure of $9 (exclusive of the effect of the performance condition), to employees who are currently retirement-eligible. The options legally vest and become exercisable only if cumulative net income over the next three annual reporting periods exceeds $1 million. The employees can retain the options for the remaining contractual life of the options even if they elect to retire. However, the options only become exercisable upon the achievement of the cumulative net income target.

In this example, the three-year service period is nonsubstantive. That is, even though the performance condition implies a service period of three years, the employees could retire the next day and retain the options. However, for the options to legally vest and become exercisable the entity must meet the specified performance target of cumulative net income in excess of $1 million over the next three annual reporting periods. Therefore, A records the $9,000 ($9 grant-date fair-value-based measure × 1,000 options) of compensation cost immediately on the grant date if it is probable that the performance target will be met. If it becomes improbable that the performance target will be met or A does not achieve the performance target, the options will be forfeited and any compensation cost previously recognized by A will be reversed even if the employees are no longer employed (i.e., they retired).
Example — Alternative 3

On January 1, 20X1, Entity A grants 1,000 at-the-money employee share options, each with a grant-date fair-value-based measure of $6 (inclusive of the effect of the postvesting restriction), to employees who are currently retirement-eligible. The options legally vest and become exercisable only if cumulative net income over the next three annual reporting periods exceeds $1 million. The employees can retain the options for the remaining contractual life of the options even if they elect to retire. However, the options only become exercisable upon the achievement of the cumulative net income target.

In this example, the three-year service period is nonsubstantive. That is, even though the legal vesting of the options implies a service period of three years, the employees could retire the next day and retain the options. Therefore, A records the $6,000 ($6 grant-date fair-value-based measure x 1,000 options) of compensation cost immediately on the grant date. In addition, because the performance target (i.e., the postvesting restriction) of the options has been captured in the grant-date fair-value-based measure, any previously recognized compensation cost will not be reversed, regardless of whether the cumulative net income target is achieved.

3-20 Market Condition

Question

What is a market condition, and how does an entity account for a share-based payment award under ASC 718 when the award contains only a market condition?

Answer

ASC 718-10-20 defines a market condition, in part, as the following:

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).

Unlike a service or a performance condition, a market condition is not a vesting condition. Rather, a market condition is directly factored into the grant-date fair-value-based measure of an award. See Q&A 3-34 for a discussion of how a market condition affects the valuation of a share-based payment award. Examples of market conditions include:

- The achievement of a specified rate of return on the employer’s stock.
- A specified return on the employer’s stock that exceeds the average return of a specified index (such as the S&P 500).
- A percentage increase in the employer’s stock price that is greater than the average percentage increase of the stock price of a peer group of entities.

Accounting for Awards With Only a Market Condition

An employee earns (i.e., vests in) an award by providing service to (i.e., remaining employed by) the entity for a specified period. Certain awards contain only a market condition (i.e., the arrangement does not include an explicit service period). In such cases, the entity must use a derived service period under ASC 718 to establish whether the employee has performed the requisite service to earn the award. See Q&A 4-03 for a discussion of a derived service period.

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6 The terms of a share-based payment award (plan) may refer to the “vesting” of an award if the market condition in the arrangement is satisfied. Such use of the word “vesting” generally refers to the employee’s ability to exercise or retain the award. This is different from the use of the term in ASC 718, in which vesting refers to the point at which the employee has provided all the necessary service in exchange for the grant-date fair-value-based measure of the award (i.e., the end of the requisite service period). For a share-based payment award with only a market condition, the requisite service period is the derived service period as discussed in Q&A 4-03. While a market condition may affect the requisite service period, it is not a vesting condition.
If an employee does not remain employed for the derived service period, the employee has not earned (i.e., vested in) the award. An entity accrues compensation cost over the derived service period if the requisite service is expected to be rendered; however, the entity will reverse any previously recognized compensation cost if the employee leaves before the completion of the derived service period. This is true unless the market condition affects the employee’s ability to exercise or retain the award and the market condition is satisfied before the end of the derived service period (i.e., the market condition is satisfied sooner than originally anticipated and the employee is still employed as of the actual date of satisfaction). In that case, any unrecognized compensation cost is recognized immediately when the market condition is satisfied.

Conversely, if an employee does remain employed for the derived service period, the employee has earned (i.e., vested in) the award. In this circumstance, the entity will not reverse any previously recognized compensation cost, even if the market condition is never satisfied.

3-21 Accounting for Share-Based Payment Awards When Vesting Is Contingent Upon a Liquidity Event and Upon the Achievement of a Specified Internal Rate of Return

Entities may provide employees with share-based payment awards that vest only if (1) a liquidity event occurs (e.g., an IPO or a change in control) while the grantee is employed and (2) the IRR to shareholders that results from the liquidity event achieves a certain target.

Question
How does an entity account for awards whose vesting is contingent upon the occurrence of a liquidity event and the achievement of a specified IRR as of the date of the liquidity event?

Answer
As noted in Q&A 3-20, achieving a specified IRR is considered a market condition under ASC 718. Achieving a specified IRR is functionally equivalent to achieving a specified rate of return on an entity’s stock, which is an example of a market condition as discussed in Q&A 3-20. Achieving a specified IRR should be factored into the fair-value-based measure of the award.

The occurrence of the liquidity event represents a performance condition under ASC 718 (see Q&A 3-18). An employee’s ability to earn the award is contingent on the employee’s fulfillment of the service requirement and the entity’s attainment of the specified performance target (i.e., the liquidity event). Because the performance condition affects the employee’s ability to earn the award, it is not factored into the fair-value-based measure of the award.

During the service (vesting) period, an entity must assess the probability that the performance condition will be achieved (i.e., the probability that the employee will earn the award). If it is not probable that the liquidity event will be achieved, the entity should not record any compensation cost. ASC 718-10-25-20 states, in part:

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.

An entity generally does not recognize compensation cost related to awards that vest upon a change in control or an IPO transaction until the date on which that transaction occurs. That is, a change in control or an IPO is generally not probable until it occurs. This position is consistent with the guidance in ASC 805-20-55-50 and 55-51 on liabilities that are triggered upon the consummation of a business combination. Therefore, compensation cost would be recognized when the liquidity event occurs. Note that compensation cost would be recognized as of the date of the liquidity event regardless of whether the IRR market condition has been achieved.

In determining the requisite service period, the entity must consider the multiple vesting conditions of the award. In this case, there is an implicit service period associated with the liquidity event performance condition and a derived service period associated with the IRR market condition. Since both conditions must be met for the awards to vest, the longer of these two periods is the requisite service period. Because the IRR market condition can only be achieved upon the occurrence of the liquidity event, the derived service period cannot extend beyond the expected date of the liquidity event. Since the expected date of the liquidity event determines the implicit service period, the requisite service period would always equal the implicit service period in this example. However, because the occurrence of a liquidity event is generally not probable until it is effective, no compensation cost would be recognized until the event occurs (see Q&A 3-31).
Chapter 3 — Initial Measurement
A Roadmap to Accounting for Share-Based Payment Awards

3-22 Multiple Performance Conditions Affecting Both Vesting Factors and Nonvesting Factors

Question
If a share-based payment award contains multiple performance conditions that affect both vesting factors and nonvesting (e.g., exercise price) factors, how should compensation cost be recognized?

Answer
ASC 718-20-55-37 states that “[a]ccruals of compensation cost are initially based on the probable outcome of the performance conditions . . . and adjusted for subsequent changes in the estimated or actual outcome.” As noted in Q&A 3-34, whether an award has been earned (i.e., whether an entity will record compensation cost) is determined on the basis of the vesting condition, whereas the nonvesting condition will affect the grant-date fair-value-based measure (i.e., how much compensation cost to record). A grant-date fair-value-based measure should be calculated for each possible nonvesting condition outcome. If the vesting condition is not expected to be achieved, no compensation cost should be recorded. If the vesting condition is expected to be achieved, the amount of compensation cost should be based on the grant-date fair-value-based measure associated with the nonvesting condition outcome whose achievement is probable. See Q&A 3-23 for a discussion of how performance conditions that affect factors other than vesting or exercisability affect the valuation of share-based payment awards.

Example
On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options with an exercise price of $10. The options vest in two years if the EBITDA growth rate exceeds the industry average by 10 percent. The grant-date fair-value-based measure of this option is $3. However, the exercise price will be reduced to $5 if regulatory approval for Product X is obtained within two years. The grant-date fair-value-based measure of this option is $6.

The EBITDA target is expected to be achieved by December 31, 20X1, but it is not probable that regulatory approval will be obtained by the end of 20X2. Therefore, compensation cost of $1,500 should be recorded in 20X1 (1,000 options × $3 grant-date fair-value-based measure × 50% for one of two years of service provided).

On December 31, 20X2, regulatory approval is obtained and A’s EBITDA target is met. Therefore, compensation cost of $4,500 should be recognized in 20X2 [(1,000 options × $6 grant-date fair-value-based measure × 100% of services provided) – $1,500 of compensation cost previously recognized].

3-23 Effect of Service and Performance Conditions on Factors Other Than Vesting or Exercisability in Valuing a Share-Based Payment Award

Question
How do service and performance conditions that affect factors other than vesting or exercisability affect the grant-date fair-value-based measure of a share-based payment award?

Answer
When service or performance conditions affect factors other than vesting or exercisability (e.g., exercise price, contractual term, quantity, or conversion ratio), the grant-date fair-value-based measure should be calculated for each possible outcome. As discussed in Q&A 3-18, initial accruals of compensation cost should be based on the probable outcome. However, the final measure of compensation cost should be adjusted to reflect the grant-date fair-value-based measure of the outcome that is actually achieved.

Example
On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options for which the exercise price is determined on the basis of whether the following performance conditions are met:

- Exercise price is $10 per share if revenues are between $20 million and $30 million in 20X1 (grant-date fair-value-based measure of $2).
- Exercise price is $8 per share if revenues are between $30 million and $40 million in 20X1 (grant-date fair-value-based measure of $3).
- Exercise price is $6 per share if revenues exceed $40 million in 20X1 (grant-date fair-value-based measure of $4).
Entity A should calculate the fair-value-based measure of the options under all three scenarios above (i.e., calculate the grant-date fair-value-based measures with $10, $8, and $6 exercise prices, respectively).

If, on the grant date, the probable outcome is that revenues will exceed $40 million in 20X1, initial accruals of compensation cost should be based on the grant-date fair-value-based measure of $4 per option. If actual revenues for 20X1 were $35 million or it becomes probable that actual revenues will be $35 million, the cumulative compensation cost recognized should be adjusted to reflect the grant-date fair-value-based measure of $3 per option.

3-24 Difference Between a Nonvested Share and a Restricted Share

Question
What is the difference between a nonvested share and a restricted share under ASC 718?

Answer
A nonvested share is an award that an employee earns once the employee has provided the service specified under the arrangement. For example, an employee may be granted a share but may not be able to sell or transfer the share unless the employee provides three years of service. If the employee fails to provide the required three years of service, the shares would be forfeited to the entity. ASC 718-10-20 defines a nonvested share as follows:

> Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

The fair-value-based measure of a nonvested share is recognized over the requisite service period (see Q&A 3-25 for a discussion of the valuation of nonvested shares).

In contrast, a restricted share is an award that an employee earns without having to provide any specified service. However, the employee’s ability to sell the share is restricted. For example, an employee may be granted a share; however, the employee’s ability to sell the share may be contingent on the lapse of a two-year period. If the employee terminates employment with the entity before the end of the two-year period, the employee retains the shares. However, the employee’s ability to sell the shares remains contingent on the lapse of the two-year period. ASC 718-10-20 defines a restricted share, in part, as follows:

> A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed nonvested shares because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. The term restricted shares refers only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

The limitations on a restricted share may decrease the fair-value-based measure of the award.

3-25 Valuation of Nonvested Shares

Question
Can the market value of an entity’s equity shares be used as the fair-value-based measure of a nonvested share?

Answer
Generally, yes. The grant-date fair-value-based measure of a nonvested share is measured at the fair value of the entity’s common stock as if the nonvested share were vested and issued on the grant date. Thus, it is not appropriate to take a discount from the fair value of the entity’s common stock to reflect that the shares being valued are not vested.

However, as discussed in paragraph B93 of Statement 123(R), if an employee holding a nonvested share award is not entitled to receive dividends (i.e., the right of a normal shareholder), the fair-value-based measure of the award would be lower than the fair value of a normal equity share. An entity should estimate the fair-value-based measure of nonvested shares that are not entitled to dividends during the service (vesting) period by reducing the fair value of its common stock by the present value of expected dividends to be paid before the service (vesting)
period. The entity should then discount this amount by using an appropriate risk-free interest rate. See Q&A 3-15 for a discussion of how dividends paid on employee share options during the service (vesting) period affect the valuation of such awards, and see Q&A 6-17 for a discussion of how dividend-paying nonvested share awards affect the computation of EPS.

The initial measurement of a nonvested share could be affected by factors such as a market condition, as discussed in ASC 718-10-30-14, or a postvesting restriction, as mentioned in ASC 718-10-30-10.

3-26 Effect of a Limited Population of Transferees on the Valuation of Nonvested Shares

Question
How does a limited population of transferees (such as in an offering under Rule 144A, “Private Resales of Securities to Institutions,” of the Securities Act of 1933) affect the value of a nonvested share?

Answer
A limited population of transferees is not a prohibition on the sale of the instrument and therefore is not considered a restriction under ASC 718-10-20. According to Q&A 3-25, the fair-value-based measure of a nonvested share is measured at the fair value of the entity’s common stock as if the nonvested share was vested and issued on the grant date. An entity should not discount that value solely because the entity’s common stock could be transferred to only a limited population of transferees.

Nonpublic Entity — Calculated Value

ASC 718-10

30-20 A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity’s share price (the calculated value). Throughout the remainder of this Topic, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value. Paragraphs 718-10-55-51 through 55-58 and Example 9 (see paragraph 718-20-55-76) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

3-27 A Nonpublic Entity’s Use of an Appropriate Industry Sector Index in Valuing a Share-Based Payment Award

Question
When should a nonpublic entity use the historical volatility of an appropriate industry sector index as a substitute for the expected volatility of its own share price in valuing a share-based payment award (i.e., measure its awards by using a calculated value instead of a fair-value-based measure)?

Answer
A nonpublic entity should use the historical volatility of an appropriate industry sector index in valuing its share-based payment award only when estimating the expected volatility of its own share price is not practicable.

A nonpublic entity may be able to estimate the expected volatility of its own share price even when its shares are not quoted on an exchange. In assessing whether it is practicable to estimate the expected volatility of its own share price, the entity should consider the following factors:

- The entity has an internal market for its shares (e.g., employees can purchase and sell shares).
- Previous issuances of equity in a private transaction or convertible debt that provide indications of the historical or implied volatility of the entity’s share price.
- Similar public entities (including entities within an index), in terms of industry and size, whose historical volatility could be used as a substitute for the nonpublic entity’s expected volatility.
If, after considering the relevant factors, the nonpublic entity determines that estimating the expected volatility of its own share price is not practicable, it is permitted to use the historical volatility of an appropriate industry sector index as a substitute in estimating the fair-value-based measure of its awards. Because of possible scrutiny in this area, a nonpublic entity should carefully consider whether it is practicable to estimate the expected volatility of its own share price. See Q&A 3-28 for a discussion of what a nonpublic entity should consider in selecting and computing the historical volatility of an appropriate industry sector index.

3-28 Nonpublic Entity’s Selection and Computation of Historical Volatility of Appropriate Industry Sector Index

Question
If it is not practicable for a nonpublic entity to estimate the expected volatility of its own share price, what should it consider in selecting and computing the historical volatility of an appropriate industry sector index to use as a substitute for the expected volatility of its own share price in valuing a share-based payment award (i.e., when it measures its awards by using a calculated value instead of a fair-value-based measure)?

Answer
A nonpublic entity should select an industry sector index that is narrow enough to reflect both its nature and its size (if possible).

For example, the use of the Philadelphia Exchange (PHLX) Semiconductor Sector Index is not an appropriate industry sector index for a small nonpublic software development entity. The index represents neither the industry in which the nonpublic entity operates nor the size of the entity. The volatility of an index that is composed of smaller software entities is a more appropriate substitute for the entity’s expected volatility of its own share price.

UnderASC 718-10-55-58, an entity that uses an industry sector index to determine the expected volatility of its own share price is required to use the historical volatility of the industry sector index (as opposed to implied volatility). However, ASC 718-10-55-56 states that "in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000” (emphasis added). See Q&A 3-27 for a discussion of when a nonpublic entity should use the historical volatility of an appropriate industry sector index in valuing a share-based payment award.

3-29 Differences in the Way Public Entities and Nonpublic Entities Measure Share-Based Payment Awards

Question
How does the measurement of share-based payment awards of nonpublic entities differ from that of public entities?

Answer
There are two measurement alternatives available to nonpublic entities for the valuation of share-based payment awards: calculated value and intrinsic value. These alternatives cannot be used by public entities. The following table summarizes when the use of these measurement alternatives is appropriate:

<table>
<thead>
<tr>
<th>Public Entities</th>
<th>Nonpublic Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity-classified awards</td>
<td>Measured at a fair-value-based measure.</td>
</tr>
<tr>
<td>Liability-classified awards</td>
<td>Measured at a fair-value-based measure, remeasured each reporting period until settlement.</td>
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</tbody>
</table>
Nonpublic entities should make every effort to value their equity-classified awards at a fair-value-based measure. However, there may be instances when it is not reasonably practicable to estimate a fair-value-based measure. The biggest challenge in a nonpublic entity’s valuation of an award is the expected volatility of its own share price because its shares are not traded in a public market. In these cases, the nonpublic entity may substitute the historical volatility of an appropriate industry sector index for the expected volatility of its own share price. This is referred to as calculated value. See Q&A 3-27 for a discussion of when a nonpublic entity may use the historical volatility of an appropriate industry sector index in valuing a share-based payment award.

A nonpublic entity may change its method for measuring awards from calculated value to a fair-value-based measure when it (1) can subsequently estimate the expected volatility of its own share price or (2) becomes a public entity. ASC 718-10-55-27 states that the valuation technique an entity selects should be used consistently and should not be changed unless a different valuation technique is expected to produce a better estimate of a fair-value-based measure (or in this case, a change to a fair-value-based measure). The guidance goes on to state that a change in valuation technique should be accounted for as a change in accounting estimate under ASC 250 and should be applied prospectively to new awards. Therefore, for existing awards (i.e., unvested awards that were granted before an entity changed its measurement method from calculated value to a fair-value-based measure), an entity would continue to recognize compensation cost on the basis of the calculated value determined as of the grant date unless the award is subsequently modified. An entity should use the fair-value-based method to measure all awards granted after it changes its measurement method from calculated value.

Under ASC 718-30-30-2, nonpublic entities can elect, as a policy decision, to measure all liability-classified awards at intrinsic value instead of a fair-value-based measure (or calculated value if a fair-value-based measure is not reasonably practicable) as of the end of each reporting period until the award is settled. The fair-value-based method is preferable to justify a change in accounting principle under ASC 250. Therefore, a nonpublic entity that has elected to measure its liability-classified awards at a fair-value-based measure (or calculated value) would not be permitted to subsequently change to the intrinsic-value method.

### Difficulty of Estimation

**ASC 718-10**

**30-21** It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. Section 718-10-55 illustrates techniques for estimating the fair values of several instruments with complicated features. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

**Intrinsic Value Method**

**30-22** An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value (see paragraph 718-20-35-1 for measurement after issue date).

### 3-30 When It Is Not Reasonable to Estimate the Fair-Value-Based Measure of a Share-Based Payment Award as of the Grant Date

**Question**

Under what circumstances may it not be possible to reasonably estimate the fair-value-based measure of a share-based payment award as of the grant date?

**Answer**

ASC 718-10-30-21 states that in rare circumstances, it may not be possible to reasonably estimate the fair-value-based measure of a share-based payment award as of the grant date. There is a strong presumption under ASC 718 that the fair-value-based measure can be estimated unless there is substantial evidence to the contrary. Paragraph B103 of Statement 123(R) emphasizes this presumption by stating that, in light of the variety of options and option-like instruments that currently trade in the external markets and the advances in estimating fair value, entities should be able to reasonably estimate the fair-value-based measure of most awards as of the grant date. Accounting for a share-based payment award by using the intrinsic-value method under ASC 718-20-35-1 is therefore only allowed in rare circumstances and only when there is substantial evidence indicating that it is impossible to estimate the fair-value-based measure of the award.
Reload and Contingent Features

ASC 718-10

30-23 The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

30-24 A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (see paragraph 718-10-55-8), shall not be reflected in estimating the grant-date fair value of an equity instrument.

Requisite Service Period

ASC 718-10

30-25 An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

30-26 The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions
b. All explicit, implicit, and derived service periods
c. The probability that performance or service conditions will be satisfied.

3-31 Effect of Multiple Conditions on Vesting or Exercisability of a Share-Based Payment Award

Question

If a share-based payment award contains multiple conditions (service, performance, or market) that affect the employees’ ability to vest in or exercise the awards, how should an entity determine the requisite service period and attribute compensation cost?

Answer

The answer depends on whether all or just one of the conditions must be met for an employee to vest in or exercise the share-based payment award.

If All Conditions Must Be Met

If all of the conditions in the terms of an award must be met for an employee to vest in or exercise the award, the requisite service period is the longest of the explicit, implicit, and derived service periods because the employee must still be employed when the last condition is met. Compensation cost should be recognized over that requisite service period.

However, when one of the conditions is a service or performance condition, recognition of compensation cost should reflect the probable outcome of the condition. That is, if it is not probable that the service or performance condition will be met, no compensation cost should be recognized. On the other hand, if one of the conditions is a market condition, the entity should not consider the probability of achieving the market condition when it attributes compensation cost because a market condition is not a vesting condition. Rather, the probability of achieving the market condition should be factored into the grant-date fair-value-based measure of the award.

See Q&A 3-34 for a discussion of how a market condition affects the valuation of a share-based payment award. Even if the market condition is never achieved, compensation cost should be recognized if the employee provides the requisite service and the other vesting conditions are met.
If Only One Condition Must Be Met

If the terms of an award contain multiple conditions, but only one condition must be met for an employee to vest in or exercise the award, the requisite service period is the shortest of the explicit, implicit, or derived service periods because the employee must only remain employed until any of the conditions is met. Compensation cost should be recognized over that requisite service period.

If the award contains a service or performance condition, and it is not probable that the employee will meet such condition, the condition should be disregarded in the determination of the requisite service period because the employee can still earn (i.e., vest in) the award upon the satisfaction of the other conditions. Therefore, a condition that is not expected to be achieved must be excluded from the determination of the shortest of the explicit, implicit, or derived service period.

If the award includes a market condition, and neither that nor any other condition was ultimately achieved, compensation cost should still be recorded as long as the employee provides the requisite service under the derived service period. As noted above, an entity should not consider the probability that the market condition will be achieved when it attributes compensation cost because a market condition is not a vesting condition. Rather, it should factor the probability of achieving the market condition into the grant-date fair-value-based measure of the award.

Summary

The following table summarizes how an award with two conditions affects the requisite service period and the subsequent recognition of compensation cost.

<table>
<thead>
<tr>
<th>Condition Combination</th>
<th>Requisite Service Period</th>
<th>Compensation Cost Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>A market condition or a performance/service condition must be met for an employee to vest in or exercise the award</td>
<td>The shortest of the derived, implicit, or explicit service periods (ASC 718-10-55-73).</td>
<td>Exclude that performance/service condition from the assessment of the requisite service period. Therefore, the derived service period is the requisite service period.</td>
</tr>
<tr>
<td>A market condition and a performance/service condition must be met for an employee to vest in or exercise the award</td>
<td>The longest of the derived, implicit, and explicit service periods (ASC 718-10-55-73).</td>
<td>Do not record compensation cost until it is probable that the award will vest (ASC 718-10-25-20).</td>
</tr>
<tr>
<td>A service condition or a performance condition must be met for an employee to vest in or exercise the award</td>
<td>The shortest of the implicit or explicit service periods (ASC 718-10-55-73).</td>
<td>Exclude that performance/service condition from the assessment of the requisite service period. Therefore, the implicit/explicit service period associated with the other vesting condition is the requisite service period.</td>
</tr>
<tr>
<td>A service condition and a performance condition must be met for an employee to vest in or exercise the award</td>
<td>The longest of the implicit and explicit service periods (ASC 718-10-55-73).</td>
<td>Do not record compensation cost until it is probable that the award will vest (ASC 718-10-25-20).</td>
</tr>
</tbody>
</table>

Under what circumstances can entities reverse previously accrued compensation cost and record no compensation cost for the award?

If the employee forfeits the award before the end of the derived service period and before the performance/service condition is met.

If the employee forfeits the award before the end of the derived service period or before the performance/service condition is met.

If the employee forfeits the award before the service and performance conditions are met.

If the employee forfeits the award before the service or performance condition is met.

Is the initial estimate of the derived service period subsequently revised on the basis of updated assumptions?

No, unless the market condition is met earlier than estimated.

No, unless the market condition is met earlier than estimated.

N/A

N/A

Is the estimate of an implicit service period subsequently revised for new assumptions?

Yes

Yes

Yes

Yes
Example 1 — Both Service Conditions and Performance Conditions
On January 1, 20X1, Entity A grants employee share options that vest at the end of the fourth year of service (cliff vesting). The options can only be exercised by employees who are still employed with the entity when it successfully completes an IPO.

The options contain an explicit service condition (i.e., the options vest at the end of the fourth year of service) and a performance condition (i.e., the options can only be exercised upon successful completion of an IPO by employees that are still employed by A upon the completion of the IPO). Entity A should treat the exercisability condition similarly to the way it would treat a vesting requirement. Under ASC 718-10-55-76, if the vesting (or exercisability) of an award is based on the satisfaction of both a service and performance condition, the entity must initially determine which outcomes are probable and recognize the compensation cost over the longer of the explicit or implicit service period. Because an IPO generally is not considered to be probable until the IPO is effective, no compensation cost would be recognized until the IPO occurs. For example, if an IPO becomes effective on December 31, 20X2, and the four years of service are expected to be rendered, upon the IPO becoming effective, A would (1) recognize a cumulative-effect adjustment to compensation cost for the service that has already been provided (two of the four years) and (2) record the unrecognized compensation cost ratably over the remaining two years of service.

Example 2 — Service or Performance Condition
On January 1, 20X1, Entity A grants employee share options that vest upon the earlier of (1) the end of the fifth year of service (cliff vesting) or (2) A’s obtaining a patent for the prescription drug it is currently developing. Entity A believes it is probable that the patent will be obtained at the end of four years. The options contain an explicit service condition (i.e., the options vest at the end of the fifth year of service) and a performance condition (i.e., the options vest when the entity obtains a patent for the prescription drug it is currently developing) with an implicit service period of four years. Because the options vest upon the achievement of either condition, the requisite service period is the shorter of the two service periods — four years.

The implicit service period is simply an estimate. Therefore, if the award becomes exercisable because the patent is obtained before A’s original estimate of four years, A should immediately record any unrecognized compensation cost on the date the performance condition is achieved.

Example 3 — Both Service Conditions and Market Conditions
On January 1, 20X1, Entity A grants employees share options that vest if A’s share price is at least $50 and the employee provides service for at least one year (the employee must also be employed when the share price is at least $50 to exercise the options). Using a lattice model valuation technique, A estimates that its share price will reach $50 in three years.

The options contain an explicit service condition (i.e., the options vest at the end of one year of service) and a market condition (i.e., the options become exercisable if A’s share price is at least $50 per share) with a three-year derived service period. Because the options vest upon the achievement of both conditions, the requisite service period is the longer of the two service periods — three years. In addition, because a market condition is not a vesting condition, the market condition should be factored into the grant-date fair-value-based measure of the options. As long as the employee provides service for three years, compensation cost must be recognized regardless of whether the market condition is satisfied. ASC 718-10-30-14 states that compensation cost is recognized regardless of when, if ever, the market condition is satisfied.

Example 4 — Service or Market Conditions
On January 1, 20X1, when Entity A’s share price is $25 per share, A grants employees share options that vest on the earlier of (1) the end of the fifth year of service (cliff vesting) or (2) A’s share price increasing to $50 per share. By using a lattice model valuation technique, A estimates that its share price will reach $50 in four years.

The options contain an explicit service condition (i.e., the options vest at the end of the fifth year of service) and a market condition (i.e., the options vest if A’s share price increases to $50 per share) with a derived service period of four years. Because the options vest upon the achievement of either condition, the requisite service period is the shorter of the two service periods — four years. If the options vest sooner because the $50 share price target is attained before the derived service period of four years, A should immediately record any unrecognized compensation cost on the date the market condition is achieved. Conversely, if the options never become exercisable because the share price target is never achieved, but the employee remains employed for at least four years, compensation cost should still be recorded.
Example 5 — Both Performance Conditions and Market Conditions

On January 1, 20X1, Entity A grants employees share options that vest if (1) A’s share price is at least $50 and (2) A’s cumulative net income over the next two annual reporting periods exceeds $12 million. As of January 1, 20X1, A’s share price is $40. By using a lattice model valuation technique, A estimates that its share price will reach $50 in three years.

The options contain a performance condition (i.e., the options vest if A exceeds $12 million in cumulative net income over the next two annual reporting periods) and a market condition (i.e., the options vest if A’s share price is at least $50 per share) with a derived service period of three years. Since the market condition is not a vesting condition, the market condition should be factored into the grant-date fair-value-based measure of the options.

The award’s vesting is based on the satisfaction of both a market condition and a performance condition and if it is probable that the performance condition will be satisfied; therefore, in accordance with ASC 718-10-55-73, the initial estimate of the requisite service period would generally be the longest of the explicit, implicit, or derived service periods. The performance condition provides an explicit service period of two years. The three-year derived service period is based on A’s share price reaching $50. Since the derived service period of three years represents the longer of the two service periods, compensation cost would be recognized over that three-year period.

If the market condition is satisfied on an earlier date, any unrecognized compensation cost would be recognized immediately upon its satisfaction. However, this accelerated service period cannot be shorter than the explicit service period of two years that is derived from the performance condition. Note that in accordance with ASC 718-10-25-20, if achieving the performance condition were to become improbable, all previously recognized compensation would be reversed. In addition, if the options never vest because the share price target is never achieved, but the employee remains employed for at least the derived service period of three years and the performance condition is satisfied, compensation cost should still be recorded.

3-32 Nonsubstantive Service Conditions Due to Retirement Provisions

In some cases, an entity may grant share-based payment awards with an explicit service condition to employees who are eligible for retirement as of the grant date. These awards may contain a clause that allows an employee who is retirement-eligible (or who becomes retirement-eligible) to (1) retain the award and (2) continue to vest in the award after the employee retires. See ASC 718-10-55-87 and 55-88 for a discussion of the accounting for awards granted to retirement-eligible employees.

Question

How does a retirement provision such as that described above affect an explicit service condition that is specified in the terms of the share-based payment award?

Answer

The existence of a retirement provision such as that described above causes the explicit service condition to become nonsubstantive. The ASC 718-10-20 definition of “terms of a share-based payment award” states, in part:

The substantive terms of a share-based payment award . . . provide the basis for determining the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the award and related arrangement, if any, are structured.

Because the retirement-eligible employee is not required to provide services during the explicit service period, the explicit service condition is not considered substantive and does not affect the requisite service period of the award. The entity has granted an award that does not contain any vesting conditions and is effectively fully vested on the grant date. Accordingly, the award’s entire grant-date fair-value-based measure should be recognized as compensation cost on the grant date.

The award may contain a provision that delays the exercisability of the award through the end of the explicit service period. However, because the employee is not required to provide services after becoming retirement-eligible, this provision represents a post-vesting exercisability condition and does not change the requisite service period of the award.

Example 1

On January 1, 20X1, an entity grants 1,000 at-the-money employee share options, each with a grant-date fair value of $6, to employees who are currently retirement-eligible. The awards legally vest and become exercisable after three years of service. The terms of the award also stipulate that the employees continue to vest after a
qualifying retirement, as defined in their employment agreements. Because the employees are retirement-eligible on the grant date, the entity should recognize compensation cost of $6,000 immediately on the grant date, since the employees are not required to work during the explicit service period to earn the award.

**Example 2**

On January 1, 20X1, an entity grants 1,000 at-the-money employee share options, each with a grant-date fair value of $6, to employees who will become retirement-eligible two years later on December 31, 20X2. The awards legally vest and become exercisable after three years of service. The terms of the award also stipulate that the employees continue to vest after a qualifying retirement, as defined in their employment agreements. Because the employees are retirement-eligible two years after the grant on December 31, 20X2, the entity should recognize compensation cost of $6,000 over the two-year period from the grant date (January 1, 20X1) to the date on which the employees become retirement-eligible (December 31, 20X2), since the employees are not required to provide employee services during the remainder of the explicit service period (January 1, 20X3, through December 31, 20X3) to earn the award.

**3-33 Noncompete Arrangement as an In-Substance Service Condition**

**Question**

Some awards may contain noncompete provisions that require an employee to forfeit share options, return shares, or return any gain realized on the sale of the options or shares if the employee goes to work for a competitor within a specified period. Does the existence of a noncompete provision create an in-substance service condition, which an entity must then consider in determining the requisite service period of an award?

**Answer**

Generally, no. The existence of a noncompete provision alone does not result in an in-substance service condition (see Q&A 3-17). For a noncompete provision to represent an in-substance service condition, the provision must compel the individual employee to provide future services to the entity to receive the benefits of the award. Further, for this condition to be met, the noncompete provision must be so restrictive that the employee is unlikely to be able to terminate and retain the award because any new employment opportunity the individual would reasonably pursue would result in forfeiture of the award.

The evaluation of whether a noncompete arrangement creates an in-substance service condition goes beyond the determination that the noncompete arrangement is, in and of itself, a substantive agreement. An entity must consider all other terms of the award when determining the requisite service period (i.e., whether the explicit service period is nonsubstantive). The entity should consider the following factors when determining whether the noncompete arrangement creates an in-substance service condition:

- Nature of the noncompete provision.
- Lack of an explicit service condition.
- Employee’s rights to the instruments (e.g., the right to sell).
- Provision’s legal enforceability.
- Employer’s intent to enforce and past practice of enforcement.
- Delayed-transfer schedule mirroring the lapse of noncompete provisions.
- Nature of the entity’s operations, industry, and employee relationships.
- Magnitude of the award’s fair value in relation to the employee’s expected future annual total compensation.
- Severity of the provision limiting the employee’s ability to work in the industry in any capacity.

Example 11 in ASC 718-20-55-88 through 55-91, which represents a situation in which the existence of a noncompete arrangement results in an in-substance service condition, states, in part:

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.
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.

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.

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.

In this example, the noncompete provision creates an in-substance service condition because the employee is essentially in the same position as if an explicit vesting period existed. Although the award was fully vested, compensation cost would be recognized over the term of the noncompete agreement. However, at a meeting of the FASB Statement 123(R) Resource Group, the FASB staff indicated that the above example was intended to be an anti-abuse provision that would apply only in limited circumstances. The FASB staff also noted that entity must use judgment in evaluating whether a noncompete provision represents an in-substance service condition.

Example 10 in ASC 718-20-55-85, which represents a situation in which the existence of a noncompete arrangement does not result in an in-substance service condition, states, in part:

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.

In this example, the noncompete provision does not compel the employee to provide services and therefore does not create an in-substance service condition that would affect the requisite service period. The noncompete provision is treated as a clawback feature (see Q&A 4-14) if and when the employee violates the provision, and the award or its cash equivalent is returned by the former employee. The entity does not consider the existence of the provision in determining the requisite service period, and the award is recognized on the basis of the stated vesting terms. In this example, if the award were fully vested, or if the employee is retirement-eligible and the award continues to vest after retirement or the employee is allowed to immediately vest upon retirement (see Q&A 3-32), compensation cost would be recognized immediately.
Market, Performance, and Service Conditions

ASC 718-10

30-27 Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (see paragraph 718-10-30-14). For purposes of this Topic, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied.

30-28 In some cases, the terms of an award may provide that a performance target that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. A performance target that affects vesting and that could be achieved after an employee’s requisite service period shall be accounted for as a performance condition. As such, the performance target shall not be reflected in estimating the fair value of the award at the grant date. Compensation cost shall be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost for which requisite service has not yet been rendered shall be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period shall reflect the number of awards that are expected to vest and shall be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

3-34 Effects of Service, Performance, Market, and Other Conditions on the Valuation of Share-Based Payment Awards

Question

How do service, performance, market, and other conditions affect a share-based payment award’s grant-date fair-value-based measure?

Answer

Service and Performance Conditions

A service or performance condition that affects either the vesting or the exercisability of a share-based payment award is considered a vesting condition. A vesting condition is not directly factored into the grant-date fair-value-based measure of an award. Rather, whether an employee has earned an award (i.e., whether an entity will record compensation cost) is determined on the basis of the vesting condition. However, a vesting condition can indirectly affect the grant-date fair-value-based measure. Since the expected term of an award cannot be shorter than the vesting period, a longer vesting period would result in a longer expected term of an award. See Q&A 3-17 and Q&A 3-18 for a discussion of how service and performance conditions affect the recognition of compensation cost.

In contrast, a service or performance condition that affects a factor (e.g., exercise price, contractual term, quantity, conversion ratio) other than vesting or exercisability of an award will be directly factored into an award’s grant-date fair-value-based measure. See Q&A 3-23 for a discussion of how service and performance conditions that affect factors other than vesting or exercisability of an award affect the award’s grant-date fair-value-based measure.

Market Condition

A market condition is not considered a vesting condition under ASC 718-10-30-27. Accordingly, it will be directly factored into the grant-date fair-value-based measure of an award and not into the determination of whether an award has been earned (i.e., whether an entity will record compensation cost). ASC 718-10-30-14 states the “effect of a market condition is reflected in the grant-date fair value of an award.” See Q&A 3-20 for a discussion of how a market condition affects the recognition of compensation cost.

7 On June 19, 2014, the FASB issued ASU 2014-12, which added ASC 718-10-30-28. The guidance in ASU 2014-12 is effective for all entities (i.e., public business entities and all other entities) for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. Entities may apply the amendments in ASU 2014-12 either (1) prospectively to all awards granted or modified after the effective date or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter.
The valuation technique must take into account all of the possible outcomes of the market condition to effectively incorporate the market condition into the grant-date fair-value-based measure of an award. That is, the valuation technique must be able to estimate the value of path-dependent options. ASC 718-10-30-14 states that “[a]wards with market conditions, as defined in this Topic, are path-dependent options.” A Monte Carlo simulation is an example of a technique that can value such options.

*Other Condition*

If an award is indexed to a factor other than a market, performance, or service condition, it is classified as a share-based liability under ASC 718-10-25-13. The additional factor should be reflected in the estimations of the fair-value-based measure of the award. For example, a share option award may have an exercise price that is indexed to the market price of a commodity such as gold. The fair-value-based measure of the award should be remeasured at the end of each reporting period through settlement and reflect changes in the market price of gold.

**Liability Awards — Measurement Objective and Measurement Date**

<table>
<thead>
<tr>
<th>ASC 718-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Entity</strong></td>
</tr>
<tr>
<td>30-1</td>
</tr>
<tr>
<td><strong>Nonpublic Entity</strong></td>
</tr>
<tr>
<td>30-2</td>
</tr>
</tbody>
</table>

**3-35 Accounting for Equity-Classified Awards Versus Liability-Classified Awards**

*Question*

Under ASC 718, how does the accounting for equity-classified awards differ from the accounting for liability-classified awards?

*Answer*

**Financial Accounting**

Under ASC 718, both equity-classified and liability-classified awards are measured at their fair-value-based amount as of the grant date. However, the primary financial accounting difference between the two is that liability-classified awards, unlike equity-classified awards, must be remeasured at their fair-value-based amount in each reporting period until settlement. The changes in the fair-value-based measure of the share-based liability at the end of each reporting period are recognized as compensation cost (with a corresponding increase or decrease in the share-based liability), either immediately or over the remaining service period depending on the vested status of the award. As with an equity-classified award, an entity generally measures a liability-classified award by using a valuation technique such as an option pricing model. See Q&A 3-01 for a more detailed discussion about selecting a valuation technique.

**Income Tax Accounting**

As with the financial accounting difference, the primary difference between the income tax accounting for equity-classified awards and that for liability-classified awards under ASC 718 is the requirement to remeasure liability-classified awards at their fair-value-based amount in each reporting period until settlement. The DTA (and corresponding deferred income tax benefit) would be recognized in the same manner as the compensation cost (i.e., either immediately or over the remaining service period, depending on the vested status of the award). Because the DTA and the associated compensation cost are remeasured in each reporting period, the tax benefit of the liability-classified award will, upon settlement, equal the DTA. Accordingly, the settlement of a liability-classified award never results in an excess tax benefit or a tax benefit deficiency.
In addition, the income tax accounting for an equity-classified award will depend on whether the award is an ISO or an NQSO. (See Q&A 8-02 for information regarding the income tax accounting for equity-classified ISOs and Q&A 8-03 for information regarding the income tax accounting for equity-classified NQSOs.) The exercise of an equity-classified ISO does not result in a tax deduction for the employer unless a disqualifying disposition by the employee or former employee occurs. Therefore, until or unless a disqualifying disposition occurs, the recognition of a DTA (and corresponding deferred income tax provision) is not permitted for an ISO. The exercise of an equity-classified NQSO results in a tax deduction for the employer that, under the U.S. tax code, is equal to the intrinsic value of the NQSO when it is exercised. Because the DTA and the associated compensation cost are recognized on the basis of the grant-date fair-value-based measure of the award, the difference between the DTA and the tax benefit results in either an excess tax benefit or a tax benefit deficiency.

**Example**

Assume the following:

- One thousand SARs are granted to one employee on January 1, 20X1.
- The SARs vest at the end of the second year of service (cliff vesting).
- The fair-value-based measures of the SARs are as follows:
  - $10 on January 1, 20X1.
  - $15 on December 31, 20X1.
  - $14 on December 31, 20X2.
  - $18 on December 31, 20X3.
  - $16 on the settlement date, May 15, 20X4.
- For simplicity, the effects of forfeitures have been ignored.
- The entity’s applicable tax rate is 40 percent.
- There are no interim reporting requirements.
- In Scenario 1 (see table below), the employer is required to settle the SARs with shares (equity-classified awards). Note that the income tax accounting for an equity-classified SAR is the same as the accounting for an equity-classified NQSO.
- In Scenario 2 (see table below), the employer is required to settle the SARs with cash (liability-classified awards).
### Scenario 1 — Equity-Classified SARs

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Compensation Cost</th>
<th>DTA Increase/ (Decrease)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 5,000</td>
<td>$ 2,000</td>
<td>Compensation cost is based on the number of SARs granted, the grant-date fair-value-based measure of the equity-classified SARs, and the amount of services rendered (1,000 SARs × $10 grant-date fair-value-based measure × 50% services rendered). The DTA is based on the compensation cost recognized and the entity’s income tax rate ($5,000 compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>5,000</td>
<td>2,000</td>
<td>Compensation cost is based on the number of SARs granted, the grant-date fair-value-based measure of the equity-classified SARs, and the amount of services rendered, less compensation costs previously recognized [(1,000 SARs × $10 grant-date fair-value-based measure × 100% services rendered) – $5,000 compensation cost previously recognized]. The DTA is based on compensation cost recognized and the entity’s income tax rate ($5,000 compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>—</td>
<td>—</td>
<td>Remeasurement of equity-classified awards is not required.</td>
</tr>
<tr>
<td>Period from January 1, 20X4, to May 15, 20X4</td>
<td>—</td>
<td>—</td>
<td>Remeasurement of equity-classified awards is not required.</td>
</tr>
<tr>
<td>Total</td>
<td>$ 10,000</td>
<td>$ 4,000</td>
<td></td>
</tr>
</tbody>
</table>

### Compensation Cost

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Compensation Cost</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 15, 20X4</td>
<td>$ 0</td>
<td>Remeasurement of the equity award on settlement is not required. The tax accounting will be based on the tax deduction the entity receives.</td>
</tr>
</tbody>
</table>

**Journal Entries:**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
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<tr>
<td>Taxes payable</td>
<td>$ 6,400</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>APIC</td>
<td>2,400</td>
</tr>
</tbody>
</table>

To adjust current tax expense and tax payable for the stock option deduction ($16 × 1,000 awards × 40%) and to record the excess tax benefit in APIC ($16,000 – $10,000) × 40%.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>4,000</td>
</tr>
<tr>
<td>DTA</td>
<td>4,000</td>
</tr>
</tbody>
</table>

To reverse the DTA.

---

8 In this calculation, 50 percent indicates that the employee is providing one of two years of service.
### Scenario 2 — Liability-Classified SARs

<table>
<thead>
<tr>
<th>Date</th>
<th>Compensation Cost</th>
<th>DTA Increase/ (Decrease)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 7,500</td>
<td>$ 3,000</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the liability-classified SARs on the reporting date, and the amount of services rendered (1,000 SARs × $15 fair-value-based measure × 50% services rendered). The DTA is based on compensation cost recognized and the entity’s income tax rate ($7,500 compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>6,500</td>
<td>2,600</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the liability-classified SARs on the reporting date, and the amount of services rendered, less compensation costs previously recognized [(1,000 SARs × $14 fair-value-based measure × 100% services rendered) – $7,500 compensation cost previously recognized]. The DTA is based on the compensation cost recognized and the entity’s income tax rate ($6,500 compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>4,000</td>
<td>1,600</td>
<td>Once all services have been provided, the liability-classified SAR is remeasured on each reporting date until the SARs are settled. Remeasurement is based on the number of SARs vested and the fair-value-based measure of the liability-classified SARs on the reporting date, less compensation cost previously recognized [(1,000 SARs × $18 fair-value-based measure) – $14,000 compensation cost previously recognized]. Adjustment to the DTA is based on the change in the compensation cost recognized and the entity’s income tax rate ($4,000 compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td>May 15, 20X4</td>
<td>(2,000)</td>
<td>(800)</td>
<td>Final measurement occurs on the settlement date. Remeasurement is based on the number of SARs settled and the fair-value-based measure of the liability-classified SARs on the settlement date, less compensation cost previously recognized [(1,000 SARs × $16 fair-value-based measure) – $18,000 compensation cost previously recognized]. Adjustment to the DTA is based on the change in the compensation cost recognized and the entity’s income tax rate ($2,000 reversal of compensation cost × 40% income tax rate).</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 16,000</td>
<td>$ 6,400</td>
<td></td>
</tr>
</tbody>
</table>
Chapter 4 — Subsequent Measurement

As discussed in Chapter 3, the cost of the employee services rendered in exchange for share-based payment awards should be measured at the fair-value-based measure of the equity instruments exchanged or the liabilities incurred and should be recognized as compensation cost over the requisite service period of the awards. To make subsequent changes to the terms or conditions of an award after the grant date, an entity may need to remeasure the fair-value-based measure of the award and related compensation cost. The same fair-value-based measurement principles are used to determine the cost of the award for changes made after the grant date (initial measurement date). ASC 718 provides explicit guidance on determining the fair-value-based measure of an award that is modified, canceled, or settled.

Estimating the Requisite Service Period

ASC 718-10-20 defines the requisite service period, in part, as the “period (or periods) during which an employee is required to provide service in exchange for an award.” As a result, the requisite service period is used to determine the period over which compensation cost is recognized. The service inception date, which is generally the grant date, is the beginning of the requisite service period. For awards with only a service condition, the vesting period is generally the requisite service period of the award unless there is clear evidence to the contrary. See Q&A 3-32 for a discussion of nonsubstantive service conditions that are due to retirement provisions.

The requisite service period is not to be confused with the expected term of an award. The expected term (1) is a required input into a valuation technique or model that is used to determine the fair-value-based measure of a share option or similar instrument and (2) represents the period during which the award is expected to be outstanding before the employee exercises it. See Chapter 3 for a more detailed discussion of the required inputs into a valuation technique or model (including expected term) in the determination of the fair-value-based measure of a share option or similar instrument.

The requisite service period of a share-based payment award may be stated in the terms of the award (explicit service period) or it may be inferred from an analysis of the award’s terms and conditions (implicit service period). For awards with market conditions, an entity may derive the requisite service period by applying certain valuation techniques or models (e.g., a lattice-based model) that are used to determine the award’s fair-value-based measure. Examples of each type of service period are as follows:

- **Explicit** — The award vests upon the completion of four years of continued service. The explicit service period is four years.
- **Implicit** — The award vests when a specified amount of the entity’s product is sold. The entity expects to sell the specified amount of its product in two years. The implicit service period is two years.
- **Derived** — The award becomes exercisable when the market price of the entity’s stock reaches a specified level. On the basis of the valuation technique used to determine the fair-value-based measure of the award, the specified level of the market price of the entity’s stock is expected to be achieved in three years. The derived service period is three years. See Q&A 4-03 for a more detailed discussion of a derived service period.

An award may contain one or more explicit, implicit, or derived service periods; however, it can have only one requisite service period, with the exception of awards accounted for as in-substance multiple awards (e.g., an award with a graded vesting schedule — see Accounting for Awards With a Graded Vesting Schedule below).
All Conditions Must Be Met (“And” Conditions)
If the terms of an award contain multiple conditions that all must be met before the award can be earned (i.e., vested) or exercised, the requisite service period is the longest of the explicit, implicit, or derived service period because the employee must still be employed at the time the last condition is met. If vesting is based on satisfying both service and performance conditions and it is not considered probable that the service or performance condition will be achieved, no compensation cost will be recognized until the achievement of both conditions is considered probable.

On the other hand, if one of the conditions is a market condition, an entity should not consider the probability of achieving the market condition when recognizing compensation cost. Rather, in such circumstances, the probability of achieving the market condition should be factored into the grant-date fair-value-based measure of the award (see Chapter 3). Even if the market condition is never achieved, compensation cost should be recognized if the requisite service has been provided and the vesting conditions have been met.

Only One Condition Must Be Met (“Or” Conditions)
If the terms of an award contain multiple conditions but only one condition must be met before the award can be earned (i.e., vested) or exercised, the requisite service period is the shortest of the explicit, implicit, or derived service period because the employee only has to remain employed until the first condition is met.

If one of the conditions is a service or performance condition and that condition is not expected to be achieved (e.g., because it is not probable that the performance condition will be met), an entity should disregard the condition in determining the requisite service period because the employee can still earn the award as a result of meeting other conditions. Accordingly, a condition that is not expected to be achieved cannot result in the shortest of the explicit, implicit, or derived service period. If none of the service or performance conditions are expected to be achieved, no compensation cost is recognized.

If there is a market condition, the probability of achieving the market condition should not be considered since it is already factored into the determination of the grant-date fair-value-based measure of the award. However, if the initial estimate of the requisite service period is based on the market condition (i.e., the derived service period) and this service period has been completed, compensation cost should not be reversed even if the market condition is not achieved. If, however, the award vests on the basis of a service or performance condition, the market condition would generally not be factored into the grant-date fair-value-based measure of the award because the award would still have vested in the absence of the market condition. As noted above, the market condition is not a vesting condition. See Q&A 3-31 for a discussion and illustrations of the impact of multiple conditions that affect the vesting or exercisability of an award.

Forfeitures
At the end of the requisite service period, the cumulative compensation cost recognized is based on the number of awards that have been earned (i.e., vested). Over the requisite service period, an entity estimates the number of awards that are expected to be earned (i.e., vested) and accrues compensation cost on the basis of that number, the fair-value-based measure of the awards, and the portion of the requisite service period that has been completed. The entity estimates the number of awards that are expected to be earned (i.e., vest) by reducing the number of outstanding awards by the number of awards that are expected to be forfeited (i.e., awards for which the requisite service is not expected to be rendered). An entity’s forfeiture estimate is revised if subsequent information indicates that the number of awards that are expected to be forfeited is likely to differ from previous estimates. The cumulative effect on current and prior periods of an entity’s change in its forfeiture estimate is recognized in compensation cost in the period of the change. See Q&A 4-01 for an example illustrating the accounting for awards that are forfeited and Q&A 4-02 for a discussion of what information an entity may use when estimating forfeitures.

Accounting for Awards With a Graded Vesting Schedule
Awards may legally vest in their entirety at the end of a stated period, which is known as cliff vesting. For example, an award that vests in its entirety at the end of the third year of service is a cliff-vesting award. For cliff-vesting awards, the compensation cost is recognized on a straight-line basis over the entire award’s requisite service period.
In contrast, awards may legally vest in increments at the end of multiple periods, which is known as graded vesting. For example, an award that vests in 25 percent increments (tranches) each year over the next four years is a graded vesting award. For awards with a graded vesting schedule and only service conditions, an entity can elect, as an accounting policy, to use one of two methods to record compensation cost:

1. A graded vesting attribution method (or accelerated attribution method) under which the entity treats each separately vesting portion (tranche) as a separate award (as if the award was, in substance, multiple awards) and recognizes compensation cost for each tranche over its separate vesting schedule. For example, an award that vests in 25 percent increments (tranches) each year over the next four years would be treated as four separate awards, one for each separately vesting tranche. Under this method, a greater amount of compensation cost would be recognized in the earlier periods of the grant and a lower amount would be recognized in later periods. (See Q&A 4-10 for examples illustrating the graded vesting attribution method.)

2. A straight-line attribution method under which the award is treated as a single award for recognition purposes and compensation cost is recognized on a straight-line basis over the entire award’s total requisite service period (i.e., over the requisite service period of the last separately vesting portion of the award).

The choice of attribution method for awards with graded vesting schedules does not depend on an entity’s choice of valuation technique. Irrespective of the method applied, the amount of compensation cost that is recognized on any given date must at least be equal to the portion of the grant-date fair-value-based measure of the award vested on that date. Further, if graded vesting awards have a market or performance condition, the entity must use the graded vesting attribution method to recognize compensation cost except when the performance condition is related to an IPO or a change in control that could only accelerate vesting.

**Modifications**

ASC 718-10-20 defines a modification as a “change in any of the terms or conditions of a share-based payment award” (emphasis added). Accordingly, if an entity makes changes to, for example, the exercise price, the vesting conditions, or the contractual terms of an award, those changes are accounted for as a modification.

ASC 718 indicates that a modification is viewed as an exchange of the original award for a new award. Any incremental value of the new (or modified) award generally is recorded as additional compensation cost on the modification date (for vested awards) or over the remaining service (vesting) period (for unvested awards). The incremental value (i.e., incremental compensation cost) is computed as the excess of the fair-value-based measure of the modified award on the modification date over the fair-value-based measure of the original award immediately before the modification.

In addition to considering whether a modification results in incremental compensation that must be recognized, an entity must consider whether it should recognize the original grant-date fair-value-based measure of the award. Generally, total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair-value-based measure of the original award unless the original award is not expected to vest under its original terms (i.e., the service condition, the performance condition, or neither is expected to be achieved).

Therefore, total recognized compensation cost attributable to an award that has been modified is generally the sum of (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned or is expected to be provided and (2) the incremental compensation cost conveyed to the holder of the award as a result of the modification. See Q&A 4-15 for additional guidance on accounting for the modification of a share-based payment award.

**Changes in the Vesting Conditions of an Award**

A modification that changes an award’s vesting conditions is accounted for in the same manner as any other modification (see Modifications above).

If, on the date of modification, it is expected (probable) that the awards will vest under their original vesting conditions, an entity records compensation cost if the awards vest under either (1) the modified vesting conditions or (2) the original vesting conditions. Because it is probable that the original vesting condition will be achieved, the total amount of compensation cost recognized cannot be less than the original grant-date fair-value-based measure. In addition, if the modification results in incremental value, total compensation cost recognized includes the incremental compensation cost only if the modified vesting condition is satisfied.
In contrast, if it is not expected (improbable) on the date of modification that the awards will vest under their original vesting conditions, an entity records compensation cost only if the award vests under the modified vesting conditions. That is, if an entity did not expect an award to vest on the basis of the original vesting conditions on the date of modification, no cumulative compensation cost would have been recorded. If the award vests under the modified vesting conditions, total recognized compensation cost is based on the number of awards that vest and the fair-value-based measure of the modified award on the date of modification. The grant-date fair-value-based measure of the original award is irrelevant. See Q&A 4-22 for a discussion of the different types of modification to an award’s vesting conditions.

Changes in Classification of an Award

A modification can also result in a change in an award’s classification (i.e., from equity-classified to liability-classified or vice versa). To account for the modification of an award that results in an award’s reclassification from equity-classified to liability-classified, an entity would recognize, on the modification date, a share-based liability for the portion of the award for which the services have already been provided, multiplied by the modified award’s fair-value-based measure. If the fair-value-based measure of the modified award is less than or equal to the fair-value-based measure of the original award, the offsetting amount would be recorded in APIC. If, however, the fair-value-based measure of the modified award is greater than the fair-value-based measure of the original award, the excess value would be recognized as additional compensation cost either immediately (for vested awards) or over the remaining requisite service period (for unvested awards). Because the award is now classified as a liability, it is remeasured at a fair-value-based measure in each reporting period until settlement. See Q&A 4-18 for guidance on accounting for the modification of an award that changes the award’s classification from equity-classified to liability-classified.

A modification that changes an award’s classification from liability-classified to equity-classified differs from other modifications with respect to the basic premise regarding total compensation cost (i.e., total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair-value-based measure of the original award unless the original award was not expected to vest). Rather, the aggregate amount of compensation cost recognized is the fair-value-based measure of the award on the modification date. To account for the modification, on the modification date, the amounts previously recorded as a share-based compensation liability would be recorded as a component of equity. Because the award is no longer classified as a liability, it no longer has to be remeasured at a fair-value-based measure in each reporting period until settlement. See Q&A 4-19 for a discussion of the accounting for the modification of an award that changes the award’s classification from liability-classified to equity-classified.

Settlements and Cancellations

A settlement of a share-based payment award is the payment (usually in the form of cash) made to fulfill an award. Because the terms of liability-classified awards often require that the awards be settled in cash, the term “settlement” generally refers to the payment to satisfy an award that is equity-classified. The amount of cash, other assets, or liabilities incurred to settle an equity-classified award is charged directly to equity. To the extent that the settlement consideration exceeds the fair-value-based measure of the equity-classified award on the settlement date, that difference is recognized as additional compensation cost.

If an entity settles an unvested award (i.e., an award for which all of the required service to earn the award has not been provided), the entity has effectively modified the award to accelerate the vesting conditions of the award. Accordingly, any remaining unrecognized compensation cost is generally recognized immediately on the settlement date.

In comparison, a cancellation can be viewed as a settlement of an award for no consideration. As a result, as with a settlement, if an entity cancels an unvested award, any remaining unrecognized compensation cost would generally be recognized immediately on the cancellation date. Note that a cancellation differs from a forfeiture. As mentioned above, a forfeiture represents an award for which the requisite service is not expected to be rendered. In contrast, a cancellation represents an award for which the requisite service is expected to be rendered but is canceled. Accordingly, for a forfeiture, any compensation cost that has been previously recognized is reversed, whereas for a cancellation, any previously recognized compensation cost is not reversed. As noted above, any remaining unrecognized compensation cost is generally recognized immediately on the cancellation date.
A cancellation may be accompanied by a concurrent grant of (or offer to grant) a new (or replacement) award. Because the entity is in effect granting (or offering to grant) an award to replace the canceled award, the accounting for a cancellation accompanied by a concurrent grant of (or offer to grant) a replacement award is accounted for in the same manner as a modification. That is, an entity must record the incremental value, if any, conveyed to the holder of the award as compensation cost on the cancellation date (for vested awards) or over the remaining requisite service period (for unvested awards). The incremental compensation cost is the excess of the fair-value-based measure of the replacement award over the fair-value-based measure of the canceled award on the cancellation date. See Q&A 4-38 for more information about the accounting differences between a modification of an existing award and a cancellation of an award with a concurrent issuance of (or offer to issue) a new award.

**Equity Restructurings**

An equity restructuring is a nonreciprocal transaction between an entity and its shareholders that causes a change in the per-share fair value of the shares underlying a share-based payment award (e.g., stock dividend, stock split, spin-off). Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring are accounted for as modifications. However, the impact of applying modification accounting depends on whether an adjustment is made in accordance with an existing nondiscretionary antidilution provision. A nondiscretionary provision is clear and measurable and requires the entity to take action. In contrast, a discretionary provision is broad and subjective and allows, but does not require, the entity to take action. An entity should compare the fair-value-based measure of the modified award with the fair-value-based measure of the original award (on the basis of the stated antidilution terms in the award) immediately before the modification to determine whether incremental compensation cost should be recognized. See Q&A 4-30 for further guidance on accounting for the impact of an award’s antidilution provisions.

**Recognition of Compensation Costs Over the Requisite Service Period**

**ASC 718-10**

| 35-1 | This Subtopic is interrelated with Subtopics 718-20 and 718-30. Material that equally applies to both liabilities and equity is generally found in this Subtopic. However, material may have been placed in one of the other Subtopics. |
| 35-2 | The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award. |
| 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). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change. 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). |
| 35-4 | An entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered. |

4-01 Accounting for Forfeitures — Example

Under ASC 718, when recognizing the grant-date fair-value-based measure of share-based payment awards as compensation cost in the financial statements, an entity must estimate forfeitures when the awards are granted (and must update its estimate if information becomes available indicating that actual forfeitures will differ from previous estimates). See Q&A 4-02 for a discussion of information an entity can consider in estimating forfeitures.

**Example**

Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $10. The options vest at the end of the fourth year of service (cliff vesting).
As of the grant date, A estimates that 100 of the stock options will be forfeited during the service (vesting) period. However, in year 3, 150 options are forfeited; there are no other forfeitures during the service (vesting) period. The following table illustrates the compensation cost that is recognized on the basis of the initial estimate of forfeitures and revised when information becomes available suggesting that actual forfeitures will differ:

<table>
<thead>
<tr>
<th>Year</th>
<th>Compensation Cost</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$2,250</td>
<td>Because A estimates that 100 options will be forfeited during the vesting period, compensation cost is recognized for only 900 of the 1,000 options granted. Compensation cost is based on the number of options expected to vest, the grant-date fair-value-based measure of the options, and the amount of services rendered (900 options × $10 fair-value-based measure × 25% services rendered).</td>
</tr>
<tr>
<td>Year 2</td>
<td>2,250</td>
<td>Because there is no change in forfeiture estimate, the amount of compensation cost is exactly the same as in year 1. Compensation cost is based on the number of options expected to vest, the grant-date fair-value-based measure of the options, and the amount of services rendered, less amounts previously recognized (900 options × $10 fair-value-based measure × 50% services rendered) – $2,250.</td>
</tr>
<tr>
<td>Year 3</td>
<td>1,875</td>
<td>In year 3, 150 options are forfeited and A expects that no other forfeitures will occur before vesting. Compensation cost is based on the number of options expected to vest, the grant-date fair-value-based measure of the options, and the amount of services rendered, less amounts previously recognized (850 options × $10 fair-value-based measure × 75% services rendered) – $4,500.</td>
</tr>
<tr>
<td>Year 4</td>
<td>2,125</td>
<td>By the end of year 4, 850 options are fully vested. Compensation cost is based on the number of options vested, the grant-date fair-value-based measure of the options, and the amount of services rendered, less amounts previously recognized (850 options × $10 fair-value-based measure × 100% services rendered) – $6,375.</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Twenty-five percent represents the employee’s providing one of four years of service.

4-02 Information Used to Estimate Forfeitures

**Question**

What information can an entity consider in estimating forfeiture rates?

**Answer**

A number of different sources of relevant information and data can be used to support an entity’s estimate of the number of share-based payment awards that eventually will vest. Examples are as follows (the list is not intended to be all-inclusive):

- Historical rates of forfeiture (before vesting) for awards with similar terms.
- Historical rates of employee turnover (before vesting).
- The intrinsic value of the award on the grant date.
- The volatility of the entity’s share price.
- The length of the vesting period.
- The number of awards granted to individual grantees.
- The nature and terms of the vesting condition(s) of the award.\(^1\)
- The characteristics of the grantees (e.g., whether the grantees 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 (before vesting).

In accordance with paragraph B166 of Statement 123(R), entities without sufficient information may base forfeiture estimates on experience of other entities in the same industry until entity-specific information is available.

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\(^1\) Accruals of compensation cost for an award that has a performance condition are based on the probable (as used in ASC 450) outcome of that condition (ASC 718-10-25-20).
Estimating the Requisite Service Period

ASC 718-10

35-5 The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value (see paragraph 718-10-55-71). An award may have one or more explicit, implicit, or derived service periods; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards. An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (see paragraph 718-10-35-8). Paragraphs 718-10-55-69 through 55-79 and 718-10-55-93 through 55-106 provide guidance on estimating the requisite service period and provide examples of how that period shall be estimated if an award’s terms include more than one explicit, implicit, or derived service period.

35-6 The service inception date is the beginning of the requisite service period. If the service inception date precedes the grant date (see paragraph 718-10-55-108), accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date). Example 6 (see paragraph 718-10-55-107) illustrates the concept of service inception date and how it is to be applied.

35-7 An entity shall adjust that initial best estimate in light of changes in facts and circumstances. Whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of the conditions identified in paragraph 718-10-30-26 and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied. Paragraphs 718-10-55-69 through 55-79 provide guidance on adjusting the initial estimate of the requisite service period.

4-03 Derived Service Period

Question
What is a derived service period, and what is its purpose?

Answer
A derived service period is unique to share-based payment awards that contain a market condition. As described in ASC 718-10-55-71 and defined in ASC 718-10-20, a derived service period is the “time from the service inception date to the expected date of satisfaction” of the market condition. Entities can infer this period by using a valuation technique (such as a lattice-based model) to estimate the fair-value-based measure of an award with a market condition. For example, an award may have a condition making the award exercisable only when the share price increases by 25 percent. In a lattice-based model, there will be a number of possible paths that reflect an increase in share price by 25 percent. Entities infer the derived service period by using the median share price path, or, in other words, the mid-point period over which the share price is expected to increase by 25 percent.

When an award only has a market condition, the derived service period is the requisite service period. That is, the derived service period establishes the period over which an entity recognizes the compensation cost for a share-based payment award with only a market condition. If the market condition is satisfied at an earlier date, any unrecognized compensation cost is recognized immediately on the date of satisfaction of the market condition. See Q&A 3-31 for a more detailed discussion of the requisite service period of awards with multiple conditions. See also Q&A 3-20 for a discussion of the accounting for awards with only a market condition.

4-04 Modification of a Share-Based Payment Award’s Requisite Service Period

Question
How should an entity account for the modification of a share-based payment award’s requisite service period?

Answer
It depends on whether the modified requisite service period is shorter or longer than the original requisite service period.
Modification to Reduce the Requisite Service Period of an Award

If an entity modifies the requisite service period of a share-based payment award and the requisite service period of the modified award is shorter than the requisite service period of the original award, the entity should recognize compensation cost over the remaining portion of the requisite service period of the modified award. The fair-value-based measure of the modified award would most likely be the same or less than the fair-value-based measure of the original award immediately before modification because (1) the modification only affects the service period of the award and (2) the service period is shorter. Accordingly, there is no incremental value conveyed to the holder of the award, and no incremental compensation cost has to be recorded in connection with this modification.

However, the entity must consider whether the reduction in the requisite service period affects the number of awards that are expected to vest. If, as a result of the modification, the entity expects additional awards to vest, those awards should be accounted for as an improbable-to-probable modification. Accordingly, the entity will record compensation cost for the awards on the basis of (1) the incremental number of awards that are now expected to vest and (2) the modification-date fair-value-based measure of the awards over the remaining portion of the requisite service period of the modified award. See Q&A 4-24 for a discussion of improbable-to-probable modifications.

Modification to Lengthen the Requisite Service Period of an Award

If the requisite service period of the modified award is longer than the requisite service period of the original award and, both before and after the modification, it is probable that the awards would vest (Type I or “probable-to-probable modification”), the entity may make an accounting policy choice to use either of the following methods (both were discussed by the Statement 123(R) Resource Group at its May 26, 2005, meeting; see Q&A 4-23 for a discussion of probable-to-probable modifications):

• The unrecognized compensation cost remaining from the original award would be recognized over the remaining portion of the requisite service period of the original award. The incremental compensation cost, if any, as a result of the modification would be recognized over the remaining portion of the requisite service period of the modified award. See Example 2(a) below.

• The unrecognized compensation cost remaining from the original award plus the incremental compensation cost, if any, as a result of the modification would be recognized in its entirety over the remaining portion of the requisite service period of the modified award. See Example 2(b) below. (Note, however, that to the extent that an employee is not expected to render service over the new requisite service period but is expected to render service over the original requisite service period, the unrecognized compensation cost remaining from the original award would be recognized over the remaining portion of the requisite service period of the original award.)

Regardless of the method chosen, the accounting policy must be applied consistently and disclosed in accordance with ASC 235-10 if it is material to the financial statements.

Under either method, if the requisite service period of the original award is not met, any previously recognized compensation cost should be reversed. However, if the requisite service period of the original award is met, but an employee terminates employment before meeting the requisite service period of the modified award, all the compensation cost associated with the original award should be immediately recognized. Any previously recognized incremental compensation cost related to the modified award should be reversed. This is because in a modification, the total recognized compensation cost attributable to an award is generally required to be at least equal to the grant-date fair-value-based measure of the original award if the original service or performance condition is met or is expected to be met as of the modification date.

Example 1 — Modification to Reduce the Requisite Service Period of an Award

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $20. The options vest at the end of the fourth year of service (cliff vesting). In addition, A estimates that 10 percent of the options will be forfeited. For simplicity, the effects of income taxes have been ignored.

Over the first year of service, A records $4,500 [(1,000 options × 90 percent of options expected to vest) × $20 grant-date fair-value-based measure × 25 percent for one of four years of services rendered] of cumulative compensation cost. On January 1, 20X2, A modifies the options to reduce the requisite service period from four years to three years. The fair-value-based measure of the modified options as of the modification date is $12. Because the modification only affects the service period of the options and the service period is shorter, the fair-
value-based measure of the modified options would most likely be less than the fair-value-based measure of the original options immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the award and, therefore, no incremental compensation cost would be recorded in connection with this modification.

However, as a result of the reduction in the requisite service period, A now expects 95 percent of the options to vest. Accordingly, A will recognize the remaining unrecognized compensation cost for the 900 options originally expected to vest [(1,000 options × 90 percent of options originally expected to vest) × $20 grant-date fair-value-based measure – $4,500 amount previously recognized = $13,500] over the remainder of the modified requisite service period (two years). For the 50 options now expected to vest as a result of the modification, A will recognize $600 of incremental compensation cost (50 options expected to vest × $12 modified-date fair-value-based measure) over the remainder of the modified requisite service period (two years).

**Example 2 — Modification to Lengthen the Requisite Service Period of an Award**

Assume the same facts as in Example 1, except that on January 1, 20X2, Entity A modifies the options to (1) reprice them (i.e., lower the exercise price to equal to the market price of A’s shares) and (2) lengthen the requisite service period from four years to five years. The fair-value-based measure of the original options immediately before modification is $12, and the fair-value-based measure of the modified options is $16. For simplicity, assume that the extension of the service period does not affect forfeitures (90 percent expected to vest) and that the effects of income taxes have been ignored.

On the modification date, A computes the incremental compensation cost as $3,600 [(5 fair-value-based measure of modified options – $12 fair-value-based measure of original options immediately before the modification) × 900 options]. Accordingly, the total remaining unrecognized compensation cost of $17,100 ($13,500 of unrecognized compensation cost from the original options plus $3,600 in incremental compensation cost from the modification) will be recognized in accordance with one of two acceptable methods:

- **Entity A will recognize the unrecognized compensation cost remaining from the original award of $13,500 over the remaining portion of the requisite service period of the original award (three years).** The incremental compensation cost of $3,600 as a result of the modification will be recognized over the remaining portion of the requisite service period of the modified award (four years).
- **Entity A will recognize $17,100 ratably over the remaining portion of the requisite service period of the modified award (four years)**

**4-05 Grant of a Fully Vested Deep Out-of-the-Money Share Option Award**

ASC 718-10-55-67 states, in part:

ASC 718-10-35-2 requires that compensation cost be recognized over the requisite service period. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. The requisite service period shall be estimated based on an analysis of the terms of the award and other relevant facts and circumstances, including co-existing employment agreements and an entity’s past practices; that estimate shall ignore nonsubstantive vesting conditions. For example, the grant of a deep out-of-the-money share option award without an explicit service condition will have a derived service period.

**Question**

How should compensation cost be recognized when an entity awards fully vested share options that are deep out-of-the-money as of the grant date?

**Answer**

The grant of fully vested, deep out-of-the-money share option awards is deemed the equivalent of the grant of an award with a market condition. The share option award effectively contains a market condition because the market price on the grant date is significantly below the exercise price. As a result, the share price must increase to a level above the exercise price before the employee receives any value from the award. The market condition would be reflected in the estimate of the fair-value-based measure on the grant date. Because ASC 718 does not provide guidance on determining whether an option is deep out-of-the-money, an entity must use judgment in making this determination. Factors that an entity may consider include those affecting the value of the award (e.g., volatility of the underlying stock, exercise price) and their impact on the expected period required for the award to become at-the-money.
Because the explicit service period is zero (i.e., the award is fully vested) and the award contains a market condition, the requisite service period equals the derived service period associated with the market condition, which is calculated by using a valuation technique (see Q&A 4-03). The lack of an explicit service period is nonsubstantive because the employee must continue to work for the entity until the share option award is in-the-money to receive any value from the award, since it is customary for awards to have features that limit exercisability upon termination (the term of the option typically truncates, such as 90 days after termination). Compensation cost should be recognized over the derived service period if the requisite service is expected to be rendered, unless the market condition is satisfied on an earlier date, in which case any unrecognized compensation cost is recognized immediately.

4-06 Determining Whether the Service Inception Date Precedes the Grant Date

ASC 718 distinguishes between service inception date and grant date. The service inception date is the date on which the requisite service period begins and is usually the grant date. However, sometimes the service inception date can precede the grant date.

Question

What conditions must be met for the service inception date to precede the grant date?

Answer

ASC 718-10-55-108 states that if all of the following criteria are met, the service inception date precedes the grant date:

a. An award is authorized. [The approvals necessary for either a grant date (see Q&A 2-05) or a service inception date to occur are the same.]

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

c. Either of the following conditions applies:
   1. The award’s terms do not include a substantive future requisite service condition . . . at the grant date [see Example 2].
   2. The award contains a market or performance condition that if not satisfied during the service period preceding the grant date . . . results in forfeiture of the award [see Example 3].

Example 1

On January 1, 20X1, an entity informs one of its employees that it will grant 1,000 fully vested equity-classified share options to the employee on January 1, 20X2, as long as the employee is still employed on that date. The exercise price of the options will equal the market price of the entity’s shares on January 1, 20X2. All necessary approvals for the future grant of these options are received by January 1, 20X1.

The grant date is January 1, 20X2, since the employee neither benefits from, nor is adversely affected by, subsequent changes in the price of the entity’s shares until that date. There is no substantive requirement for additional service to be rendered after December 31, 20X1, and the options cannot be forfeited between January 1, 20X1, and December 31, 20X1, because of failure of satisfaction of a market or performance condition. Accordingly, the service inception is January 1, 20X1, and compensation cost is recorded from January 1, 20X1, to December 31, 20X1. See Q&A 4-07 for a discussion of how to account for a share-based payment award when the service inception date precedes the grant date.

Example 2

On January 1, 20X1, an entity informs one of its employees that it will grant 1,000 fully vested equity-classified share options to the employee on January 1, 20X3, as long as the employee is still employed on that date. The exercise price of the options will equal the market price of the entity’s shares on January 1, 20X2. All necessary approvals for the future grant of these options are received by January 1, 20X1.

The grant date is January 1, 20X2, since the employee neither benefits from, nor is adversely affected by, subsequent changes in the price of the entity’s shares until that date. Because there is a requirement for the employee to provide service from January 1, 20X2, to December 31, 20X2, the options contain a “substantive future requisite service condition . . . at the grant date.” Accordingly, the service inception date is January 1, 20X2, the grant date. Compensation cost would be recognized over the period from January 1, 20X2, to December 31, 20X2.
Example 3

On January 1, 20X1, an entity informs one of its employees that it will grant 1,000 fully vested equity-classified share options to the employee on January 1, 20X3, as long as the employee (1) is still employed on that date and (2) sells 1,000 units of product during 20X1. The exercise price of the options will equal the market price of the entity’s shares on January 1, 20X2. All necessary approvals for the future grant of these options are received by January 1, 20X1.

The grant date is January 1, 20X2, since the employee neither benefits from, nor is adversely affected by, subsequent changes in the price of the entity’s shares until that date. Because the employee could forfeit the options by not selling enough units of product before January 1, 20X2 (the grant date), the service inception date precedes the grant date (i.e., condition (c)(2) above is met). Accordingly, the service inception date is January 1, 20X1; the grant date is January 1, 20X2; and compensation cost would be recognized over the period from January 1, 20X1, to December 31, 20X2. See Q&A 4-07 for a discussion of how to account for a share-based payment award when the service inception date precedes the grant date.

4-07 Accounting When Service Inception Date Precedes the Grant Date

Question

If the service inception date precedes the grant date (see Q&A 4-06), how is a share-based payment award accounted for before the grant date?

Answer

Compensation cost is remeasured on the basis of the award’s estimated fair-value-based measure at the end of each reporting period until the grant date, to the extent that service has been rendered in proportion to the total requisite service period. In the period in which the grant date occurs, cumulative compensation cost is adjusted to reflect the cumulative effect of measuring compensation cost on the basis of the fair-value-based measure of the award on the grant date and is not subsequently remeasured (assuming the award is equity classified).

Example

On January 1, 20X1, an entity informs one of its employees that it will grant 1,000 fully vested equity-classified share options to the employee on January 1, 20X3, as long as the employee (1) is still employed on that date and (2) sells 1,000 units of product during 20X1. The exercise price of the options will equal the market price of the entity’s shares on January 1, 20X2. All necessary approvals for the future grant of these options are received by January 1, 20X1. Accordingly, the service inception date is January 1, 20X1, and the grant date is January 1, 20X2.

Compensation cost is recognized on the basis of the proportion of service rendered over the period from January 1, 20X1, to December 31, 20X2. From the service inception date until the grant date (January 1, 20X1, to December 31, 20X1), the entity remeasures the options at their fair-value-based measure at the end of each reporting period on the basis of the assumptions that exist on those dates. Once the grant date is established (January 1, 20X2), the entity discontinues remeasuring the options at the end of each reporting period. That is, the compensation cost that is recognized over the remaining service period (January 1, 20X2, to December 31, 20X2) is based on the fair-value-based measure on the grant date.

Graded Vesting Awards

ASC 718-10

35-8 An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:

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

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

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. Example 1, Case B (see paragraph 718-20-55-25) provides an illustration of the accounting for an award with a graded vesting schedule.
4-08 Valuation Techniques and Accelerated Versus Straight-Line Attribution

Some share-based payment awards may have a graded vesting schedule (i.e., awards that are split into multiple tranches in which each tranche legally vests separately). For example, an entity may grant an employee 1,000 awards in which 250 of the awards legally vest for each of four years of service provided.

When determining the fair-value-based measure of a share-based payment award with only a service condition that has a graded vesting schedule, an entity’s use of certain valuation techniques may directly or indirectly result in each portion of the award that vests separately being valued as an individual award. That is, directly or indirectly, certain valuation techniques may cause an award with a graded vesting schedule to be characterized as multiple awards instead of a single award.

**Question**

If an entity uses a valuation technique that directly or indirectly values each portion of a graded vesting award separately, can it still avail itself of the policy decision to record compensation cost on a straight-line basis over the total requisite service period for the entire award?

**Answer**

Yes. Regardless of the valuation technique used, even though the valuation technique may directly or indirectly result in each portion of a graded vesting award being valued as individual awards, an entity is able to make a policy decision about how to recognize compensation cost. That is, an entity may recognize compensation cost for an award with only a service condition that has a graded vesting schedule on either (1) an accelerated basis (i.e., the method illustrated in Q&A 4-10) as though each separately vesting portion of the award was, in substance, a separate award or (2) a straight-line basis over the total requisite service period for the entire award.

However, ASC 718-10-35-8 maintains the requirement that if straight-line attribution is used, “the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date.”

4-09 Examples Illustrating the Straight-Line Attribution Method for Graded Vesting Awards

For share-based payment awards with only service conditions that have a graded vesting schedule, ASC 718-10-35-8 allows entities to make a policy decision about whether to recognize compensation cost on (1) an accelerated basis (i.e., the method illustrated in Q&A 4-10) as though each separately vesting portion of the award is, in substance, a separate award or (2) “a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).”

In addition, ASC 718-10-35-8 requires that “the amount of compensation cost recognized at any date . . . at least equal the portion of the grant-date value of the award that is [legally] vested at that date.”

The examples below illustrate the attribution of compensation cost under a straight-line method for graded vesting awards. Note that the vesting percentage does not increase (e.g., 25 percent, 25 percent, 50 percent) in any of these examples. The compensation cost recognized will be equal to the straight-line calculated amortization amount, since the straight-line amount will generally be greater than the portion of the grant-date fair-value-based measure of the award that is legally vested.

**Example 1**

Entity A grants 1,000 “in-the-money” share options to each of its 100 employees. The grant-date fair-value-based measure of each option is $12. The options vest in 25 percent increments (tranches) each year over the next four years (i.e., a graded vesting schedule). To determine the grant-date fair-value-based measure, A uses a valuation technique in which the award is treated as a single award rather than as multiple awards. (See Q&A 4-08 for a discussion of the interaction between valuation techniques and the graded vesting attribution methods.) Assume that no employees will leave in year 1, three employees will leave in year 2, five employees will leave in year 3, and seven employees will leave in year 4.

Entity A elected, as an accounting policy, to use the straight-line attribution method to recognize compensation cost. Under this method, the award is treated as a single award.
The following table summarizes the calculation of total compensation cost by taking into account the estimated forfeitures noted above:

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,000</td>
</tr>
<tr>
<td>2</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>276,000</td>
</tr>
<tr>
<td>4</td>
<td>255,000</td>
</tr>
<tr>
<td><strong>Total compensation cost</strong></td>
<td><strong>$1,122,000</strong></td>
</tr>
</tbody>
</table>

On the basis of the calculation of total compensation cost above, A should recognize $280,500 ($1,122,000 total compensation cost ÷ 4 years of service) of compensation cost each year over the next four years under the straight-line attribution method. However, because, at the end of the first, second, and third years, 25,000, 24,250, and 23,000 employee share options have legally vested, A would have to ensure that, at a minimum, $300,000, $591,000 ($300,000 + $291,000), and $867,000 ($300,000 + $291,000 + $276,000) of cumulative compensation cost is recognized at the end of the first, second, and third years, respectively. Accordingly, A would recognize $300,000 of compensation cost in year 1, $291,000 in year 2, $276,000 in year 3, and $255,000 in year 4, rather than the $280,500 that would have been recognized under a straight-line attribution method. Note that if A’s estimate of forfeitures changes, the cumulative effect of that change on current and prior periods would be recognized as compensation cost in the period of the change. See Q&A 8-13 for a discussion of the tax effects of awards with graded vesting.

**Example 2**

Assume the same facts as in Example 1, except that the options vest over three years in increments (tranches) of 50 percent for the first year of service, 25 percent for the second year of service, and 25 percent for the third year of service (i.e., a graded vesting schedule).

The following table summarizes the calculation of total compensation cost by taking into account the estimated forfeitures noted above:

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
</tr>
<tr>
<td>2</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>276,000</td>
</tr>
<tr>
<td><strong>Total compensation cost</strong></td>
<td><strong>$1,167,000</strong></td>
</tr>
</tbody>
</table>

On the basis of the calculation of total compensation cost above, A should recognize $389,000 ($1,167,000 total compensation cost ÷ 3 years of service) of compensation cost each year over the next three years under the straight-line attribution method. However, because, at the end of the first and second years, 50,000 and 24,250 employee share options have legally vested, A would have to ensure that a minimum of $600,000 and $891,000 ($600,000 + $291,000) of cumulative compensation cost is recognized at the end of the first and second years, respectively. Accordingly, A would recognize $600,000 of compensation cost in year 1, $291,000 in year 2, and $276,000 in year 3, rather than the $389,000 that would have been recognized under a straight-line attribution method. Note that if A’s estimate of forfeitures changes, the cumulative effect of that change on current and prior periods would be recognized as compensation cost in the period of the change. See Q&A 8-13 for a discussion of the tax effects of awards with graded vesting.

4-10 Graded Vesting Attribution Model — Examples

**Example 1**

Entity A grants 1,000 “at-the-money” employee share options to 100 employees, each with a grant-date fair-value-based measure of $12. The options vest in 25 percent increments (tranches) each year over the next four years (i.e., a graded vesting schedule). To determine the grant-date fair-value-based measure, A used a valuation technique that treated the award as a single award rather than as multiple awards. See Q&A 4-08 for a discussion of the interaction of valuation techniques and the graded vesting attribution methods. Assume that no employee will leave in year 1, three employees will leave in year 2, five employees will leave in year 3, and seven employees will leave in year 4.
Entity A elected, as an accounting policy, to use the graded vesting attribution method to recognize compensation cost. The graded vesting attribution method treats each tranche that vests separately as an individual award. In this example, since a portion of the options vests annually, there are only four tranches (i.e., four separate awards). However, if 1/48 of the options vested each month over a four-year period, the grant would contain 48 separate tranches (i.e., 48 separate awards).

The following table summarizes the calculation of total compensation cost by tranche.

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,000</td>
</tr>
<tr>
<td>2</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>276,000</td>
</tr>
<tr>
<td>4</td>
<td>255,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,122,000</strong></td>
</tr>
</tbody>
</table>

The following table summarizes the allocation of total compensation cost over each of the four years of service. For simplicity, the effect of income taxes has been ignored.

<table>
<thead>
<tr>
<th>Award</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,000</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>$300,000</td>
</tr>
<tr>
<td>2</td>
<td>145,500</td>
<td>$145,500</td>
<td>—</td>
<td>—</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>92,000</td>
<td>92,000</td>
<td>$92,000</td>
<td>—</td>
<td>276,000</td>
</tr>
<tr>
<td>4</td>
<td>63,750</td>
<td>63,750</td>
<td>63,750</td>
<td>$63,750</td>
<td>255,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$601,250</strong></td>
<td><strong>$301,250</strong></td>
<td><strong>$155,750</strong></td>
<td><strong>$63,750</strong></td>
<td><strong>$1,122,000</strong></td>
</tr>
</tbody>
</table>

Example 2

Assume all the same facts as in Example 1, except that the options vest over three years in increments (tranches) of 50 percent for the first year of service, 25 percent for the second year of service, and 25 percent for the third year of service (i.e., a graded vesting schedule).

The following table summarizes the calculation of total compensation cost by tranche.

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
</tr>
<tr>
<td>2</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>276,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,167,000</strong></td>
</tr>
</tbody>
</table>

The following table summarizes the allocation of total compensation cost over each of the three years of service. For simplicity, the effect of income taxes has been ignored.

<table>
<thead>
<tr>
<th>Award</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
<td>—</td>
<td>—</td>
<td>$600,000</td>
</tr>
<tr>
<td>2</td>
<td>145,500</td>
<td>$145,500</td>
<td>—</td>
<td>291,000</td>
</tr>
<tr>
<td>3</td>
<td>92,000</td>
<td>92,000</td>
<td>$92,000</td>
<td>276,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$837,500</strong></td>
<td><strong>$237,500</strong></td>
<td><strong>$92,000</strong></td>
<td><strong>$1,167,000</strong></td>
</tr>
</tbody>
</table>

ASC 718-10-35-8 allows an entity to make a policy decision about whether to recognize compensation cost for its awards with only service conditions that have a graded vesting schedule on either (1) an accelerated basis as though each separately vesting portion of the award was, in substance, a separate award or (2) a straight-line basis over the total requisite service period for the entire award (i.e., over the requisite service period of the last separately vesting portion of the award).
**4-11 Attribution Method for Graded Vesting Awards With Both a Service and a Performance Condition**

ASC 718-10-35-8 states, in part:

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

- On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards
- On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). [Emphasis added]

**Question**

For a graded vesting award with both a service and a performance condition, is an entity precluded from using a “straight-line attribution method” over the requisite service period for the entire award?

**Answer**

Generally, yes. ASC 718-10-35-5 requires that awards with graded vesting be treated as in-substance multiple awards with more than one requisite service period, and ASC 718-10-35-8 provides an exception to that requirement for awards with “only service conditions.” Accordingly, ASC 718-10-35-8 cannot be applied broadly to awards that contain vesting conditions beyond service conditions.

However, on the basis of discussions with the FASB staff, we believe that ASC 718 does not intend to preclude straight-line attribution when the only performance condition is a change in control or an IPO that accelerates vesting when the awards otherwise vest solely on the basis of service conditions. Although ASC 718-10-35-8 outlines two acceptable methods for recognizing compensation cost for graded vesting awards “with only service conditions,” we believe the two acceptable methods can also be applied when the performance condition concerns a change in control or an IPO that accelerates vesting when the awards otherwise vest solely on the basis of service conditions.

As discussed in Q&A 3-31, (1) it is generally not probable that an IPO will occur until the IPO is effective and (2) if it is not probable that an award contains a performance condition that will be met, an entity should disregard that condition in determining the requisite service period. Similarly, as discussed in Q&A 10-09, it generally is not probable that a change in control will occur until the change in control is consummated. When the change in control or IPO performance condition accelerates (but does not preclude) vesting, the performance condition generally does not affect vesting or the related attribution method unless a change in control or IPO occurs. Therefore, an entity may elect to apply a straight-line attribution method for graded vesting awards with service conditions and a change in control or IPO performance condition that accelerates vesting. If the change in control or IPO becomes effective, the awards would accelerate vesting and the entity would recognize the remaining compensation cost upon occurrence.

**4-12 Acceptability of Alternative Approach for Recognizing Compensation Cost for Graded Vesting Awards**

Because of the volume and complexity of certain stock-based compensation plans, it is common for entities to use third-party software programs to calculate compensation cost for their share-based payment awards. Certain software programs recognize compensation cost for a graded vesting award with only a service condition by using an approach in which the compensation cost recognized in a given reporting period is aligned with the percentage of awards that are legally vesting in that reporting period. The use of this method is not acceptable under U.S. GAAP when a graded vesting award with only a service condition has a back-loaded vesting schedule (e.g., an award that vests 25 percent in year 1, 25 percent in year 2, and 50 percent in year 3).

**Question**

Is it acceptable under ASC 718 for entities to use an approach such as the one described above for recognizing compensation cost for graded vesting awards with only a service condition?
**Answer**

No. ASC 718-10-35-8 provides only two acceptable approaches for recognizing compensation cost for a graded vesting award with only a service condition:

a. On a straight-line basis over the requisite service period for each separately vesting portion (tranche) of the award as if the award was, in-substance, multiple awards [i.e., accelerated recognition]

b. On a straight-line basis over the requisite service period for the entire award [i.e., straight-line recognition].

The examples below demonstrate the differences in the recognition of compensation costs for graded vesting awards with only a service condition under the two acceptable methods in ASC 718 and under the alternative method. For simplicity, the effects of forfeitures and income taxes have been excluded.

**Assumptions**

<table>
<thead>
<tr>
<th>Grant: 1,000 options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair-value-based measure: $10 per option</td>
</tr>
<tr>
<td>Vesting: Year 1: 25%, Year 2: 25%, and Year 3: 50%</td>
</tr>
<tr>
<td>Total expense: 1,000 × $10 = $10,000</td>
</tr>
</tbody>
</table>

**Straight-Line Recognition**

Under this method, the three tranches are treated as one award and the total compensation cost is recognized on a straight-line basis over the three-year service period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$3,333</td>
</tr>
<tr>
<td>Year 2</td>
<td>3,333</td>
</tr>
<tr>
<td>Year 3</td>
<td>3,334</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$10,000</td>
</tr>
</tbody>
</table>

**Accelerated Recognition**

Under this method, each tranche is treated as a separate award and the total compensation cost is recognized on an accelerated basis over the three-year service period.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1</td>
<td>$2,500</td>
<td>—</td>
<td>$2,500</td>
</tr>
<tr>
<td>Tranche 2</td>
<td>1,250</td>
<td>$1,250</td>
<td>2,500</td>
</tr>
<tr>
<td>Tranche 3</td>
<td>1,666</td>
<td>1,667</td>
<td>$1,667</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,416</td>
<td>2,917</td>
<td>1,667</td>
</tr>
</tbody>
</table>

**Ratable Method Recognition**

Under this method, compensation cost is recognized for the portion of the award that legally vests in a particular period.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$2,500</td>
</tr>
<tr>
<td>Year 2</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 3</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Comparison Between Methods

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight-line recognition</td>
<td>$3,333</td>
<td>$3,333</td>
<td>$3,333</td>
</tr>
<tr>
<td>Accelerated recognition</td>
<td>5,416</td>
<td>2,917</td>
<td>1,667</td>
</tr>
<tr>
<td>Ratable method recognition</td>
<td>2,500</td>
<td>2,500</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Awards May Become Subject to Other Guidance

**ASC 718-10**

35-9 Paragraphs 718-10-35-10 through 35-14 are intended to apply to those instruments issued in share-based payment transactions with employees accounted for under this Topic, and to instruments exchanged in a business combination for share-based payment awards of the acquired business that were originally granted to employees of the acquired business and are outstanding as of the date of the business combination. Instruments issued, in whole or in part, as consideration for goods or services other than employee service shall not be considered to have been issued in exchange for employee service when applying the guidance in those paragraphs, irrespective of the employment status of the recipient of the award on the grant date.

35-10 A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this Topic shall continue to be subject to the recognition and measurement provisions of this Topic throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

35-11 Other modifications of that instrument that take place when the holder is no longer an employee shall be subject to the modification guidance in paragraph 718-10-35-14. Following modification, recognition and measurement of the instrument should be determined through reference to other applicable generally accepted accounting principles (GAAP).

35-12 Once the classification of an instrument is determined, the recognition and measurement provisions of this Topic shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 718-10-35-10. Topic 480 or other applicable GAAP, such as Topic 815, applies to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this Topic. This guidance is not intended to suggest that all freestanding financial instruments shall be accounted for as liabilities pursuant to Topic 480, but rather that freestanding financial instruments issued in share-based payment transactions may become subject to that Topic or other applicable GAAP depending on their substantive characteristics and when certain criteria are met.

35-13 Paragraph Not Used

35-14 An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Topic 480 or other applicable GAAP. Such a modification or settlement shall be accounted for under the provisions of this Topic unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee’s beneficiary). Following the modification, the instrument continues to be accounted for under that Topic or other applicable GAAP. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Topic. See paragraph 718-10-35-10 for a discussion of changes to awards made solely to reflect an equity restructuring.

4-13 Settlement of Liabilities Not Initially Subject to ASC 718 With Awards That Are Within the Scope of ASC 718

**Question**

If an employer settles or extinguishes a liability to an employee that is not subject to the provisions of ASC 718 by issuing awards that are subject to ASC 718 (e.g., stock options are granted in place of an LTIP), should the settlement or extinguishment transaction be accounted for under ASC 718?

**Answer**

Yes. If a liability that was not initially within the scope of ASC 718 is settled through the issuance of a new instrument that is within the scope of ASC 718, the settlement transaction, as well as the new award, should be accounted for under ASC 718.
Example

On January 1, 20X1, Entity A entered into a long-term incentive agreement with its CFO. The earliest date on which the CFO would be entitled to receive payment under the agreement is 10 years from the date of the agreement (January 1, 20Y1). Entity A accounts for the plan in accordance with ASC 710-10-25-9 and recognizes the cost of the agreement in a systematic and rational manner over this 10-year period.

On January 1, 20X6, A and the CFO agree to terminate the agreement in exchange for A’s granting the CFO employee share options to purchase A’s common stock. The number of share options that will be granted is determined on the basis of the fair value of the long-term incentive agreement on the date of the exchange.

The fair value of the agreement on January 1, 20X6, was determined to be $2 million. The number of shares to be issued to the CFO on that date was based on the fair-value-based measure of the share options, determined by using an appropriate pricing model, and the $2 million fair value of the agreement. The share option will vest after the CFO’s fifth year of service (cliff vesting). As of January 1, 20X6, A had recorded cumulative compensation cost and an accrued liability of $1 million associated with the long-term incentive agreement because 50 percent (for 5 of 10 years of services rendered) of the required service period had been rendered.

Although the accounting for the original agreement was not within the scope of ASC 718, such guidance is relevant in the determination of the cost of the share-based payment awards (whether newly granted or as replacements of prior awards).

Therefore, A should reclassify the $1 million accrued liability to equity (APIC). The difference between the $2 million aggregate fair-value-based measure of the share options and the $1 million of cumulative compensation cost previously recognized in connection with the long-term incentive agreement ($1 million) should be recognized as compensation cost over the remaining five-year service period of the share options. Entity A is not required to recognize any incremental compensation cost beyond this $1 million because the fair-value-based measure of the replacement share options was equal to the fair value of the long-term incentive agreement they replaced. If the fair-value-based measure of the share options granted in exchange for canceling the long-term incentive arrangement exceeded the fair value of the long-term incentive arrangement, the incremental fair-value-based measure should be recognized as compensation cost over the CFO’s remaining service period. See the journal entries below:

Journal Entry: January 1, 20X6

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued liability</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

To reclassify the amount previously recorded as an accrued liability related to the long-term incentive agreement to equity (APIC) at the date of the modification.

Journal Entry: December 31, 20X6, Through December 31, 20Y0

<table>
<thead>
<tr>
<th>Account</th>
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</thead>
<tbody>
<tr>
<td>Compensation cost</td>
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<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>200,000</td>
</tr>
</tbody>
</table>

To record compensation cost for each year from December 31, 20X6, to December 31, 20Y0, for the replacement stock options.

Change in Classification Due to Change in Probable Settlement Outcome

ASC 718-10

35-15 An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award’s fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.
**Equity-Classified Awards**

**ASC 718-20**

**Fair Value Not Reasonably Estimable**

35-1 An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

**Contingent Features**

35-2 A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (see paragraph 718-10-55-8), shall be accounted for if and when the contingent event occurs. Example 10 (see paragraph 718-20-55-84) provides an illustration of an award with a clawback feature.

4-14 Forfeiture of Vested Awards and Clawback Features

ASC 718-20-35-2 requires that the effect of certain contingent features, “such as a clawback feature . . . be accounted for if and when the contingent event occurs.” ASC 718-20-55-85 states that contingent features, such as clawback features, “are accounted for . . . by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of [1] the recognized compensation cost of the share-based payment [award] that contains the contingent feature . . . and [2] the fair value of the consideration received.” (See Example 10 in ASC 718-20-55-84 through 55-86 for an illustration of the accounting for awards with clawback features.) In contrast, in the absence of a clawback feature, a credit to the income statement is not recorded for vested awards (i.e., awards for which the services required to earn the award have been provided), even if the awards expire unexercised.

**Question**

Many share-based payment awards contain provisions requiring employees to exercise vested awards within a specified period after termination of employment. Awards not exercised within the specified period are usually canceled. Can entities account for such a provision as a clawback feature and reverse the compensation cost for vested awards that are returned because of employment termination?

**Answer**

No. Clawback features, as contemplated in ASC 718, relate to provisions designed to recover value previously transferred to award holders who violate the conditions of the clawback feature (e.g., a noncompete agreement). The requirement to forfeit a vested award after a specified period is not considered a clawback feature. For example, a requirement to return only vested awards not yet exercised does not represent a clawback feature. For awards not containing clawback features, ASC 718-10-35-3 states that previously recognized compensation cost should not be reversed if the holder has rendered the requisite services for the award to vest.

**Example — Clawback Feature**

On January 1, 20X1, Entity A grants to its CEO 1 million “at-the-money” employee share options, each with a grant-date fair-value-based measure of $6. The options vest at the end of the fourth year of service (cliff vesting). However, the options contain a provision that requires the CEO to return vested options, including any gain realized by the CEO related to vested and previously exercised options, to the entity for no consideration if the CEO terminates employment to work for a competitor any time within six years of the grant date. Assume that the clawback feature does not create an in-substance service period for the options. (See Example 11 in ASC 718-20-55-87 through 55-92 for an illustration of a clawback feature that functions as a noncompete provision that creates an in-substance service period.) The CEO completes four years of service and exercises the vested options. Entity A has recognized total compensation cost of $6 million (1 million options × $6 grant-date fair-value-based measure) over the four-year service period. Approximately one year after the options vest, the CEO terminates employment and is hired as an employee of a direct competitor. Because of the options’ provisions, the former CEO returns 1 million shares of A’s common stock with a total fair value of $3 million. Entity A records the following amounts on the date the clawback feature is enforced (i.e., the date the CEO is hired by the direct competitor and the shares are returned). For simplicity, the effects of income taxes have been ignored.
**Journal Entry**

<table>
<thead>
<tr>
<th>Treasury stock</th>
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</thead>
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<tr>
<td>Other income</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

To record other income for the consideration received as a result of the clawback feature.

Alternatively, assume — in accordance with the provisions of the options — that the former CEO returns 1 million shares of A’s common stock with a total fair-value of $7.5 million. Since the fair value of the shares returned ($7.5 million) is greater than the compensation cost previously recorded ($6 million), an amount equal to the compensation cost previously recorded would be recorded as other income. The difference ($1.5 million) would be recorded as an increase to paid-in capital. See the journal entry below.

**Journal Entry**

<table>
<thead>
<tr>
<th>Treasury stock</th>
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</tr>
<tr>
<td>APIC</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

To record other income and return of capital (for the consideration received in excess of compensation cost previously recognized) as a result of the clawback feature.

**Modification of an Equity Award**

<table>
<thead>
<tr>
<th><strong>ASC 718-20</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-3</strong></td>
</tr>
</tbody>
</table>

A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Topic over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 718-10-30-20, references to fair value throughout this Topic shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-30-20 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

1. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date
2. The incremental cost resulting from the modification.

Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraph 718-10-55-107 through 55-121).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 718-20-35-1 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

**35-4** Examples 12 through 16 (see paragraphs 718-20-55-93 through 55-144) provide additional guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial instruments from equity to liability or vice versa, and modifications of vesting conditions. Paragraphs 718-10-35-9 through 35-14 provide additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this Topic but subsequently became subject to other applicable generally accepted accounting principles (GAAP).
### ASC 718-20 (continued)

#### Short-Term Inducements

**35-5** A short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

#### Equity Restructuring or Business Combination

**35-6** Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this Subtopic. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 718-20-35-3. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. Example 13 (see paragraph 718-20-55-103) provides further guidance on applying the provisions of this paragraph. See paragraph 718-10-35-10 for an additional exception.

#### Repurchase or Cancellation

**35-7** The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

#### Cancellation and Replacement

**35-8** Cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. (The phrase offer to grant is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 718-20-35-3. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

**35-9** A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

### 4-15 Accounting for the Modification of a Share-Based Payment Award

**Question**

How is a modification accounted for under the provisions of ASC 718?

**Answer**

Modified awards are viewed as an exchange of the original award for a new award, presumably one with greater value. As a result, entities are required to record the incremental fair-value-based measure, if any, of the modified award, as compensation cost on the date of modification (for vested awards) or over the remaining service (vesting) period (for unvested awards). The incremental compensation cost is the excess of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification.

Generally, total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair-value-based measure of the original award unless the original award is not expected to vest under its original terms (i.e., the service condition, the performance condition, or neither is expected to be achieved). See Q&A 4-24 for an illustration of an award that has been modified and is not expected to vest under the original vesting conditions. Therefore, in most circumstances, total recognized compensation cost attributable to an award that has been modified is (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned) or is expected to be provided and (2) the incremental compensation cost conveyed to the holder of the award as a result of the modification.
Example 1
On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest at the end of the fourth year of service (cliff vesting). On January 1, 20X4, A modifies the options. The modification does not affect the remaining requisite service period of the options. The fair-value-based measure of the original options immediately before modification is $4 and the fair-value-based measure of the modified options is $6. For simplicity, the effects of forfeitures and income taxes have been ignored.

Over the first three years of service, A records $6,750 (1,000 options × $9 grant-date fair-value-based measure × 75% for three of four years of services rendered) of cumulative compensation cost. On the modification date, A computes the incremental compensation cost as $2,000 (($6 fair-value-based measure of modified options − $4 fair-value-based measure of original options immediately before the modification) × 1,000 options). The $2,000 incremental compensation cost is recorded over the remaining year of service. In addition, A records the remaining $2,250 of compensation cost over the remaining year of service attributable to the original options. Therefore, total compensation cost associated with these options is $11,000 ($9,000 grant-date fair-value-based measure + $2,000 incremental fair-value-based measure) recorded over four years of required service for both the original and modified options.

Example 2
Assume all the same facts as in Example 1, except that the options contain a graded vesting schedule (i.e., 25 percent of the options vest at the end of each year of service). Entity A has elected to record compensation cost on a straight-line basis over the total requisite service period for the entire award pursuant to the accounting policy election permitted by ASC 718-10-35-8.

Over the first three years of service, A records $6,750 (1,000 options × $9 grant-date fair-value-based measure × 75% for three of four years of services rendered) of cumulative compensation cost. On the date of modification, A computes the incremental compensation cost as $2,000 (($6 fair-value-based measure of modified options − $4 fair-value-based measure of original options immediately before the modification) × 1,000 options). Entity A records $1,500 of incremental compensation cost immediately because 75 percent of the options have vested. The remaining $500 of incremental compensation cost is recorded over the remaining year of service. In addition, A records the remaining $2,250 of compensation cost over the remaining year of service attributable to the original options. Therefore, total compensation cost associated with these options is $11,000 ($9,000 grant-date fair-value-based measure + $2,000 incremental fair-value-based measure).

4-16 Conditions for Establishing a Modification Date for an Employee Award
Establishing a modification date, like establishing a grant date, is essential to determining the accounting period in which to record the incremental compensation cost (resulting from an award’s modification), if any, in the financial statements. For instance, if the award is fully vested, establishing a modification date will determine the period in which all of the incremental compensation cost, if any, is recognized.

Question
What conditions should an employer evaluate in establishing a modification date for a share-based payment transaction with an employee?

Answer
In accordance with ASC 718-20-35-3, a modification is considered an exchange of an old award for a new award. Therefore, the conditions must be the same for establishing both (1) a grant date for an original share-based payment award and (2) a modification date for the issuance of a new share-based payment award in exchange for an old award.

As discussed in Q&A 2-04, a grant date is generally considered to be the date on which all of the following conditions have been met:

1. The employer and employee have reached a mutual understanding of the key terms and conditions of the share-based payment award (see Q&A 2-06, Q&A 2-08, and Q&A 2-10).
2. The employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares (see Q&A 2-07).
3. All necessary approvals have been obtained. 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 shareholder approval is required but management and the members of the board of directors control enough votes to approve the arrangement, shareholder approval is essentially a formality or perfunctory. 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 (see Q&A 2-05).

4. The recipient meets the definition of an employee (see Q&A 1-01) for guidance on the definition of an employee.

4-17 Modification of Stock Options During Blackout Periods

In certain instances, employees (or former employees) may not be able to exercise their employee share options because of blackout periods imposed by the entity or others. Blackout periods may be imposed for various reasons, including:

- The terms of an award include such periods (e.g., to restrict the selling of an entity’s securities around its earnings releases).
- The entity’s registration statements on Form S-8 are temporarily suspended because its filing requirements under the Securities Exchange Act of 1934 are not current.
- The delisting of an entity’s stock.

If employees or former employees have vested options that will expire during a blackout period, sometimes entities will (even though they have no obligation to do so) extend the options’ terms to give employees (or former employees) the ability to exercise the options after the blackout period is over (or provide other assets in lieu of the options).

**Question**

How should an entity account for the extension of the contractual term of a vested option during a blackout period?

**Answer**

The extension of the option’s contractual term should be accounted for as a modification. See Q&A 4-15 for a discussion of the accounting for a modification. If, at the time of the modification, the original option is not exercisable because of a blackout period and the entity is not obligated to settle the option in cash or other assets, the option has no value to the holder. The determination of whether the entity is obligated to settle in cash or other assets may require the opinion of legal counsel. In accordance with ASC 718-20-35-3, the incremental compensation cost is the excess of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification. Since the original option’s value is zero, the incremental value would be the fair-value-based measure of the modified option because the entity has, in substance, replaced a worthless option with an option that the employee (or former employee) will have an opportunity to exercise in the future. Further, because the award is fully vested, the compensation cost would be recognized in full on the date of the modification.

4-18 Modification That Changes an Award’s Classification From Equity to Liability

**Question**

How does an entity account for a modification that results in a change in an award’s classification from equity to liability?

**Answer**

A modification that changes an award’s classification from equity to liability is accounted for in the same manner as any other modification. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

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3 As defined in ASC 718-10-20, a blackout period is a “period of time during which exercise of an equity share option is contractually or legally prohibited.”
To record a new liability award, the entity recognizes a share-based liability for the portion of the award related to prior service, multiplied by the modified award’s fair-value-based measure. If the fair-value-based measure of the modified award is less than or equal to the fair-value-based measure of the original award, then the offsetting amount is recorded to APIC (i.e., final compensation cost cannot be less than the grant-date fair-value-based measure). If, on the other hand, the fair-value-based measure of the modified award is greater than the fair-value-based measure of the original award, then the excess is recognized as compensation cost either immediately (for vested awards) or over the remaining service (vesting) period (for unvested awards). Because the award is now classified as a liability, it is remeasured at a fair-value-based measure each reporting period.

Note that if an entity cash settles a fully vested equity award rather than modifies its terms to reclassify the award as a liability (i.e., to allow for cash settlement), the resulting accounting would be different. That is, the cash settlement, as long as it is transacted at the award’s then-current fair-value-based measure, would result in no additional compensation cost pursuant to ASC 718-20-35-7. In addition, see Q&A 4-36 for a discussion of a cash settlement at less than the current fair-value-based measure. In contrast, if the fair-value-based measure of the modified liability award was greater than the grant-date fair-value-based measure of the equity award on the date of modification, then the modification would result in additional compensation cost.

**Example 1**

On January 1, 20X1, Entity A grants 1,000 “at-the-money” share-settled SARs, each with a grant-date fair-value-based measure of $3. The SARs vest at the end of the fourth year of service (cliff vesting). On December 31, 20X2, A modifies the SARs from share-settled SARs to cash-settled SARs. The fair-value-based measure of the SARs on December 31, 20X2, and December 31, 20X3, is $4 and $5, respectively.

Because the modification only affects the settlement feature of the SARs (i.e., cash settlement versus share settlement), presumably the fair-value-based measure of the modified SARs equals the fair-value-based measure of the original SARs immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the SARs and, therefore, no incremental compensation cost has to be recorded in connection with this modification from an equity to a liability award.

Because the modified-date fair-value-based measure is greater than the grant-date fair-value-based measure, A (1) reclassifies the amount currently residing in APIC, $1,500 (1,000 SARs × $3 grant-date fair-value-based measure × 50% for two of four years of services rendered), as a share-based liability and (2) records the excess $500 (($4 modified-date fair-value-based measure – $3 grant-date fair-value-based measure) × 1,000 SARs × 50% for two of four years of services rendered) as additional compensation cost to record the new liability award at its fair-value-based measure, with a corresponding adjustment to share-based liability in the period of modification. See the journal entries below.

**Journal Entry: December 31, 20X1**

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<tr>
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<tr>
<td>APIC</td>
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To record compensation cost for the year ended December 31, 20X1.

**Journal Entry: December 31, 20X2**

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<tr>
<td>APIC</td>
<td></td>
<td>750</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X2.

**Journal Entry: Date of Modification**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Compensation cost</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Share-based liability</td>
<td></td>
<td>2,000</td>
</tr>
</tbody>
</table>

To record the award as a liability on the date of modification.

Now that the SARs are classified as a liability, A is required to remeasure the SARs at their fair-value-based measure each reporting period until settlement pursuant to ASC 718-30-35-2. In addition, see Q&A 3-35 for a discussion of the differences in accounting treatment of equity and liability awards. See the journal entry below.
Chapter 4 — Subsequent Measurement  
A Roadmap to Accounting for Share-Based Payment Awards

Journal Entry: December 31, 20X3  
Compensation cost 1,750  
Share-based liability 1,750  
To remeasure the liability award at the fair-value-based measure at the end of the next reporting period (December 31, 20X3) [(1,000 SARs × $5 fair-value-based measure × 75% for three of four years of services rendered) – $2,000 compensation cost previously recognized].

Example 2  
Alternatively, assume all the same facts as above, except that the fair-value-based measure of the SARs on the date of modification (December 31, 20X2) and December 31, 20X3, is $2.50 and $2, respectively. Entity A reclassifies the portion of the SARs’ modified-date fair-value-based measure of $1,250 (1,000 SARs × $2.50 fair-value-based measure × 50% for two of four years of services rendered) currently residing in APIC as a share-based liability. See the journal entries below.

Journal Entry: December 31, 20X1  
Compensation cost 750  
APIC 750  
To record compensation cost for the year ended December 31, 20X1.

Journal Entry: December 31, 20X2  
Compensation cost 750  
APIC 750  
To record compensation cost for the year ended December 31, 20X2.

Journal Entry: Date of Modification  
APIC 1,250  
Share-based liability 1,250  
To record the award as a liability on the date of modification.

Now that the SARs are classified as a liability, in accordance with ASC 718-30-35-2, A is required to remeasure the SARs at their fair-value-based measure each reporting period until settlement. If the value of the liability award at settlement is less than its grant-date fair-value-based measure, then total compensation cost will equal the grant-date fair-value-based measure, with a portion of that value remaining in equity. On the other hand, if at settlement the value of the liability award is greater than its grant-date fair-value-based measure, total compensation cost will equal the liability award’s value at settlement. This is consistent with the requirement in ASC 718 that compensation cost for an equity award (the original treatment of this award before modification) should generally be recorded at least at its grant-date fair-value-based measure. See the journal entries below.

Journal Entries: December 31, 20X3  
Compensation cost 750  
APIC 750  
To record compensation cost based on the grant-date fair-value-based measure ($3) and the continued employee service (one of four years).

APIC 250  
Share-based liability 250  
To remeasure the liability award at the fair-value-based measure at the end of the next reporting period (December 31, 20X3) [(1,000 SARs × $2 fair-value-based measure × 75% for three of four years of services rendered) – $1,250 share-based compensation liability previously recognized].
4-19  Modification That Changes an Award’s Classification From Liability to Equity

**Question**

How does a company account for a modification that results in a change in an award’s classification from a liability to an item of equity?

**Answer**

A modification that changes an award’s classification from liability to equity is accounted for in the same manner as any other modification. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award. The effect on total compensation cost, however, will not be the same as in other modifications (i.e., total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair-value-based measure of the original award). Rather, the aggregate amount of compensation cost is the fair-value-based measure of the award on the date of modification.

On the date of modification, the entity records the amounts previously recorded as a share-based liability as a component of equity in the form of a credit to APIC.

**Example**

On January 1, 20X1, Entity A grants 1,000 “at-the-money” cash-settled share appreciation rights (SARs), each with a grant-date fair-value-based measure of $3. The SARs vest at the end of the fourth year of service (cliff vesting). On December 31, 20X1, the SARs’ fair-value-based measure is still $3. On December 31, 20X2, A modifies the SARs, changing them from cash-settled SARs to share-settled SARs. The fair-value-based measure of the SARs on December 31, 20X2, is $2.50.

Because the modification only affects the settlement feature of the SARs (i.e., share settlement versus cash settlement), presumably the fair-value-based measure of the modified SARs equals the fair-value-based measure of the original SARs immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the SARs and, therefore, no incremental compensation cost has to be recorded in connection with this modification from a liability to an equity award.

On December 31, 20X2, the modified SARs are accounted for as an equity award from the date of modification with compensation cost fixed at $2.50, the fair-value-based measure on the modification date. As a result, the entity reclassifies the amount previously recorded as a share-based liability ($1,250 = 1,000 SARs × $2.50 modified-date fair-value-based measure × 50% for two of four years of services rendered) to APIC. In addition, A records the remaining $1,250 of compensation cost over the remaining service period (two years). See the journal entries below.

**Journal Entry: December 31, 20X1**

| Compensation cost | 750 |
| Share-based liability | 750 |

To record compensation cost for the year ended December 31, 20X1.

**Journal Entry: December 31, 20X2**

| Compensation cost | 500 |
| Share-based liability | 500 |

To record compensation cost for the year ended December 31, 20X2.

**Journal Entry: Date of Modification**

| Share-based liability | 1,250 |
| APIC | 1,250 |

To record the award as an equity award on the date of modification.
Chapter 4 — Subsequent Measurement
A Roadmap to Accounting for Share-Based Payment Awards

Journal Entry: December 31, 20X3

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>625</td>
</tr>
<tr>
<td>APIC</td>
<td>625</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X3, for an equity award that is based on the fair-value-based measure ($2.50) fixed at the date of modification.

4-20 Liability-to-Equity Modification With a Decrease in the Fair-Value-Based Measure

Question

If a reduction in an award’s fair-value-based measure occurs in conjunction with a change in its classification from liability to equity, how should an entity recognize the decrease in the fair-value-based measure between the previously recorded liability award and the new equity award for the portion of the services that already have been rendered?

Answer

The entity should record the reduction in the fair-value-based measure in equity (as APIC), not in the income statement. Employees ordinarily would not exchange one award for another that is less valuable. Therefore, their acceptance of the new award is analogous to a forgiveness of debt by a related party and should be treated as a contribution of capital (see ASC 470-50-40-2).

This situation is also analogous to the circumstance in paragraph 5 of Interpretation 28, in which employees are granted a combination award (i.e., share appreciation rights that are exercisable for the same period as companion share options, and the exercise of either cancels the other). If facts change such that the employee will exercise the share option rather than the appreciation right, accrued compensation related to the appreciation right is not adjusted. Although Interpretation 28 has been nullified, the guidance in paragraph 5 remains applicable by analogy.

Example

On January 1, 20X1, Entity A grants 100 cash-settled performance units to each of its 100 employees. The units vest at the end of third year of service (cliff vesting). On January 1, 20X2, A modifies the units (after obtaining approval from each of the unit holders) to require settlement in shares and further restricts the employees from selling the shares for one year after they become vested. The fair-value-based measure of the units immediately before modification is $12 and the fair-value-based measure of the modified award is $9. The decrease in value is due to the addition of the restriction on the ability to sell the vested shares.

On December 31, 20X1, A records the 20X1 compensation cost and a corresponding share-based liability on the basis of the current fair-value-based measure of the units ($12), the number of units to be issued (10,000), and the percent of services rendered (33 percent for one of three years of services rendered). See the journal entries below.

Journal Entry: December 31, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>40,000</td>
</tr>
<tr>
<td>Share-based liability</td>
<td>40,000</td>
</tr>
</tbody>
</table>

On January 1, 20X2, A accounts for the modification by first reclassifying the accumulated value of the equity award (on the basis of the new fair-value-based measure) to APIC (10,000 units × $9 fair-value-based measure × 33% for one of three years of services rendered = $30,000). Next, the remaining share-based liability (representing the employees’ capital contributions) is reclassified to equity ($40,000 – $30,000 = $10,000).

Journal Entry: January 1, 20X2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based liability</td>
<td>40,000</td>
</tr>
<tr>
<td>APIC</td>
<td>30,000</td>
</tr>
<tr>
<td>APIC — capital contribution</td>
<td>10,000</td>
</tr>
</tbody>
</table>
Using the new fair-value-based measure of the award, A would record the following entry to recognize the compensation cost of $30,000 (10,000 units \times \$9 \text{ fair-value-based measure} \times 33\% \text{ for one of three years of services rendered}) for both 20X2 and 20X3.

**Journal Entry: December 31, 20X2, and December 31, 20X3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>30,000</td>
</tr>
<tr>
<td>APIC</td>
<td>30,000</td>
</tr>
</tbody>
</table>

### 4-21 Modifications of Deep Out-of-the-Money Share Option Awards

Share option awards previously granted “at the money” may become “out-of-the-money” because of declines in the value of the underlying securities. The value of the underlying securities may be so severely depressed that the share option awards are considered “deep out-of-the-money.” Entities may question whether deep out-of-the-money share option awards continue to offer the appropriate retention motivation to employees. Accordingly, some entities may contemplate whether to accelerate the vesting of these awards.

**Question**

How should an entity account for a share option award with an explicit service condition that is modified to accelerate the vesting at a time when the award is deep out-of-the-money?

**Answer**

As indicated in ASC 718-10-55-67, the acceleration of the vesting of a deep out-of-the-money award is not substantive. Accordingly, any remaining unrecognized compensation cost should not be recognized immediately. In addition, because the acceleration of the vesting of the award is not substantive, an entity should generally continue to recognize the compensation cost over the remaining original requisite service period.

The acceleration of the vesting of a deep out-of-the-money award is not substantive because the explicit service period is replaced with a derived service period. (See Q&A 4-03 for a discussion of derived service periods.) During this derived service period, the share price must increase to a level above the grant-date stock price before it becomes “in-the-money,” and it will take some time to achieve that stock price before the employee can receive any value from the award. Accordingly, the employee must continue to work for the entity during that period to receive any benefit from the share option award because it is customary for awards to have features that limit exercisability upon termination (the term of the option typically truncates, such as 90 days after termination).

An entity will need to determine whether the accelerated share option award is considered deep out-of-the-money. Because ASC 718 does not provide guidance on making this determination, it will involve professional judgment. Among other factors, an entity may consider the factors affecting the value of the award (e.g., volatility of the underlying stock, exercise price, risk-free rate) and their impact on the expected period required for the award to return to being at-the-money. In addition, an entity may calculate the derived service period of the modified award and compare it with the original remaining service period to determine whether the modification is substantive. If the derived service period approximates or is longer than the original remaining service period, the modification would most likely not be substantive. In certain situations, it may be clear that the award is deep out-of-the-money.

**Example**

On January 1, 20X1, Entity A granted its employees 100 at-the-money share options, each with a grant-date fair-value-based measure of $10. The awards vest at the end of the fourth year of service (cliff vesting) and have an exercise price of $20. Accordingly, the compensation cost is being recognized ratably over the four-year service period. On January 1, 20X4, when the share options are deemed to be deep out-of-the-money, A modifies the award to accelerate the remaining service period of the award. Because the award is considered deep out-of-the-money, the acceleration of the award’s remaining service period is not substantive. Accordingly, the remaining unrecognized compensation cost should not be recognized immediately on January 1, 20X4. Rather, A should continue to recognize the remaining unrecognized compensation cost over the remaining original requisite service period. That is, A should continue recognizing compensation cost as if the modification never occurred and recognize the remaining $250 ($10 grant-date fair-value-based measure \times 100 awards \times \frac{1}{4} \text{ remaining service period}) in compensation cost in 20X4.
4-22 Modification of Awards With Performance and Service Vesting Conditions

Question

How does an entity account for a modification that causes a change in the vesting conditions of an award?

Answer

A modification that changes an award’s vesting conditions is accounted for in the same manner as any other modification. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

Generally, total recognized compensation cost attributable to an award that has been modified is, at least, the grant-date fair-value-based measure of the original award unless the original award is not expected to vest under its original terms (i.e., the service condition, the performance condition, or neither is expected to be achieved). Therefore, in most circumstances, total recognized compensation cost attributable to an award that has been modified is (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned) or is expected to be provided and (2) the incremental compensation cost conveyed to the holder of the award as a result of the modification.

If, on the date of modification, it is expected (probable) that the awards will vest under their original vesting conditions, an entity records compensation cost if the awards vest under either (1) the modified vesting conditions or (2) the original vesting conditions. See Type I and II modifications in the table below.

In contrast, if it is not expected (improbable) on the date of modification that the awards will vest under their original vesting conditions, an entity records compensation cost only if the award vests under the modified vesting conditions. That is, if an entity did not expect an award to vest on the basis of the original vesting conditions on the date of modification, no cumulative compensation cost would have been recorded. If the award vests under the modified vesting conditions, total recognized compensation cost is based on the number of awards that vest and the fair-value-based measure of the modified award on the date of modification. The grant-date fair-value-based measure of the original award is irrelevant. See Type III and IV modifications in the table below.

The following table summarizes the various types of modification, the accounting results, and the bases for the recognition of compensation cost. In addition, it provides a cross-reference to the applicable implementation guidance ASC 718-20-55 and to Deloitte guidance.

<table>
<thead>
<tr>
<th>Type of Modification</th>
<th>Accounting Result</th>
<th>Basis for Recognition of Compensation Cost</th>
<th>ASC 718 Guidance</th>
<th>Deloitte Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probable-to-probable (Type I modification)</td>
<td>Record compensation cost if the award vests under either the original terms or the modified terms.</td>
<td>Grant-date fair-value-based measure plus incremental fair-value-based measure conveyed on the modification date, if any.</td>
<td>ASC 718-20-55-111 and 55-112</td>
<td>Q&amp;A 4-23</td>
</tr>
<tr>
<td>Probable-to-improbable (Type II modification)</td>
<td>Record compensation cost if the award vests under either the original terms or the modified terms.</td>
<td>Grant-date fair-value-based measure plus incremental fair-value-based measure conveyed on the modification date, if any.</td>
<td>ASC 718-20-55-113 through 55-115</td>
<td>None (Type II modification expected to be rare)</td>
</tr>
<tr>
<td>Improbable-to-probable (Type III modification)</td>
<td>Record compensation cost if the award vests under the modified terms.</td>
<td>Modified-date fair-value-based measure.</td>
<td>ASC 718-20-55-116 and 55-117</td>
<td>Q&amp;A 4-24</td>
</tr>
<tr>
<td>Improbable-to-improbable (Type IV modification)</td>
<td>Record compensation cost if the award vests under the modified terms.</td>
<td>Modified-date fair-value-based measure.</td>
<td>ASC 718-20-55-118 and 55-119</td>
<td>Q&amp;A 4-25</td>
</tr>
</tbody>
</table>
Modification of Vesting Conditions in Which Original Awards Are Expected to Vest (Probable-to-Probable) — Example

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest only if A’s cumulative net income over the succeeding four-year period is greater than $5 million. Accordingly, A begins to recognize compensation cost on a straight-line basis over the four-year service period. See the journal entries below.

Journal Entry: December 31, 20X1

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>2,250</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X1.

Journal Entry: December 31, 20X2

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>2,250</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X2.

Journal Entry: December 31, 20X3

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>2,250</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X3.

On January 1, 20X4, A believes it is probable that the performance condition will be achieved. To provide additional retention incentives to the employees for the fourth year of service, A modifies the performance condition to decrease the cumulative net-income target to $4.5 million. After the modification, A continues to believe the options are expected to vest on the basis of the revised cumulative net income target. The modification does not affect any of the other terms or conditions of the options.

If the modified performance condition ($4.5 million) is met, then A will record total compensation cost ($9,000) on the basis of the number of options expected to vest (1,000 options, assuming no forfeitures) and the grant-date fair-value-based measure of the options of $9.4 Because the modification does not affect any of the other terms or conditions of the options, presumably the fair-value-based measure before and after the modification will be the same. Accordingly, there is no incremental value conveyed to the holder of the options and, therefore, no incremental compensation cost has to be recorded in connection with this modification. See the journal entry below.

Journal Entry: December 31, 20X4

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>2,250</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X4.

Alternatively, if the modified performance condition ($4,500,000) is not met, then the options will not vest under either the original or the modified terms. Accordingly, A should not recognize any cumulative compensation cost for these options (i.e., any previously recognized compensation cost should be reversed). See the journal entry below.

Journal Entry: December 31, 20X4

<table>
<thead>
<tr>
<th>APIC</th>
<th>6,750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>6,750</td>
</tr>
</tbody>
</table>

To reverse previously recognized compensation cost.

4 The principle in ASC 718 requires an entity to record compensation cost if either the original performance condition or the modified performance condition is met. However, in this case, since the modified performance target is lower than the original performance target, the attainment of the modified target would be sufficient to trigger the recognition of compensation cost.
4-24 MODIFICATION OF VESTING CONDITIONS IN WHICH ORIGINAL AWARDS ARE NOT EXPECTED TO VEST (IMPROBABLE-TO-PROBABLE) — EXAMPLE

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest only if A’s cumulative net income over the succeeding four-year period is greater than $5 million. Entity A believes it is probable the performance condition will be achieved (i.e., the options are expected to vest). Accordingly, A begins to recognize compensation cost on a straight-line basis over the four-year service period.

Journal Entry: December 31, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>2,250</td>
</tr>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X1.

Journal Entry: December 31, 20X2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>2,250</td>
</tr>
<tr>
<td>APIC</td>
<td>2,250</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X2.

On December 31, 20X3, on the basis of its financial performance over the preceding three years, A does not believe it is probable that the performance condition will be achieved (i.e., the options are not expected to vest). Accordingly, A should reverse any previously recognized compensation cost associated with these options. That is, because A does not expect the options to vest, cumulative recognized compensation cost as of December 31, 20X3, is zero (0 options expected to vest x $9 grant-date fair-value-based measure).

Journal Entry: December 31, 20X3

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>4,500</td>
</tr>
<tr>
<td>Compensation cost</td>
<td>4,500</td>
</tr>
</tbody>
</table>

To reverse previously recognized compensation cost.

On January 1, 20X4, to restore the retention incentives to the employees for the fourth year of service, A modifies the performance condition to decrease the cumulative net income target to $3 million. The fair-value-based measure of the modified award as of the modification date is $12. After the modification, A believes that the options are expected to vest on the basis of the revised cumulative net income target. The modification does not affect any of the other terms or conditions of the award. Accordingly, A will record total compensation cost ($12,000) on the basis of the number of options expected to vest (1,000 options, if no forfeitures are assumed) and the modified-date fair-value-based measure of the options of $12 over the remaining year of service. As demonstrated in Example 14, Case C, of ASC 718-20-55-116 and 55-117, since it is improbable that the options will vest before the modification, the compensation cost is based on the fair-value-based measure of the modified options.

Journal Entry: December 31, 20X4

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>12,000</td>
</tr>
<tr>
<td>APIC</td>
<td>12,000</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X4.

Alternatively, if the modified performance condition ($3 million) is not met, the options will not vest. In this case, A should not recognize any cumulative compensation cost for these options (i.e., any previously recognized compensation cost should be reversed).
**Chapter 4 — Subsequent Measurement**

**A Roadmap to Accounting for Share-Based Payment Awards**

4-25 **Modification of Vesting Conditions in Which Original Awards Are Not Expected to Vest (Improbable-to-Improbable) — Example**

*Example*

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest only if A’s cumulative net income over the succeeding four years is greater than $5 million. Accordingly, A begins to recognize compensation cost on a straight-line basis over the four-year service period. See the journal entries below.

**Journal Entry: December 31, 20X1**

```
Compensation cost 2,250
APIC 2,250
To record compensation cost for the year ended December 31, 20X1.
```

**Journal Entry: December 31, 20X2**

```
Compensation cost 2,250
APIC 2,250
To record compensation cost for the year ended December 31, 20X2.
```

On December 31, 20X3, because of its financial performance over the preceding three years, A does not believe it is probable that the performance condition will be achieved (i.e., the options are not expected to vest). Accordingly, A should reverse any previously recognized compensation cost associated with these options. That is, because A does not expect the options to vest, cumulative recognized compensation cost as of December 31, 20X3, is zero (0 options expected to vest × $9 grant-date fair-value-based measure). See the journal entry below.

**Journal Entry: December 31, 20X3**

```
APIC 4,500
Compensation cost 4,500
To reverse previously recognized compensation cost.
```

On January 1, 20X4, to restore the retention incentives to employees for their fourth year of service, A modifies the performance condition to decrease the cumulative net income target to $4 million. The modification does not affect any of the other terms or conditions of the options. The fair-value-based measure of the modified options as of the modification date is $12.

Contemporaneously with the modification, A loses a major customer; this loss will have a detrimental effect on A’s financial results for the year ended December 31, 20X4. Even though A modified the options to reduce the performance target, loss of the significant customer prompts A to maintain that the achievement of the performance target is improbable (i.e., the options are not expected to vest). Therefore, total recognized compensation cost for the modified award is zero (0 options expected to vest × $12 modified-date fair-value-based measure). As demonstrated in Example 14, Case D of ASC 718-20-55-118 and 55-119, since it is improbable the options will vest before the modification, the compensation cost is based on the fair-value-based measure of the modified award.

Alternatively, if the modified performance condition ($4 million net income) is met, the options will vest. Accordingly, A should recognize compensation cost of $12,000 on the basis of the number of options vested (1,000 options, assuming no forfeitures) and the fair-value-based measure of the modified options on the date of modification ($12).

**Journal Entry: December 31, 20X4**

```
Compensation cost 12,000
APIC 12,000
To record compensation cost for the year ended December 31, 20X4.
```
Modification of a Market Condition

As discussed in Q&A 3-20, unlike a service or a performance condition, a market condition is not a vesting condition. Rather, a market condition is factored into the grant-date fair-value-based measure of an award.

Question

How should an entity account for the modification of a market condition?

Answer

Unlike the modification of a vesting condition (i.e., a service or performance condition), the modification of an award’s market condition does not affect the probability of the award being earned. The determination of whether the award will be earned depends on whether the employee remains employed for the derived service period of the award. See Q&A 4-03 for a discussion of a derived service period. Accordingly, the modification of an award’s market condition can never result in an “improbable-to-probable” modification. Thus, incremental compensation cost is computed as the change in both (1) the number of awards expected to vest and (2) the excess of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification.

Example — Modification of an Award’s Market Condition

On January 1, 20X1, Entity A granted 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $5 and a derived service period of five years. The options have an exercise price of $12 and become exercisable only if the market price of A’s shares reaches $20. In addition, A estimates that 15 percent of the options will be forfeited because the employees will terminate employment before the end of the derived service period.

Over the first year of service, A records $850 [(1,000 options × 85 percent of options expected to vest) × $5 grant-date fair-value-based measure × 20 percent for one of five years of services rendered] of cumulative compensation cost. On January 1, 20X2, because of a significant decline in the market price of A’s shares, A modifies the options to become exercisable when the market price of A’s shares reaches $10. The fair-value-based measure of the original options immediately before modification is $3, and the fair-value-based measure of the modified options is $4. In addition, the derived service period of the modified options is three years. As a result of the reduction in the derived service period, A expects additional options to vest. Accordingly, A revises its forfeiture estimate from 15 percent to 10 percent. Entity A computes the incremental compensation cost as a result of modifying the options’ market condition as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair-value-based measure of the modified options</td>
<td>$3,600</td>
</tr>
<tr>
<td>Fair-value-based measure of the original options</td>
<td>$2,550</td>
</tr>
<tr>
<td>Incremental compensation cost</td>
<td>$1,050</td>
</tr>
</tbody>
</table>

The total compensation cost to be recognized over the remaining derived service period of the modified options (three years) of $4,450 is the unrecognized compensation cost from the original options of $3,400 [(1,000 options × 85 percent of options expected to vest) × $5 grant-date fair-value-based measure – $850 previously recognized] plus the incremental compensation cost resulting from the modification of the options’ market condition of $1,050 (determined above).

Modification of Market Condition When Performance Condition Is Improbable

In accordance with ASC 718-10-25-20, when an entity issues share-based payment awards that contain both a market condition and a performance condition, and both conditions must be satisfied for the entity to retain the awards, compensation cost should not be recognized unless it is probable that the performance condition will be met. For example, the effective date of an IPO may be a performance condition. In this situation, it is generally not probable that the IPO will occur until the IPO becomes effective; therefore, compensation cost should generally not be recognized until the IPO occurs. When an award is modified, an entity must account for the effects of the modification in accordance with ASC 718-20-35-3.
Question
When share-based payment awards contain both a market condition and a performance condition, and both conditions must be satisfied for an entity to retain the awards, how does the entity account for a modification that only changes the market condition of the award and for which the performance condition is improbable immediately before and as of the modification date?

Answer
The modification should be accounted for as an “improbable-to-improbable” modification in accordance with Example 14 of ASC 718-20-55. ASC 718-20-55-108 states, in part:

“If at the date of modification awards are not expected to vest under the original vesting conditions, an entity shall recognize compensation cost only if the awards vest under the modified vesting conditions. Said differently, if the entity believes that the original performance or service vesting condition is not probable of achievement at the date of the modification, the cumulative compensation cost related to the modified award, assuming vesting occurs under the modified performance or service vesting condition, is the modified award’s fair value at the date of the modification.

Example 14 does not specifically address modifications to market conditions. However, on the basis of informal discussions with the FASB staff, we believe that an entity should apply the above guidance on improbable-to-improbable modifications even if a vesting condition has not been modified.

Because it is not probable that the original and modified awards will vest immediately before and as of the modification date, the entity would ultimately recognize compensation cost on the basis of the fair-value-based measure of the modified award only when it becomes probable that the performance condition will be achieved (e.g., upon the occurrence of an IPO). When an award contains a performance condition and it is not probable that the entity will meet that condition, the original grant-date fair-value-based measure of compensation cost is disregarded once a modification is made. Modification accounting reflects a view that a preexisting award has been exchanged for a new award. Because it was improbable that the old award would vest, the entity would effectively treat the old award as though it did not exist when measuring the exchange. A new fair-value-based measure of compensation cost should be determined on the modification date on the basis of the terms of the new award.

4-28  Modification of an Award Accounted for Under ASR 268 and ASC 480-10-S99-3A
SEC ASR 268 and ASC 480-10-S99-3A require (with limited exceptions) temporary equity classification for share-based payment awards with redemption features not solely within the control of the entity. See Q&A 2-21 for a discussion of classification of awards with redemption features not solely within the control of the entity.

Question
How should an SEC registrant account for the modification of an award that is accounted for in accordance with ASR 268 and ASC 480-10-S99-3A?

Answer
The modification guidance in ASC 718-20 also applies to awards that are accounted for in accordance with ASR 268 and ASC 480-10-S99-3A. In other words, SEC registrants are required to record the incremental fair-value-based measure, if any, of the modified award as compensation cost on the date of modification (for vested awards) or over the remaining service (vesting) period (for unvested awards). In addition, on the modification date SEC registrants are required to reclassify the redemption amount to temporary equity.

Example 1 — Accounting for the Modification of an Award With a Contingent Cash-Settlement Feature
On January 1, 20X1, Entity A, an SEC registrant, granted 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $12 and an exercise price of $25. The options vest at the end of the fifth year of service (cliff vesting). In addition, the options contain a redemption feature in which the employee can require A to net cash settle the options upon a change in control (the occurrence of which is not probable as of the grant date). For simplicity, the effects of forfeitures and income taxes have been ignored.
Since the intrinsic value of the awards on the grant date is zero, and the occurrence of the contingent redemption feature is not probable, there would be no amount to reclassify to temporary equity until the occurrence of the contingent event becomes probable. Accordingly, for the year ended December 31, 20X1, A (1) recognizes compensation cost on the basis of the grant-date fair-value-based measure of the options and (2) reclassifies no amount to temporary equity. See the journal entry below.

**Journal Entry: December 31, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>2,400</td>
</tr>
<tr>
<td>APIC</td>
<td>2,400</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X1 (1,000 options × $12 grant-date fair-value-based measure × 20% for one of five years of services rendered).

On December 31, 20X2, A modifies the options to reduce the requisite service period from five years to four years. Because the modification only affects the service period of the options and the service period is shorter, the fair-value-based measure of the modified options would most likely be less than the fair-value-based measure of the original options immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the award; therefore, no incremental compensation cost has to be recorded in connection with this modification. Entity A will recognize the remaining unrecognized compensation cost (1,000 options × $12 grant-date fair-value-based measure – $2,400 amount previously recognized = $9,600) over the remainder of the modified requisite service period (three years).

However, on the modification date, the market price of A’s shares is $27, while the exercise price of the options remained at $25. Because the modification of an award is viewed as the exchange of a new award for an old award, A must again consider the application of the measurement guidance in ASR 268 and ASC 480-10-S99-3A as of the modification date. Therefore, in accordance with ASC 480-10-S99-3A, A will reclassify the redemption amount (i.e., the intrinsic value of the options on the modification date) to temporary equity. Accordingly, for the year ended December 31, 20X2, A (1) recognizes compensation cost on the basis of the grant-date fair-value-based measure of the options and (2) reclassifies an amount to temporary equity on the basis of the options’ intrinsic value ($2) and the portion of the options that are vested. See the journal entries below.

**Journal Entries: December 31, 20X2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>3,200</td>
</tr>
<tr>
<td>APIC</td>
<td>3,200</td>
</tr>
</tbody>
</table>

To record compensation cost for the year ended December 31, 20X2 [(1,000 options × $12 grant-date fair-value-based measure – $2,400 amount previously recognized) × 33% for one of three years of service remaining].

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Temporary equity 1,000

To reclassify the redemption value (i.e., the intrinsic value of the options on the modification date) from APIC to temporary equity in accordance with ASC 480-10-S99-3A [1,000 options × ($27 market price of A’s shares – $25 exercise price) × 50% for two of four years of services rendered]. The remaining $1,000 [1,000 options × ($27 market price – $25 exercise price) – $1,000 reclassified in 20X2] would be reclassified into temporary equity over the two years of remaining service. Entity A would not be required to remeasure the amount recorded in temporary equity until the occurrence of the contingent event is considered probable.

**Example 2 — Accounting for the Modification of an Award That Is Puttable by the Employee**

On January 1, 20X1, Entity A, an SEC registrant, granted 1,000 at-the-money employee share options, each with a grant-date fair-value-based measure of $6 and an exercise price of $15. The options vest at the end of the fifth year of service (cliff vesting). In addition, the shares underlying the options contain a redemption feature allowing the employee to require A to repurchase the shares six months and one day after exercise of the options. For simplicity, the effects of forfeitures and income taxes have been ignored.
Since the options were granted at the money and they are not fully vested, no amount is initially reclassified to temporary equity. However, because the options contain a redemption feature, A is required to remeasure the options to their redemption value (i.e., their intrinsic value) in temporary equity each reporting period until settlement. The amount recorded in temporary equity is computed on the basis of the options’ redemption amount and the portion of the options that are vested as of each reporting period. On December 31, 20X1, the market price of A’s shares is $18. Accordingly, for the year ended December 31, 20X1, A (1) recognizes compensation cost on the basis of the grant-date fair-value-based measure of the options and (2) reclassifies an amount to temporary equity on the basis of the options’ intrinsic value ($3) and the portion of the options that are vested. See the journal entries below.

**Journal Entries: December 31, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>1,200</td>
</tr>
<tr>
<td>APIC</td>
<td>1,200</td>
</tr>
<tr>
<td>To record compensation cost for the year ended December 31, 20X1 (1,000 options × $6 grant-date fair-value-based measure × 20% for one of five years of services rendered).</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td>600</td>
</tr>
<tr>
<td>Temporary equity</td>
<td>600</td>
</tr>
<tr>
<td>To reclassify the redemption value (i.e., the intrinsic value of the options at the end of the reporting period) from APIC to temporary equity in accordance with ASC 480-10-S99-3A (1,000 options × ($18 market price of A’s shares – $15 exercise price) × 20% for one of five years of services rendered).</td>
<td></td>
</tr>
</tbody>
</table>

On December 31, 20X2, A modifies the options to reduce the requisite service period from five years to four years. Because the modification only affects the service period of the options, and the service period is shorter, the fair-value-based measure of the modified options would most likely be less than the fair-value-based measure of the original options immediately before modification. Accordingly, there is no incremental value conveyed to the holder of the award; therefore, no incremental compensation cost has to be recorded in connection with this modification. Entity A will recognize the remaining unrecognized compensation cost (1,000 options × $6 grant-date fair-value-based measure – $1,200 amount previously recognized = $4,800) over the remainder of the modified requisite service period (three years).

However, on the modification date, the market price of A’s shares is $19, while the exercise price of the options remained at $15. In accordance with ASR 268 and ASC 480-10-S99-3A, A will reclassify the redemption amount (i.e., the intrinsic value of the options on the modification date) to temporary equity. Accordingly, for the year ended December 31, 20X2, A (1) recognizes compensation cost on the basis of the grant-date fair-value-based measure of the options and (2) reclassifies an amount to temporary equity on the basis of the options’ intrinsic value ($4) and the portion of the options that are vested. See the journal entries below.

**Journal Entries: December 31, 20X2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>1,600</td>
</tr>
<tr>
<td>APIC</td>
<td>1,600</td>
</tr>
<tr>
<td>To record compensation cost for the year ended December 31, 20X2 (1,000 options × $6 grant-date fair-value-based measure – $1,200 amount previously recognized) × 33% for one of three years of services remaining).</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td>1,400</td>
</tr>
<tr>
<td>Temporary equity</td>
<td>1,400</td>
</tr>
<tr>
<td>To reclassify the redemption value (i.e., the intrinsic value of the options on the modification date, which is also the end of the reporting period) from APIC to temporary equity in accordance with ASR 268 and ASC 480-10-S99-3A (1,000 options × ($19 market price of A’s shares – $15 exercise price) × 50% for two of four years of services rendered) – $600 amount previously reclassified.</td>
<td></td>
</tr>
</tbody>
</table>
4-29 Inducements

**Question**
What is an inducement, and how should it be accounted for?

**Answer**
An inducement is an offer by an entity that results in modification of an award to which an award holder may subscribe. An inducement (if not considered “short-term”) is accounted for as a modification of all awards subject to the inducement, even if not accepted by the holder. However, there is an exception for short-term inducements (i.e., those that are offered for only a limited period of time). For short-term inducements, modification accounting applies only to the awards for which holders accept the offer. Entities must use judgment in determining what constitutes a limited period of time.

**Example 1**
On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options to each of its 100 employees. The options have a grant-date fair-value-based measure of $3, an exercise price of $10, and they vest at the end of the third year of service (cliff vesting).

On December 31, 20X1, A offers to all 100 employees the ability to reduce the exercise price of the share options to $8 if the employees are willing to extend the vesting period for an additional year. The offer is valid for the remaining original service period of two years. Because the inducement is not short term (i.e., it is not offered for a limited period), A should account for the inducement as a modification of all 100,000 share options, regardless of how many employees accept the offer. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

**Example 2**
Assume all the same facts as in Example 1, except that employees have only one month to accept the offer. During that one-month period, 60 employees accept the offer. Because A determines that this offer represents a short-term inducement, A would apply modification accounting to only the 60,000 share options associated with the employees that accepted the offer. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

4-30 Accounting for Share-Based Payment Awards in an Equity Restructuring — Impact of Antidilution Provisions

**Question**
What is an equity restructuring and how does it affect the accounting for a share-based payment award?

**Answer**
An equity restructuring is a nonreciprocal transaction between an entity and its shareholders that causes a change in the per-share fair value of the shares underlying an option or similar award (e.g., stock dividend, stock split, spin-off). Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring are modifications. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award. However, the impact of applying modification accounting depends on whether an adjustment is made pursuant to an existing nondiscretionary antidilution provision. A nondiscretionary provision is clear and measurable and requires the entity to take action. In contrast, a discretionary provision is broad, subjective, and allows but does not require the entity to take action.

**Original Award Contains a Nondiscretionary Antidilution Provision**
To determine whether incremental compensation cost should be recognized, an entity should compare the fair-value-based measure of the modified award with the fair-value-based measure of the original award (on the basis of the stated antidilution terms in the award) immediately before the modification. See below for illustrations of original awards that contain either a nondiscretionary (Example 2) or a discretionary (Example 3) antidilution provision.
Nondiscretionary Antidilution Provision Is Added to an Award — Not in Contemplation of an Equity Restructuring

A modification to add an antidilution provision that is not made in contemplation of an equity restructuring does not require a comparison of the fair-value-based measure before and after the modification. Therefore, such a modification would not result in incremental compensation cost.

Nondiscretionary Antidilution Provision Is Added to an Award — in Contemplation of an Equity Restructuring

An entity that adjusts the terms of an award to maintain the holder’s value in response to an equity restructuring may trigger the recognition of significant compensation cost if (1) the adjustment is not required under the existing terms of the award (plan) and (2) the provision that requires an adjustment is added in contemplation of an equity restructuring. Accordingly, the entity should review the terms of its awards (plans) to determine whether an adjustment is required in the event of an equity restructuring. See Example 1 below for an illustration of an award in which a nondiscretionary antidilution provision was added to the award’s terms in contemplation of an equity restructuring.

Note that the addition of an antidilution provision to a stock option plan could result in unintended tax consequences and could be considered a disqualifying event of an ISO. An entity should consult with its tax professional regarding the tax implications before making changes to its stock option plans.

Example 1 — Stock Split When a Nondiscretionary Antidilution Provision Is Added

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options. The options have a grant-date fair-value-based measure of $6 and an exercise price of $10, and they vest at the end of the third year of service (cliff vesting). The options do not contain an antidilution provision. On July 1, 20X2, A announces a two-for-one stock split and the addition of a nondiscretionary antidilution provision to each of the options. The fair-value-based measure of the options immediately before the addition of the antidilution provision is $4, and the fair-value-based measure immediately after is $7. On December 31, 20X2, the stock split occurs and A (1) modifies the exercise price of the options and (2) issues the additional options to the employee to reflect the effects of the stock split. The fair-value-based measure of the options before and after the stock split is the same.

The addition of the antidilution provision on July 1, 20X2, should be accounted for as a modification. The $3,000 incremental value ([$7 – $4] × 1,000 options) conveyed to the holder as a result of adding the nondiscretionary antidilution provision should be recorded as incremental compensation cost over the remaining 18-month service period. The premodification fair-value-based measure is based on the original options without a nondiscretionary antidilution provision and takes into account the effect of the contemplated equity restructuring (i.e., the stock split) on its value. The postmodification fair-value-based measure is based on the modified options with a nondiscretionary antidilution provision and takes into account the effect of the contemplated equity restructuring on its value.

On December 31, 20X2, the reduction in the exercise price of the options and the issuance of the additional options as a result of the stock split would also be treated as a modification. However, because the fair-value-based measure of the options before and after the modification is exactly the same, no incremental compensation cost would be recorded. Changes to the terms of an award in accordance with its nondiscretionary antidilution provisions generally do not result in incremental compensation cost if the antidilution provisions are properly structured.

Example 2 — Stock Split When the Original Award Contains Nondiscretionary Antidilution Provisions

Assume all the same facts as in Example 1, except that (1) the nondiscretionary antidilution provision existed in the original terms of the options and (2) it requires an adjustment to preserve the value of the options after the stock split. Because the antidilution provision is not discretionary and already existed, no modification occurs on July 1, 20X2, when A announces the two-for-one stock split. Accordingly, A records no incremental compensation cost. In addition, given that the fair-value-based measure of the options immediately before and after the stock split is the same, no incremental compensation cost would be recorded over the remaining 12-month service period after the December 31, 20X2, modification.
**Example 3 — Stock Split When the Original Award Contains Discretionary Antidilution Provisions**

Assume all the same facts as in Example 1, except that a discretionary antidilution provision existed in the original terms of the options. The discretionary antidilution provision provides that A may but is not required to adjust the terms of the options in response to an equity restructuring (e.g., stock split). Because the antidilution provision is discretionary, the options are treated as though an antidilution provision did not exist. That is, if A were to reduce the exercise price of the options and issue additional options on December 31, 20X2, in effect two modifications are made to the original terms of the options. The first modification is to “add” a nondiscretionary antidilution provision to the terms of the options, and the second is to reduce the exercise price of the options and issue additional options. As in Example 1, the first modification would result in incremental value conveyed to the holder. Accordingly, A should record incremental compensation cost of $3,000, as determined in Example 1, for the incremental value conveyed to the holder over the remaining 12-month service period. The second modification should result in no incremental compensation cost since there was no incremental value conveyed to the holder because the changes to the terms of the options are consistent with an existing nondiscretionary antidilution provision.

Alternatively, if A announces on July 1, 20X2, that it will require an adjustment to the terms of the options in response to the stock split, a modification occurs on July 1, 20X2, to effectively “add” a nondiscretionary antidilution provision to the terms of the options. The addition of the nondiscretionary antidilution provision results in incremental value conveyed to the holder. Accordingly, A should record incremental compensation cost of $3,000, as determined in Example 1, over the remaining 18-month service period.

Note that when assessing whether an antidilution provision is discretionary, an entity should consider whether the holder of the award could enforce an antidilution adjustment. This determination may require the opinion of legal counsel.

**4-31 Accounting for Share-Based Payment Awards in a Spin-Off — Awards Held by Employees of the Former Subsidiary in the Equity of the Former Parent**

As discussed in Q&A 4-30, a spin-off is considered an equity restructuring, which is defined in the Codification Master Glossary 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.” Further, ASC 718-20-35-6 indicates that “[e]xchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring” are treated as modifications.

In a spin-off transaction, individuals who were originally employees of an entity (the former parent or spinnor) that is spinning off a consolidated entity (the former subsidiary or spinnee) become employees of the former subsidiary. In some cases, those individuals may retain the share-based payment awards that they received while they were employees of the former parent. See Q&A 4-33 for a discussion of the accounting for share-based payment awards that are modified by the former parent (rather than held by employees of the former subsidiary) to be indexed to the former subsidiary’s equity.

**Question**

How should the former parent (spinnor) and the former subsidiary (spinnee) account for share-based payment awards as a result of a spin-off?

**Answer**

**Attribution of Compensation Cost in a Spin-Off Transaction**

In a spin-off transaction, compensation cost related to share-based payment awards should be recognized by the entity whose employees are providing the service to earn any remaining portions of the award. When discussing issues related to spin-off transactions at its September 1, 2004, Board meeting, the FASB reached the following conclusion:

In connection with a spinoff transaction and as a result of the related modification, employees of the former parent may receive unvested equity instruments of the former subsidiary, or employees of the former subsidiary may retain unvested 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 unvested modified awards for those employees that provide service to each
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A Roadmap to Accounting for Share-Based Payment Awards

respective entity. For example, if an employee of the former subsidiary retains unvested 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 unvested equity instruments held by those former employees that subsequent to
the spinoff provide services solely to the former subsidiary.

We understand that this guidance was not included in the final standard because the example of a spin-off
transaction was deleted just before its issuance. However, the thinking behind the above discussion by the FASB is
still appropriate.

Classification of Awards in a Spin-Off Transaction

Interpretation 44 provided an exception that did not require an entity to change the accounting method of an
award when there is a change in the award holder’s status from that of an employee to a nonemployee as a direct
result of a spin-off. If an employee was granted a share-based payment award that is outstanding as of the date of
the spin-off, and that employee is now considered a nonemployee as a direct result of the spin-off, a change from
the intrinsic value method to the fair value method for the award previously granted is not required.

Although (1) ASC 718 does not provide guidance on the classification of awards that are indexed to the spinnor’s
equity (i.e., the former parent’s equity) and held by employees of the spinnee (i.e., the former subsidiary) after
a spin-off transaction and (2) Interpretation 44 has been nullified, the guidance in Interpretation 44 remains
applicable by analogy since it is the only available guidance on accounting for share-based payment awards in
a spin-off transaction. Accordingly, similar to the exception that did not require a change in accounting method
when there is a change in the award holder’s status, the spinnee should continue to account for the award in the
same manner as the spinnor (i.e., equity versus liability), using the guidance for employee awards as though the
spin-off had not occurred, assuming no other changes to the award have been made.

4-32 Accounting for Share-Based Payment Awards of Former Employees — Awards
Modified as a Result of a Spin-Off

As discussed in Q&A 4-30, a spin-off is considered an equity restructuring, which is defined in the Codification
Master Glossary 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.” Further, ASC 718-20-35-6
indicates that “[e]xchanges of share options or other equity instruments or changes to their terms in conjunction
with an equity restructuring” are treated as modifications.

Question

How should a parent (spinnor) account for share-based payment awards that (1) were originally granted to
individuals in their capacity as employees and (2) are modified as a direct result of a spin-off when such individuals
are no longer employed by the spinnor or spinnee?

Answer

Share-based payment awards that were originally granted to individuals in their capacity as employees continue to
be accounted for under ASC 718 throughout the award’s life unless its terms are modified when the holder is no
longer an employee. Because a spin-off is considered a modification, changes to an award’s terms as a direct result
of a spin-off when the individuals are no longer employees would normally require the spinnor to account for
(1) the modification in accordance with the guidance in ASC 718 and (2) the award after the modification under
other applicable GAAP. However, if the changes to award’s terms are made solely as a direct result of a spin-off,
ASC 718-10-35-10 does not require the spinnor to account for the award after the modification under other
applicable GAAP provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the
award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the
terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same
manner.

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Even though, in a spinnor’s accounting for an award after its terms have changed, the spinnor may not consider changes that result directly from the spin-off to be a modification under other applicable GAAP, the spinnor still would need to treat the changes to the terms as a modification in accordance with the guidance in ASC 718. That is, the spinnor would need to consider whether the changes in the award’s terms would result in the recognition of any incremental compensation cost under ASC 718-20-35-3. For example, the nonemployee may be made whole by preserving the ratio of intrinsic value to the exercise price of the award. However, the fair-value-based measure of the modified award on the date of the spin-off may be greater than the fair-value-based measure of the original award immediately before the spin-off. As a result, the spinnor would recognize incremental compensation cost for the excess of the fair-value-based measure of the modified award over the fair-value-based measure of the original award. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award.

4-33  Accounting for Share-Based Payment Awards in a Spin-Off — Awards Modified to Become Indexed to the Equity of the Former Subsidiary

As discussed in Q&A 4-30, a spin-off is considered an equity restructuring, which is defined in the Codification Master Glossary 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.” Further, ASC 718-20-35-6 indicates that “[e]xchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring” are treated as modifications.

In a spin-off transaction, individuals who were originally employees of an entity (the former parent or spinnor) that is spinning off a consolidated entity (the former subsidiary or spinnee) become employees of the former subsidiary exclusively upon completion of the spin-off. Many times the former parent, in contemplation of a spin-off and in accordance with the award’s antidilution provisions, may arrange with those employees to exchange unvested options indexed to the former parent’s equity for unvested options to purchase new shares of the former subsidiary. See Q&A 4-30 for a more detailed discussion of the impact of antidilution provisions in an equity restructuring and Q&A 4-31 for a discussion of the accounting for share-based payment awards that are held (rather than modified) by employees of the former subsidiary and continue to be indexed to the former parent’s equity.

Question

How should the former parent (spinnor) and the former subsidiary (spinnee) account for the modification of share-based payment awards as a result of a spin-off?

Answer

Although the employees of the former subsidiary will no longer be employed by the former parent as of the date of the spin-off, the services they provide to the former subsidiary will not be interrupted. Therefore, the former parent does not reverse any compensation cost recorded for the options before the date of the spin-off (i.e., the awards are not forfeited). Instead, the former parent exchanges the original awards for modified (new) awards of the former subsidiary. After the spin-off, the former parent would no longer record compensation cost related to the original or modified awards issued to the former employees. The remaining unrecognized fair-value-based measure of the original awards and the incremental compensation cost associated with the modified awards, if any, would be recognized by the former subsidiary over the remaining service period.

When discussing issues related to spin-off transactions at its September 1, 2004, Board meeting, the FASB reached the following conclusion:

In connection with a spinoff transaction and as a result of the related modification, employees of the former parent may receive unvested equity instruments of the former subsidiary, or employees of the former subsidiary may retain unvested 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 unvested modified awards for those employees that provide service to each respective entity. For example, if an employee of the former subsidiary retains unvested 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 unvested equity instruments held by those former employees that subsequent to the spinoff provide services solely to the former subsidiary.

We understand that this guidance was not included in the final standard because the example of a spin-off transaction was deleted just before its issuance. However, the thinking behind the above discussion by the FASB is still appropriate.
4-34 Determining Market Price Before and After a Spin-Off

As discussed in Q&A 4-30, a spin-off is considered an equity restructuring, which is defined in the Codification Master Glossary 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.” Further, ASC 718-20-35-6 indicates that “exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring” are treated as modifications.

Question

In a spin-off, how should an entity determine the market price when calculating the fair-value-based measure of the original share-based payment award and the modified share-based payment award?

Answer

To account for the modification and determine whether any incremental fair-value-based measure results from the spin-off, an entity would compare the fair-value-based measure of the award immediately before the spin-off with the fair-value-based measure of the award immediately after the spin-off. The fair-value-based measure of the award immediately before the spin-off will be determined on the basis of the assumptions (e.g., stock price, volatility, expected dividends, risk-free interest rate) before the spin-off, and the fair-value-based measure after the spin-off will be determined on the basis of the assumptions that exist immediately after the spin-off.

Depending on the structure of the share-based payment plan, the market price of the parent’s shares before and after the spin-off, as well as the market price of the spinnee’s shares after the transaction, may also be relevant.

Determining the Market Price of the Parent’s and Spinnee’s Shares

The market price of the parent’s shares immediately before the modification should be based on the closing price on the date of the spin-off, otherwise known as the “record date.” Sometimes the parent’s shares begin trading on an “ex-dividend” basis before the distribution date, which already excludes the value of the spinnee’s shares. If this happens and the spinnee’s shares are trading on a “when-issued” basis, to determine the market price of the parent’s shares immediately before the modification, an entity would add the distribution-date closing price of the spinnee’s shares to the distribution-date (i.e., spin-off date) closing price of the parent’s shares, since the parent’s shares incorporate the reduction in value that is due to the spin-off.

The market price of the parent’s shares immediately after the modification is the opening price on the first trading date after the distribution, unless the parent’s shares are traded on an “ex-dividend” basis and the spinnee’s shares are trading on a “when-issued” basis. If this is the case, the price of the parent’s shares at the time of the spin-off is used, since the market price will already exclude the closing price of the spinnee’s shares.

The market price of the spinnee’s shares immediately after the modification is the closing price of the spinnee’s shares on the distribution date, as long as the shares are traded on a “when-issued” basis. Otherwise, the opening price of the spinnee’s shares on the first trading date after the distribution should be used as the market price of the spinnee’s shares immediately after the modification.

4-35 Accounting for the Repurchase of an Equity Award

Question

How should an entity account for a separation agreement with one of its employees in which (1) it agrees to make a termination payment in cash and (2) the employee separately agrees to cancel all outstanding share-based payment awards?

Answer

The separation agreement and cancellation of employee awards should be accounted for as a single transaction. That is, the separation agreement should be viewed as the repurchase of all outstanding awards for cash. Accordingly, as long as the settlement consideration (cash, other assets, or liabilities incurred) does not exceed the fair-value-based measure of the equity-classified award as of the settlement date, no additional compensation cost is recorded, and the amount of cash, other assets, or liabilities incurred to settle the award is charged directly to equity. If the settlement consideration exceeds the fair-value-based measure of the equity-classified award as of the settlement date, the amount in excess of the fair-value-based measure is recognized as additional compensation cost.
In determining the fair-value-based measure of the outstanding awards that are settled, an entity should consider the vested and unvested awards as follows:

- **Vested awards** — The termination payment for the vested awards would be viewed as a settlement. Accordingly, an entity should recognize the amount paid to repurchase the vested awards that is less than or equal to the fair-value-based measure of the vested awards on the repurchase date as a charge to equity.

- **Unvested awards** — Since the employee will not continue employment and complete the requisite service to earn the awards, the unvested awards are not expected to vest as of the separation date. The entity should reverse any previously recognized compensation cost related to the unvested awards. The termination payment is an improbable-to-probable modification of the unvested options. (See Q&A 4-22 and Q&A 4-24 for a discussion of improbable-to-probable modifications.) That is, as a result of the separation agreement, the employee would not have vested in these awards upon termination of employment (improbable). The termination payment effectively accelerated the vesting of the award, making it probable that the awards would vest upon cash settlement. Accordingly, the total fair-value-based measure of the unvested awards is zero immediately before settlement on the separation date (0 awards expected to vest × fair-value-based measure of the unvested awards as of the date of the separation agreement). To determine the incremental compensation cost resulting from the modification, the entity would subtract this value from the fair-value-based measure of the modified awards, which is the amount of cash paid for the unvested awards. Therefore, the amount of cash paid for the unvested awards will be recognized as compensation cost on the date of the separation agreement. No amount should be recognized as the repurchase of an equity-classified award.

Note that the determination of whether the payment is a modification, settlement, or other action is based on the facts and circumstances of each situation.

**Example**

Entity A enters into a separation agreement with one of its executives as of January 1, 20X3. In connection with the separation agreement:

- Entity A agrees to pay $1 million in cash to the executive.
- The executive agrees to cancel all outstanding employee share options to purchase A’s common stock (both vested and unvested) upon termination of employment.
  - The executive had 10,000 vested employee share options, each with a grant-date fair-value-based measure of $30 and a fair-value-based measure of $40 as of the date of the separation agreement.
  - The executive had 10,000 unvested employee share options, each with a grant-date fair-value-based measure of $35 and a fair-value-based measure of $42 as of the date of the separation agreement. The options were granted on January 1, 20X1, and vest at the end of the fourth year of service (cliff vesting).
- For simplicity, the effects of income taxes have been ignored.

In determining the fair-value-based measure of the outstanding options that are settled, A should consider the vested and unvested options as follows:

**Vested Options**

The termination payment is viewed as a settlement of the vested options. Therefore, A should recognize in equity the amount of cash paid to settle the options up to the fair-value-based measure of the options. See the journal entry below.

**Journal Entry: January 1, 20X3 — Date of Separation Agreement**

<table>
<thead>
<tr>
<th></th>
<th>400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

To record the repurchase of the vested options on the date of the separation agreement (10,000 options × $40 fair-value-based measure as of the date of the separation agreement).
Unvested Options

Since the executive’s unvested options are no longer expected to vest as of the date of the separation agreement, A should reverse any previously recognized compensation cost associated with these options on the date of the separation agreement. The termination payment is then treated as an improbable-to-probable modification of the unvested options. Accordingly, the total fair-value-based measure of the unvested options is zero immediately before the date of the separation agreement (0 options expected to vest × $42 fair-value-based measure of the unvested options as of the date of the separation agreement). The fair-value-based measure of the modified awards is $600,000, which is the total amount of cash paid for the vested and unvested options ($1 million) less the fair-value-based measure of the vested options ($400,000). Therefore, Entity A shall recognize the fair-value-based measure of the modified options ($600,000) as compensation cost on the date of the separation agreement. See the journal entries below.

Journal Entries: January 1, 20X3 — Date of Separation Agreement

<table>
<thead>
<tr>
<th>Description</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC 175,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation cost 175,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To reverse any previously recognized compensation cost associated with the unvested options that are no longer expected to vest (10,000 options × $35 grant-date fair-value-based measure × 50% for two of four years of services rendered).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation cost 600,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>APIC 600,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record incremental compensation cost resulting from the modification on the date of the separation agreement.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4-36 Settlement of an Unvested Award for Less Than Its Fair-Value-Based Measure

Question

How does an entity account for the settlement of an unvested award at less than its current fair-value-based measure?

Answer

ASC 718 does not specifically address the settlement of an award for an amount less than its fair-value-based measure on the settlement date. However, in accordance with ASC 718-20-35-7, the amount of cash or other assets transferred (or liabilities incurred) to settle an award is charged directly to equity, provided that the amount transferred does not exceed the fair-value-based measure of the instruments settled on the settlement date. However, the settlement of an unvested award effectively vests the award. Therefore, any previously unrecognized compensation cost attributable to the award is recognized immediately on the date of settlement.

Example

On January 1, 20X1, Entity A grants 1,000 at-the-money employee share options, each with a grant-date fair-value-based measure of $9. The options vest at the end of the fourth year of service (cliff vesting). On December 31, 20X2, the market price of A’s stock has declined so dramatically that A wishes to terminate the options because they provide little future incentive value to the employees. In this case, employees may be willing to relinquish the options for an amount less than their current fair-value-based measure because payment would be immediate and would not require future service. The fair-value-based measure of the options on the settlement date is $3.50, and A wishes to cash settle the options for $2 in cash.

Before settlement, A recorded compensation cost of $4,500 on the basis of the number of options expected to vest (1,000 options, assuming no forfeitures), the grant-date fair-value-based measure of the options ($9), and the amount of services rendered (50 percent for two of four years of services rendered). On the settlement date, A would record the amount of cash paid ($2,000 = 1,000 options × $2 cash paid per option) with a corresponding charge to equity. Simultaneously, A records the remaining unvested compensation cost ($4,500) because the settlement has fully vested the options. See the journal entries below, which are recorded on the settlement date.
Journal Entries: December 31, 20X2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$4,500</td>
</tr>
<tr>
<td>APIC</td>
<td>$4,500</td>
</tr>
</tbody>
</table>

To record the remaining unrecognized compensation cost on the date of settlement.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

To record the amount of cash paid to settle the options with a corresponding charge to equity.

4-37 Distinguishing a Cash Settlement From a Modification That Changes an Award’s Classification From Equity to Liability

During the contractual life of an equity-classified share-based payment award, the employer may enter into a separate agreement to repurchase (or offer to repurchase) the award from the employee for cash. Because the accounting consequences are considerably different, it is important to distinguish whether the repurchase of the award for cash constitutes (1) a settlement of the equity award or (2) a modification of the equity award that changes the award’s classification from equity to liability followed by a settlement of the now liability award.

If the repurchase of (or offer to repurchase) the equity award is considered a settlement, then the requirements of ASC 718-20-35-7 would apply. That is, as long as the settlement consideration (cash, other assets, or liabilities incurred) does not exceed the fair-value-based measure of the equity award as of the settlement date, no additional compensation cost is recorded. The amount of cash, other assets, or liabilities incurred to settle an award is charged directly to equity. To the extent that the settlement consideration exceeds the fair-value-based measure of the equity award on the settlement date, that difference is recognized as additional compensation cost.

Alternatively, if the repurchase of (or offer to repurchase) the equity award is considered a modification that changes the award’s classification from equity to liability followed by a subsequent settlement of the now liability award, additional compensation cost may need to be recognized as of the modification date. That is, upon changing the award’s classification from equity to liability, an entity would adjust the carrying value of the equity award to its current fair-value-based measure as a share-based liability. Additional compensation cost would be recorded only if the fair-value-based measure of the liability award on the modification date is greater than the original grant-date fair-value-based measure of the equity award. See Q&A 4-18 for a more detailed discussion of the accounting for a modification that changes an award’s classification from equity to liability. Because the award is now a share-based liability, if the entity does not immediately cash settle the award, the award would be remeasured at its fair-value-based amount each reporting period until settlement. See Q&A 4-39 for a more detailed discussion of the accounting for liability awards. When the cash is paid to settle the liability award equal to its fair value, the share-based liability is relieved with a corresponding credit to cash.

Question

What factors should an entity consider in determining whether the repurchase of an equity award constitutes (1) a settlement of the equity award or (2) a modification of the equity award and subsequent settlement of a liability award?

Answer

A repurchase transaction in which an equity award is immediately settled for cash, other assets, or liabilities incurred is accounted for as a settlement of an equity award in accordance with ASC 718-20-35-7.

In contrast, an entity must determine whether a repurchase transaction in which an employer offers to settle the equity award for cash or other assets (or liabilities incurred) on some future date is accounted for as a settlement or a modification of the equity award. The FASB clarified in FSP FAS 123(R)-6 that it did not intend for an offer

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5 The accounting for a repurchase feature embedded in the original terms of the award should be evaluated in accordance with ASC 718-10-25-9 through 25-12.
to repurchase an award for a limited period to change the classification of the award from equity to liability. Paragraph 11 of FSP FAS 123(R)-6 states, in part:

The Board did not intend for a short-term inducement that is deemed to be a settlement to affect the classification of the award for the period it remains outstanding (for example, change the award from an equity instrument to a liability instrument). Therefore, an offer (for a limited time period) to repurchase an award should be excluded from the definition of a short-term inducement and should not be accounted for as a modification pursuant to paragraph 52 of Statement 123(R) [codified in ASC 718-20-35-5].

Entities should exercise professional judgment in determining whether the offer to repurchase an equity award is outstanding for more than a “limited time period”; that is, whether the repurchase of the equity award should be accounted for as (1) a settlement of the equity award or (2) a modification of the equity award followed by the settlement of a liability award. The following are among the items an entity should consider in determining whether an offer to repurchase an award is a modification that changes the award’s classification from equity to liability:

- The amount that would be paid to settle the awards continues to be indexed to the employer’s equity (i.e., the settlement amount is not fixed or determinable).
- Whether substantive future service is required.

Note that if an entity repurchases (or offers to repurchase) equity awards, it should evaluate the substantive terms of all outstanding share-based payment awards in accordance with ASC 718-10-25-15. A consistent pattern of cash settling awards may suggest that the substantive terms of the award provide for cash settlement, which, in turn, requires liability classification of all outstanding awards. This concept was emphasized in paragraph 11 of FSP FAS 123(R)-6, which states, in part:

If an entity has a history of settling its awards for cash, the entity should consider whether at the inception of the awards it has a substantive liability pursuant to paragraph 34 of Statement 123(R) [codified in ASC 718-10-25-15].

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $10. Throughout their life, the options are classified as equity. After the options are fully vested, A offers to repurchase them for cash equal to the current fair-value-based measure of the options ($12 per option). If the offer to repurchase the options is considered a settlement, the entire $12,000 (1,000 options × $12 fair-value-based measure on the settlement date) will be charged to equity with the corresponding credit to cash. See the journal entry below. For simplicity, the effects of forfeitures and income taxes have been ignored.

Journal Entry: At Settlement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC ($12 × 1,000 options)</td>
<td>12,000</td>
</tr>
<tr>
<td>Cash</td>
<td>12,000</td>
</tr>
</tbody>
</table>

To record the cash paid to settle the employee share options at their current fair-value-based measure.

Alternatively, if the offer to repurchase the options is considered a modification, the options are first reclassified to a share-based liability with the difference ($2) between the grant-date fair-value-based measure ($10) and the current fair-value-based measure ($12) recorded as additional compensation cost. Because the award is now a share-based liability, if the entity does not immediately cash settle the award, the award would be remeasured at its fair-value-based amount each reporting period until settlement. See Q&A 4-39 for a more detailed discussion of the accounting for liability awards. When the cash is paid to settle the liability award, the share-based liability is relieved with a corresponding credit to cash. See the journal entries below.

Journal Entry: At Settlement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC ($10 × 1,000 options)</td>
<td>10,000</td>
</tr>
<tr>
<td>Compensation cost</td>
<td>2,000</td>
</tr>
<tr>
<td>Share-based liability ($12 × 1,000 options)</td>
<td>12,000</td>
</tr>
</tbody>
</table>

To reclassify the grant-date fair-value-based measure recorded in equity as a share-based liability and record the additional compensation cost.
Journal Entry: At Settlement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based liability</td>
<td>12,000</td>
</tr>
<tr>
<td>Cash</td>
<td>12,000</td>
</tr>
</tbody>
</table>

To record the cash paid to settle the employee share options at the fair-value-based measure of the share-based liability.

4-38 Modifications Versus Cancellations

**Question**

What is the accounting difference between a modification of an existing award and a cancellation of an award with a concurrent issuance of (or promise to issue) a new award?

**Answer**

There is no accounting difference between a modification of an existing award and a cancellation of an award with a concurrent issuance of (or promise to issue) a new award. That is, an entity is required to record the incremental value, if any, conveyed to the holder of the award as compensation cost on the date of cancellation (for vested awards) or over the remaining requisite service period (for unvested awards). The incremental compensation cost is the excess of the fair-value-based measure of the replacement award over the fair-value-based measure of the canceled award on the cancellation date.

Generally, total recognized compensation cost attributable to an award that has been canceled is, at least, the grant-date fair-value-based measure of the original award. Therefore, total recognized compensation cost attributable to an award that has been canceled is (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the award has been earned) or is expected to be provided and (2) the incremental compensation cost conveyed as a result of the cancellation and replacement.

In contrast, if an award without a concurrent issuance of (or promise to issue) a new award is canceled, the entity is required to immediately recognize any unvested compensation cost attributable to the canceled award.

**Example 1**

On January 1, 20X1, Entity A grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $9. The options vest at the end of the fourth year of service (cliff vesting). On January 1, 20X4, A cancels the options and concurrently issues replacement options. The service period of the replacement options covers the remaining one-year service period of the canceled options. The fair-value-based measure of the replacement award is $7, and the fair-value-based measure of the canceled award is $4 on the date of cancellation. For simplicity, the effects of forfeitures and income taxes have been ignored.

During the first three years of service, A records cumulative compensation cost of $6,750 (1,000 options × $9 grant-date fair-value-based measure × 75% for three of four years of services rendered). On the cancellation date, A computes the incremental compensation cost as $3,000 (i.e., (($7 fair-value-based measure of replacement options – $4 fair-value-based measure of canceled options on the date of cancellation) × 1,000 options)). The $3,000 incremental compensation cost is recorded over the remaining year of service of the replacement options. In addition, A records the remaining $2,250 of compensation cost over the remaining year of service attributable to the canceled options. Therefore, total compensation cost associated with these options is $12,000 ($9,000 grant-date fair-value-based measure + $3,000 incremental fair-value-based measure) recorded over four years of required service for both the canceled and replacement options.

**Example 2**

Assume all the same facts as in Example 1, except that A cancels the original options with no concurrent issuance of (or offer to issue) replacement options. Six months later, A issues 1,000 new “at-the-money” employee share options, each with a grant-date fair-value-based measure of $12. The options vest over the remaining six-month service period attributable to the canceled options. For simplicity, the effects of forfeitures and income taxes have been ignored.
During the first three years of service, A records cumulative compensation cost of $6,750 (1,000 options × $9 grant-date fair-value-based measure × 75% for three of four years of services rendered). On the cancellation date, the options are treated as though they are fully vested. Accordingly, A records the remaining $2,250 of compensation cost attributable to the canceled options. Therefore, total compensation cost associated with the canceled options is the $9,000 grant-date fair-value-based measure.

For the options issued six months later, A records $12,000 (1,000 options × $12 grant-date fair-value-based measure) of compensation cost over the remaining six-month service period of the options. Therefore, total compensation cost associated with these options is the $12,000 grant-date fair-value-based measure.

Because the cancellation of the original options and issuance of the new options was not viewed as a cancellation and replacement (and therefore modification accounting was not applied), A records total compensation cost of $21,000 (i.e., $9,000 for the canceled options and $12,000 for the options issued six months later). In contrast, if A had canceled and replaced the original options (and therefore modification accounting was applied), A would record only total compensation cost of $17,000, which is equal to the grant-date fair-value-based measure of the canceled options ($9,000) and the incremental value conveyed to the holders of the replacement options ($8,000, which assumes [($12 fair-value-based measure of replacement options – $4 fair-value-based measure of canceled options on the date of cancellation) × 1,000 options]).

### Liability-Classified Awards

<table>
<thead>
<tr>
<th>ASC 718-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement</strong></td>
</tr>
<tr>
<td>35-1 The fair value of liabilities incurred in share-based payment transactions with employees shall be remeasured at the end of each reporting period through settlement.</td>
</tr>
<tr>
<td>35-2 Changes in the fair value (or intrinsic value for a nonpublic entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation cost of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this Subtopic is an adjustment of compensation cost in the period of settlement. Example 1 (see paragraph 718-30-55-1) provides an illustration of accounting for a liability award from the grant date through its settlement.</td>
</tr>
<tr>
<td><strong>Public Entity</strong></td>
</tr>
<tr>
<td>35-3 A public entity shall measure a liability award under a share-based payment arrangement based on the award’s fair value remeasured at each reporting date until the date of settlement. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period. Example 1 (see paragraph 718-30-55-1) provides an illustration of accounting for an instrument classified as a liability using the fair-value-based method.</td>
</tr>
<tr>
<td><strong>Nonpublic Entity</strong></td>
</tr>
<tr>
<td>35-4 Regardless of the measurement method initially selected under paragraph 718-10-30-20, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under Topic 250. Example 1 (see paragraph 718-30-55-1) provides an illustration of accounting for an instrument classified as a liability using the fair-value-based method. Example 2 (see paragraph 718-30-55-12) provides an illustration of accounting for an instrument classified as a liability using the intrinsic value method.</td>
</tr>
<tr>
<td><strong>Modification of an Award</strong></td>
</tr>
<tr>
<td>35-5 A modification of a liability award is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or intrinsic value for a nonpublic entity that elects that method) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification (see Example 15, Case C [paragraph 718-20-55-135] for what happens when the modification causes the award to no longer be a liability).</td>
</tr>
</tbody>
</table>

**Question**

How should entities measure compensation cost for a liability award under ASC 718?
Answer

Entities determine the fair-value-based measure of a liability award the same way they measure an equity award—that is, they often use a valuation technique such as an option pricing model. See Q&A 3-01 for a more detailed discussion of selecting a valuation technique. Entities then remeasure the award’s fair-value-based measure, which is used to determine the measurement of the liability on the balance sheet, as of each reporting period until the award is settled. Fluctuations in the fair-value-based measure of the liability award are recorded as increases or decreases in compensation cost, either immediately or over the remaining service period, depending on the vested status of the award.

Example

Assume the following facts:

- On January 1, 20X1, Entity A grants 1,000 cash-settled SARs to an employee.
- The SARs vest at the end of the second year of service (cliff vesting).
- The fair-value-based measures of each SAR are as follows:
  - $10 on January 1, 20X1.
  - $15 on December 31, 20X1.
  - $14 on December 31, 20X2.
  - $18 on December 31, 20X3.
  - $16 on the date of settlement, May 15, 20X4.
- For simplicity purposes, the effects of forfeitures and income taxes have been ignored.
- There are no interim reporting requirements.

The following table illustrates the compensation cost that is recognized in each reporting period until the liability award is settled.

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>Compensation Cost</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 7,500</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the SARs as of the reporting date, and the amount of services rendered (1,000 awards × $15 × 50% services rendered).*</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>6,500</td>
<td>Compensation cost is based on the number of SARs granted, the fair-value-based measure of the SARs as of the reporting date, and the amount of services rendered, less amounts previously recognized ((1,000 awards × $14 × 100% services rendered) – $7,500).</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>4,000</td>
<td>Once all the services have been provided, the liability is remeasured each reporting date until the award is settled. Remeasurement is based on the number of awards vested and the fair-value-based measure of the liability award as of the reporting date, less amounts previously recognized ((1,000 awards × $18) – $14,000).</td>
</tr>
<tr>
<td>Period from January 1, 20X4 to May 15, 20X4</td>
<td>(2,000)</td>
<td>Once all the services have been provided, the liability is remeasured each reporting date until the award is settled. Remeasurement is based on the number of awards vested and the fair-value-based measure of the SARs as of the reporting date, less amounts previously recognized ((1,000 awards × $16) – $18,000).</td>
</tr>
<tr>
<td>Total</td>
<td>$ 16,000</td>
<td></td>
</tr>
</tbody>
</table>

* Fifty percent represents the employee providing one of two years of service.
Change in Measuring Share-Based Liabilities From Intrinsic Value to Fair Value When Entity Becomes Public

To measure liabilities incurred under share-based payment arrangements, public entities must use a fair-value-based measure, while nonpublic entities may choose either a fair-value-based measure (or calculated value) or intrinsic value. Nonpublic entities that elect the intrinsic value method and subsequently decide to become public entities would be required to measure the liabilities by using a fair-value-based measure in initial registration statements.

Question

Upon becoming public, how should an entity that previously used intrinsic value to measure liabilities incurred under share-based payment arrangements record the effect of a change to a fair-value-based measure?

Answer

An informal inquiry with the SEC staff has indicated that recording the effect of such a change as either of the following would be acceptable: (1) compensation cost in the current period or (2) the cumulative effect of a change in accounting principle in accordance with ASC 250.

The preferred approach is to treat the change in method of measuring the liability as a change in accounting principle under ASC 250, with the cumulative effect of the change recorded accordingly. However, in light of the SEC staff’s view, recording the effect of the change as compensation cost is not objectionable.

SAB Topic 14 states that entities transitioning from nonpublic to public status are not permitted to apply the fair-value-based method retrospectively, as ASC 250 allows. Therefore, such a change would be recorded as a cumulative-effect adjustment and applied prospectively, as discussed in ASC 250-10-45-6 and 45-7.

Under either approach, entities should include appropriate disclosures in the financial statements.

Nonpublic entities that previously used intrinsic value to measure share-based liabilities and that voluntarily change to using a fair-value-based method should follow the guidance in ASC 250 for a change in accounting principle, as referred to in ASC 718-30-35-4.
Chapter 5 — Disclosure

This chapter outlines ASC 718 disclosures that entities are required to provide in the notes to, and on the face of, the financial statements. ASC 718-10-50-1 lays out four disclosure objectives, while ASC 718-10-50-2 describes the “minimum information” that an entity would need to disclose in its annual financial statements to achieve those four objectives. See Appendix D for an example disclosure.

Interim Disclosure Considerations

ASC 718 does not prescribe share-based compensation disclosure requirements for an entity’s quarterly financial statements. However, if an entity’s share-based compensation cost is significant, it may provide additional information, including the total amount of that cost, on a quarterly basis. This may be the case for registrants that grant a substantial portion of their share-based payment awards at a single time each year. In addition, under SEC Regulation S-X, Rule 10-01(a)(5), when events have occurred that have a material impact on a registrant’s financial statements, the registrant should disclose the events in its quarterly financial statements and such disclosures should be similar to the ones it would provide in its annual financial statements.

Other Disclosure Considerations

In addition to the disclosure guidance in ASC 718, an entity should consider SEC guidance when preparing financial statement disclosures related to share-based-payment awards. See Chapter 12 for additional information. SAB Topic 1.B.1 provides guidance on a subsidiary’s requirement to comply with the disclosure requirements of ASC 718-10-50 in its stand-alone financial statements.

General Requirements

<table>
<thead>
<tr>
<th>ASC 718-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:</td>
</tr>
<tr>
<td>a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders</td>
</tr>
<tr>
<td>b. The effect of compensation cost arising from share-based payment arrangements on the income statement</td>
</tr>
<tr>
<td>c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period</td>
</tr>
<tr>
<td>d. The cash flow effects resulting from share-based payment arrangements.</td>
</tr>
</tbody>
</table>

This disclosure is not required for interim reporting. For interim reporting see Topic 270. See Example 9 (paragraph 718-10-55-134 through 55-137) for an illustration of this guidance.
Chapter 5 — Disclosure
A Roadmap to Accounting for Share-Based Payment Awards

ASC 718-10 (continued)

50-2 The following list indicates the minimum information needed to achieve the objectives in the preceding paragraph 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 requisite service period(s) 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 with employees.

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 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
### ASC 718-10 (continued)

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 employees’ expected exercise and postvesting employment 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 post-vesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraph (a) through (f) separately for different types of awards 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 with employees 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 employees affected
   
   iii. The total 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. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period

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.

50-3 Paragraph Not Used

50-4 In addition to the information required by this Topic, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this Topic. The alternative assumptions shall be described to enable users of the financial statements to understand the basis for the supplemental information.
5-01 Disclosure in Quarterly Financial Statements

Question
Under ASC 718, what share-based compensation information must an SEC registrant disclose in its quarterly financial statements?

Answer
ASC 718 does not provide explicit requirements for share-based compensation disclosures in quarterly financial statements. However, paragraph B239 of the Basis for Conclusions in Statement 123(R) refers to the requirements (codified in ASC 270-10-50-1) for disclosing “information about changes in accounting principles or estimates and significant changes in financial position.”

Paragraph B239 also notes that when “share-based compensation cost is significant [registrants] may wish to provide additional information, including the total amount of that cost, on a quarterly basis.” This may be the case for registrants that grant a substantial portion of their share-based payment awards at a single time each year.

In addition, under SEC Regulation S-X, Rule 10-01(a)(5), when events have occurred that have a material impact on a registrant’s financial statements, the registrant should disclose the events in its quarterly financial statements, and the disclosures it uses should be similar to those it would provide in its annual financial statements. When assessing the amount and type of information to be disclosed in quarterly financial statements, registrants should consider items such as the amount and timing of grants of share-based payment awards, material modifications to existing share-based payment awards, material share repurchases, material changes in assumptions used in the valuation of awards, and material changes to the type of awards issued.

5-02 Disclosure Requirements for Changes in Valuation Techniques Related to Share-Based Payment Awards

ASC 718-10-55-27 states that the “valuation technique an entity selects . . . shall be used consistently and shall not be changed unless a different valuation technique is expected to produce a better estimate of fair value.” It also states that a change in valuation technique should be accounted for as a change in accounting estimate and applied prospectively to new awards.

In addition, Question 3 of SAB Topic 14.C states that the SEC staff would not object to an entity changing its valuation technique or model as long as the new technique or model meets the fair value measurement objective of ASC 718.

Question
What disclosures are required when an entity changes its valuation technique or method for valuing its share-based payment awards under ASC 718?

Answer
As indicated in ASC 718-10-55-27, if an entity changes its valuation technique or method for valuing its share-based payment awards, the entity should account for this change as a change in accounting estimate under ASC 250.

ASC 250-10-50-5 indicates that entities are not required to disclose the information outlined in ASC 250-10-50-4 for changes in estimate that are due to a change in valuation technique. However, SAB Topic 14.C states that in the case of a change in valuation techniques for valuing a share-based payment award, “[d]isclosure in the footnotes of the basis for any change in technique or model would be appropriate.” Accordingly, an entity is encouraged to disclose the basis for any change in valuation technique for valuing its share-based payment awards.

In addition, SEC registrants may consider additional disclosures in MD&A if the change in estimate had a material impact on the entity’s results of operations.
Section 5 — Disclosure

A Roadmap to Accounting for Share-Based Payment Awards

5-03 Disclosure in a Subsidiary’s Stand-Alone Financial Statements

Question
Is a subsidiary required to comply with the disclosure requirements of ASC 718-10-50 in its stand-alone financial statements?

Answer
Yes. SAB Topic 1.B.1 notes that a registrant (subsidiary) should reflect all the costs of doing business in the subsidiary’s financial statements (to help financial statement users understand such costs). Furthermore, SAB Topic 1.B.1 requires that expenses incurred by a parent on behalf of its subsidiary be reflected in the historical financial statements of the subsidiary and states that examples of such expenses may include, but are not limited to:

1. Officer and employee salaries;
2. Rent or depreciation;
3. Advertising;
4. Accounting and legal services, and
5. Other selling, general and administrative expenses.

In determining the disclosures required in their stand-alone financial statements, subsidiaries (regardless of whether they are SEC registrants) should apply the same rationale as that in SAB Topic 1.B.1. That is, subsidiaries should provide similar disclosures as those required by the parent.

5-04 SEC Views on MD&A Disclosures About Share-Based Compensation Disclosures in IPO Registration Statements

A registrant undergoing an IPO of its equity securities typically identifies share-based compensation as a critical accounting estimate because the lack of a public market for the pre-IPO shares makes the estimation process complex and subjective. Section 9520 of the FRM, which discusses disclosure considerations related to critical accounting estimates by companies going public, was updated in February 2014. The updated interpretive guidance calls for significantly reduced disclosures in the critical accounting estimates section of MD&A about share-based compensation and the valuation of a company’s pre-IPO common stock (often referred to as “cheap stock”).

Question
What are the SEC staff’s views regarding the nature and extent of share-based compensation disclosures in the critical accounting estimates section of MD&A about the valuations of registrants’ pre-IPO common stock in IPO registration statements?

Answer
At the “SEC Speaks in 2014” Conference (the “conference”), the staff of the SEC’s Division of Corporation Finance discussed its recent changes to Section 9520 of the FRM and described the types of detailed disclosures observed in IPO registration statements that had prompted those changes. The staff noted that registrants have historically included:

- A table of equity instruments issued during the past 12 months.
- A description of the methods used to value the registrant’s pre-IPO common stock (i.e., income approach or market approach).
- Detailed disclosures about certain select assumptions used in the valuation.
- Discussion about changes in the fair value of the company’s pre-IPO common stock, which included each grant leading up to the IPO and resulted in repetitive disclosures.

1 For additional information about the conference, see Deloitte’s March 20, 2014, Heads Up.
The staff indicated that despite the volume of share-based compensation information included in IPO filings, disclosures of such information were typically incomplete because registrants did not discuss all assumptions related to their common stock valuations. Further, disclosures about registrants’ pre-IPO common stock valuations were not relevant after an IPO transaction and were generally removed from their periodic filings after the IPO. The SEC staff expressed the view that if registrants streamline their share-based compensation disclosures, they will not only reduce the volume of disclosures but also make the disclosures more meaningful. In addition, the staff indicated that by eliminating unnecessary information, registrants could reduce many of their prior disclosures “down to one paragraph.”

At the conference, the SEC staff also offered the following insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM (and thereby reduce their share-based compensation disclosures in their IPO registration statements):

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need only state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would not be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a statement indicating that “a discount cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate”; no additional details would be needed.

- Registrants would have to include a statement indicating that the estimates in their share-based compensation valuations are “highly complex and subjective.” They would not need to provide additional details about the estimates.

- Registrants would also need to include a statement disclosing that such “valuations and estimates will no longer be necessary once the company goes public [because] once it goes public it will rely on the market price to determine the market value of [its] common stock.”

The staff emphasized that its ultimate concern is whether registrants correctly accounted for pre-IPO share-based compensation. Accordingly, the staff will continue to ask registrants for supplemental information to support their valuations and accounting conclusions — especially when the fair value of the company’s pre-IPO common stock is significantly less than the expected IPO price.2

2 At the conference, the SEC staff noted that valuations that appear to be unusual may be attributable to the peer companies selected when a market approach is used. Specifically, the staff indicated that there are often inconsistencies between the peer companies used by registrants and those used by the underwriters, which result in differences in the valuations. Accordingly, the staff encouraged registrants to talk to the underwriters “early and often” to avoid such inconsistencies.
Chapter 6 — Other Presentation

This chapter provides guidance on presentation matters related to the statement of operations, statement of cash flows, and EPS. Presentation guidance on other share-based payment award topics, such as income taxes, is located in other chapters of this Roadmap.

Statement of Operations

ASC 718 requires that compensation cost from share-based payment awards be (1) recorded in net income, (2) either expensed or capitalized (and subsequently expensed) in an entity’s financial statements, and (3) classified appropriately as either equity or a liability in accordance with the classification criteria in ASC 718 (see Chapter 3). However, ASC 718 provides little guidance on how compensation cost associated with share-based payment awards should be presented the statement of operations.

SAB Topic 14.F provides some additional guidance on this topic. The SEC staff believes that compensation cost related to share-based payment arrangements (e.g., cost of sales, R&D, selling and administrative expenses) should be included in the appropriate line items on the face of the statement of operations and not separately presented in a single share-based compensation line item. That is, presentation in the statement of operations should not be governed by the form of consideration paid (e.g., cash or share-based payment).

Statement of Cash Flows

Because the receipt of employee services in exchange for a share-based payment award is a noncash item, the granting of such awards is not presented in the statement of cash flows. However, in presenting cash flows under the indirect method, an entity would present the compensation cost recognized in net income in each reporting period as a reconciling item in arriving at cash flows from operations. In addition, an entity must present any excess tax benefits associated with share-based payment awards, as well as any cash paid by employees (e.g., the exercise price) to the entity for such awards, as cash inflows from financing activities.

Earnings per Share

In calculating EPS, an entity should consider the impact that a share-based payment award may have on (1) net income or income available to common shareholders (i.e., the numerator in the computation of EPS) and (2) the weighted-average number of common shares or dilutive potential common shares (i.e., the denominator in the computation of EPS). Because an entity recognizes the grant-date fair-value-based measure of an award as compensation cost in arriving at the entity’s net income or income available to common shareholders, all awards for which the requisite service has been provided or is expected to be provided have an impact on the numerator of EPS. That is, the compensation cost will reduce net income or income available to common shareholders.

Basic EPS

During the requisite service period, share-based payment awards do not affect the computation of basic EPS unless such awards are considered participating securities. A share-based payment award is considered a participating security if it participates in current-period earnings (usually in the form of dividend distributions) with common shareholders. An entity must apply the two-class method when computing basic and diluted EPS for such awards.
Once the requisite service period has been completed, awards that are considered outstanding common shares may affect the denominator in the computation of basic EPS. Such awards will be included in the weighted-average number of common shares (i.e., in the denominator of the computation of basic and diluted EPS) from the date on which they become outstanding common shares. If the awards do not become outstanding common shares during the period and are not considered participating securities, they are not included in the computation of basic EPS (with the exception of the impact of the compensation cost recorded in net income or income available to common shareholders).

**Diluted EPS**

While share-based payment awards do not affect the denominator in the computation of basic EPS during the requisite service period (unless the award is a participating security), an entity may include them in the denominator when calculating diluted EPS. Further, awards (e.g., employee share options) that do not become outstanding common shares upon completion of the requisite service, and that are not considered participating securities, may be included in the diluted EPS denominator until they are settled (e.g., are exercised, are canceled, or expire).

**Awards With a Service Condition**

Generally, an entity will use the treasury stock method to include share-based payment awards with only a service condition (i.e., no performance or market condition) in the denominator of the computation of diluted EPS provided that the awards are dilutive. (See Q&A 6-08 for an example illustrating the application of the treasury stock method to share-based payment awards.) While any such share-based payment award — vested or unvested — may be dilutive, the treasury stock method only applies to “in-the-money” awards on an award-by-award basis. In-the-money awards are awards in which the average market price during the period is greater than the exercise price of the award. Thus, an entity needs to perform a separate treasury stock method computation for each individual in-the-money award. An entity would perform the same computation for awards that are granted to employees on the same day with the same terms and conditions (i.e., the award would presumably have the same grant-date fair-value-based measure). “Out-of-the-money” awards are considered antidilutive and excluded from the denominator in the computation of diluted EPS. See Q&A 6-19 and Q&A 6-20 for additional guidance on excluding out-of-the-money awards in the computation of diluted EPS.

**Awards With a Performance or Market Condition**

For share-based payment awards with a performance or market condition, entities must first apply the guidance on contingently issuable shares in ASC 260-10-45-48 through 45-54 to determine whether the awards should be included in the computation of diluted EPS for the reporting period. That is, for all outstanding performance- and market-based awards, an entity needs to determine the number of shares, if any, that would be issuable at the end of the reporting period if the end of the reporting period were the end of the contingency period (e.g., the number of shares that would be issued on the basis of current-period earnings or period-end market price). Once an entity has determined that the award should be included in the computation of diluted EPS for the reporting period, the entity must use the treasury stock method to determine the number of incremental shares to include in the denominator of diluted EPS.

Note that an entity may be recording compensation cost for an award that only contains a performance or market condition because the entity believes that it is probable that the award will vest (performance condition) or that the employee will remain employed for the derived service period (market condition). However, in such cases, the incremental shares that would be included in the denominator of the computation of diluted EPS would be excluded because the performance or market condition (i.e., the contingency) has not been achieved as of the end of that particular reporting period. See Q&A 6-16 for a discussion of the impact that share-based payment awards with a performance or market condition have on EPS.

**The Treasury Stock Method**

In applying the treasury stock method, an entity assumes two hypothetical transactions. The first is the hypothetical exercise of the award, and the second is the hypothetical repurchase of shares at the average market price during the period by using the assumed proceeds that will be generated from the hypothetical exercise of the award. The incremental shares that would be hypothetically issued are the number of shares assumed to be issued upon hypothetical exercise of the award in excess of the number of shares assumed to be hypothetically repurchased with the assumed proceeds. The incremental shares are included in the number of diluted potential common shares as a component of the denominator of diluted EPS.
Components of the Treasury Stock Method

While determining the number of shares assumed to be issued upon hypothetical exercise is straightforward, determining the amount of assumed proceeds that a share-based payment award will generate is more complex. An entity must aggregate the (1) exercise price of the award; (2) average amount of unrecognized compensation cost attributed to future service not yet recognized; and (3) amount of tax benefits, if any, that would be credited or debited to APIC provided that the award is exercised. See Q&A 6-13 for an example illustrating how assumed proceeds are computed when share-based payment awards are forfeited during the reporting period.

Proceeds Include Certain Hypothetical Tax Benefits

To compute the tax benefit component of assumed proceeds under the treasury stock method, an entity must determine all the hypothetical excess tax benefits that would be created, assuming hypothetical exercise of all in-the-money awards, as of the reporting date. An entity will also use those hypothetical excess tax benefits in constructing a hypothetical pool of excess tax benefits (i.e., hypothetical APIC pool) to determine whether a hypothetical tax benefit deficiency would reduce hypothetical APIC or would be charged to hypothetical income tax expense. The hypothetical APIC pool is developed by combining the actual APIC pool available for recognition purposes with the hypothetical excess tax benefits and tax benefit deficiencies that would be included in the hypothetical APIC pool (if it is assumed that all in-the-money awards will be exercised). (See Chapter 8 for a discussion of the APIC pool and Q&A 6-21 and Q&A 6-22 for a discussion of the tax benefit component of assumed proceeds.)

Note that when the amount of a tax benefit resulting from the hypothetical exercise of an award reduces APIC (i.e., a debit), that amount is treated as a reduction of assumed proceeds. For example, if the intrinsic value upon hypothetical exercise of the award (i.e., the tax deduction) is less than the compensation cost recognized for the award, the resulting tax benefit deficiency reduces the assumed proceeds to the extent that an entity has a sufficient hypothetical APIC pool to offset such a deficiency. If an entity does not have a sufficient APIC pool, the tax benefit would not hypothetically reduce APIC and would therefore not reduce assumed proceeds. The reduction in assumed proceeds results in fewer repurchased shares, which, when all other factors remain the same, increases the dilutive effect of the award (i.e., increases the number of incremental shares added to the denominator).

Period Outstanding

An entity must weight a share-based payment award for the time the award was outstanding during the reporting period. For an award that was outstanding for the entire reporting period, the incremental shares determined under the treasury stock method are included in the computation of EPS for the entire reporting period. In contrast, for an award that was issued, exercised (or, for a nonvested award, becomes vested), or forfeited during the reporting period, the incremental shares are only included for the period in which the award was outstanding. Once the award is exercised (or, for a nonvested award, becomes vested), the shares issued are considered outstanding common shares and are included in the weighted-average number of common shares (i.e., the denominator in the computation of basic and diluted EPS).

Quarter-to-Date Versus Year-to-Date Computations

In applying the treasury stock method to a quarterly period, an entity should use the average market price for the quarterly period to determine the number of incremental shares to include in the denominator of the computation of diluted EPS. That is, the entity computes the number of incremental shares for the quarter-to-date period as though the quarterly period is a discrete period. In contrast, for the year-to-date period, rather than using an average market price for the year-to-date period as though it was a separate discrete period, an entity computes a weighted-average number of incremental shares included in each of the quarterly periods for inclusion in the denominator of the computation of diluted EPS for the year-to-date period. See Example 1 in ASC 260-10-55-38 through 55-50 for an example illustrating the quarter-to-date and year-to-date EPS computations.

Statement of Operations

6-01 Presentation of Share-Based Compensation on the Face of the Statement of Operations

Question

Is it acceptable for SEC registrants to report share-based compensation expense as a separate line item on the face of the statement of operations?
Answer

No. The SEC staff discussed the presentation of share-based compensation expense at the 1999 and 2000 AICPA Conferences. The SEC staff noted that these noncash expenses should be classified in the same manner as other similar expenses and that the presentation should not be driven by the form of consideration paid. The amount of share-based compensation attributable to a line item (e.g., cost of sales, R&D, selling and administrative expenses) should be included in such line item on the face of the statement of operations and not separately presented in a single share-based compensation line item. The SEC staff also noted that the presentation of separate line items solely to emphasize that a particular expense did not involve a cash outlay is more effective in the statement of cash flows (and may be further highlighted in the financial statement footnotes and in MD&A) than on the face of the statement of operations.

The SEC staff reiterated its view in SAB Topic 14.F, which states, in part:

| Question: | How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements? |
| Interpreted 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. [Footnote omitted] |

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.

The SEC’s Current Accounting and Disclosure Issues in the Division of Corporation Finance publication (as updated November 30, 2006) also reiterated this view. Section I.B.2 states, in part:

Registrants should avoid presentations on the face of the financial statements that give the impression that the nature of the expense related to share-based compensation is different from cash compensation paid to the same employees (for example by creating one or more separate line items for share-based compensation or by adding a table totaling the amount of share-based compensation included in various line item[s]).

It is not appropriate to present a specific line item that excludes share-based compensation expense. The following is an example of an acceptable disclosure of share-based compensation expense included in a specific line item.

Example

| Revenue | $ 100 |
| Cost of sales (including noncash compensation expense of $10) | 40 |
| Gross profit | 60 |
| Selling expense (including noncash compensation of $5) | 20 |
| General and administrative expense (including noncash compensation expense of $5) | 25 |
| Total operating expenses | 45 |
| Income from operations | $ 15 |

Statement of Cash Flows

6-02  Presentation in the Statement of Cash Flows of Cash Received Upon Early Exercise of a Share-Based Payment Award

An early exercise refers to an employee’s ability to change his or her tax position by exercising a share-based payment award and receiving shares before the completion of the requisite service period (i.e., before the award is vested). The early exercise of an award results in the employee’s deemed ownership of the shares for U.S. federal income tax purposes, which in turn results in the commencement of the holding period (under the tax law), allowing any subsequent appreciation in the value of the shares received (and realized upon the sale of those shares) to be taxed at a capital gains rate rather than an ordinary income tax rate. See Q&A 2-23 for a more detailed discussion of an early exercised share-based payment award.
Question
How should an entity present the cash received upon early exercise of a share-based payment award in the statement of cash flows?

Answer
Under ASC 718, an early exercise of a share-based payment award is not considered substantive for accounting purposes (see ASC 718-10-55-31(a)). That is, the share is not considered “issued” because the employee is still required to perform the requisite service to earn the share. Although the share is not considered issued, the cash received from the early exercise represents proceeds from the issuance of an equity instrument and would still be classified as a financing activity. As a result, such cash would be recognized as a cash inflow for financing activities under ASC 230-10-45-14(a).

In addition, as defined in ASC 230-10-20, cash flows from operating activities are “generally the cash effects of transactions and other events that enter into the determination of net income.” A transaction in which cash is received from an employee who elects to early exercise an option is not the type of transaction that enters into the determination of net income.

6-03 Presentation in the Statement of Cash Flows of the Settlement of Equity-Classified Share-Based Payment Awards

Question
How does an entity present the settlement of an equity-classified share-based payment award in the statement of cash flows?

Answer
An entity bases presentation in the statement of cash flows on the amount paid to settle the award:

- **Amount paid to settle the award does not exceed the fair-value-based measure of the award on the settlement date** — In accordance with ASC 718-20-35-7, if the cash paid to repurchase the equity-classified award does not exceed the fair-value-based measure of the award on the repurchase date, the cash paid to repurchase the award is charged to equity. That is, repurchase of the equity-classified award is viewed as reacquisition of the entity’s equity instruments. Accordingly, the cash paid to reacquire the entity’s equity instruments is presented as a cash outflow for financing activities under ASC 230-10-45-15(a).

- **Amount paid to settle the award exceeds the fair-value-based measure of the award on the settlement date** — In accordance with ASC 718-20-35-7, if the cash paid to repurchase the equity-classified award exceeds the fair-value-based measure of the award on the repurchase date, the cash paid in excess of the fair-value-based measure of the award is viewed as compensation for additional employee services and is recognized as additional compensation cost.

Accordingly, if the equity-classified award is repurchased for an amount in excess of the fair-value-based measure, the portion of the cash paid to reacquire the entity’s equity instruments that equals the fair-value-based measure of the award is presented as a cash outflow for financing activities under ASC 230-10-45-15(a). The portion of the cash paid in excess of the fair-value-based measure, for additional employee services, is presented as a cash outflow for operating activities under ASC 230-10-45-17(b).

See Q&A 6-04 for a discussion of the presentation in the statement of cash flows of the settlement of liability-classified awards.

6-04 Presentation in the Statement of Cash Flows of the Settlement of Liability-Classified Share-Based Payment Awards

Question
How does an entity present the settlement of a liability-classified share-based payment award in the statement of cash flows?
Answer

In accordance with ASC 718-30, the grant-date fair-value-based measure and any subsequent changes in the fair-value-based measure of a liability-classified award through the date of settlement are recognized as compensation cost. Accordingly, the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities under ASC 230-10-45-17(b).

Note that an entity may enter into an agreement to repurchase (or offer to repurchase) an equity-classified award for cash. Depending on the facts and circumstances, the agreement to repurchase (or offer to repurchase) may be accounted for as either (1) a settlement of the equity-classified award or (2) a modification of the equity-classified award that changes the award’s classification from equity to liability, followed by a settlement of the new liability-classified award. See Q&A 4-37 for a discussion of distinguishing a cash settlement of an equity-classified award from a modification that changes an award’s classification from equity to liability.

- If the agreement to repurchase (or offer to repurchase) is considered a settlement of an equity-classified award — The cash paid to reacquire the entity’s equity instruments is presented as a cash outflow for financing activities. See Q&A 6-03 for a discussion of the presentation in the statement of cash flows of the settlement of equity-classified awards.

- If the agreement to repurchase (or offer to repurchase) is considered a modification of the equity-classified award that changes the award’s classification from equity to liability — The cash paid to settle the liability-classified award should be presented in the statement of cash flows in a manner similar to the conclusion above. That is, under ASC 230-10-45-17(b), the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities.

6-05 Presentation in the Statement of Cash Flows of the Income Tax Effects of Share-Based Payment Awards

Question

How are the income tax effects of share-based payment awards presented in the statement of cash flows?

Answer

Entities must present, in the statement of cash flows, the impact of the tax benefit of any realized excess tax deduction. (See Q&A 8-19 for a discussion of the realization of excess tax benefits.) This “excess tax benefit” is separate and apart from taxes paid and is reported as a component of cash inflows from financing activities. The excess tax benefit should be determined on a gross basis (i.e., as the sum of excess tax benefits on an award-by-award basis only, not netted with tax deficiencies). (See Q&A 6-06 for a discussion of including tax benefit deficiencies in the statement of cash flows.) Actual taxes paid (an operating cash outflow) are increased by the same amount, resulting in an operating cash flows total that shows taxes that an entity would have paid had it not been for the excess tax benefit.

Example

On January 1, 20X1, Entity A grants 1,000 “at-the-money” nonqualified employee share options, each with a grant-date fair-value-based measure of $10 and an exercise price of $30. Assume that A’s applicable tax rate is 40 percent. As a result, A will record a $4,000 tax benefit [(1,000 options × $10 grant-date fair-value-based measure) × 40 percent tax rate] and a related DTA, for financial reporting purposes, over the requisite service period of the options.

On December 31, 20X4, the employee exercises all 1,000 options. On the date of exercise, A’s common stock has a fair value of $42 per share. Under current U.S. income tax law, A will receive an income tax deduction on the basis of the difference between the fair value of the stock on the exercise date and the amount the employee pays to exercise the options ($12,000 = ($42 fair value of A’s common stock – $30 exercise price) × 1,000 options). As a result of the increase in A’s share price, A realizes a tax benefit of $4,800 ($12,000 income tax deduction × 40 percent tax rate) for income tax purposes. The $4,800 tax benefit exceeds the tax benefit recognized for financial reporting purposes by $800 (which is recorded directly to equity) and represents the excess tax benefit.

Also, assume that in the year of exercise, A has taxable income in the amount of $21,000 (before the impact of the $12,000 stock compensation deduction is taken into account) or $9,000 of taxable income after the stock compensation deduction. Entity A pays tax of $3,600 ($9,000 taxable income × 40 percent tax rate). Under ASC
230, the $3,600 of taxes paid is reflected as an operating cash outflow. However, in the absence of the excess tax benefit, A would have paid an additional $800 of taxes (($12,000 income tax deduction – $10,000 compensation cost) × 40 percent tax rate). The amount of taxes A would have paid in the absence of an excess tax benefit ($800) should be shown as an additional cash outflow from operations and a corresponding cash inflow from financing activities.

6-06 Presentation in the Statement of Cash Flows of Tax Benefit Deficiencies of Share-Based Payment Awards

**Question**
Do tax benefit deficiencies (tax shortfalls) reduce the amount of realized excess tax benefits presented as cash inflows from financing activities?

**Answer**
No. The amount presented as financing cash inflows related to excess tax benefits should be determined on a gross basis (i.e., the sum of excess tax benefits on an award-by-award basis only). Tax benefit deficiencies realized in the same period do not reduce the amount of cash inflows from financing activities in the statement of cash flows for that period. Paragraph B228 of Statement 123(R) states:

> The Board considered whether the cash flow statement should report an increase in operating cash flows and a decrease in financing cash flows in a reporting period in which there is a charge to paid-in capital as a result of the write-off of a deferred tax asset related to an award that did not result in deductible compensation cost. The Board decided not to require that presentation because it believes that the operating and financing sections of the cash flow statement should reflect only the effects of awards that generated tax savings from excess tax benefits. [Emphasis added]

Therefore, for the same period, the amount presented as a financing cash inflow and an operating cash outflow for realized excess tax benefits will differ from the increase in APIC as a result of the realization of excess tax benefits because the increase in APIC is recorded net of tax benefit deficiencies realized in the period.

**Example**
Assume that, in the same period:

- 100 stock options are exercised that result in the realization of a $100 excess tax benefit.
- Another 100 stock options are exercised that result in the realization of a $20 tax benefit deficiency.

In the statement of cash flows, the financing cash inflow and the operating cash outflow related to excess tax benefits would be $100. However, the increase in APIC for the same period would be $80.

6-07 Presentation in the Statement of Cash Flows of Remittances of Minimum Statutory Withholding on Share-Based Payment Awards

**Question**
How does an employer present the net settlement or repurchase of shares in the statement of cash flows to meet the minimum statutory tax withholding requirement?

**Answer**
Regardless of whether the employer meets the employee’s minimum statutory tax withholding requirement through either a net settlement feature or a repurchase of shares upon exercise of an employee share option (or vesting of a nonvested share), an entity must account for the withholding as two transactions in the statement of cash flows. That is, in substance, this transaction is (1) a gross issuance of shares and (2) a repurchase of the amount of shares needed to satisfy the employee’s minimum statutory tax withholding requirement. Therefore, the presentation in the statement of cash flows must also reflect the two transactions.

First, the gross issuance of shares is presented as a financing activity. For example, the cash received for an employee share option as payment for the exercise price of the award is classified as a financing cash inflow. In contrast, for a nonvested share award, because no cash is received from the employee, the gross issuance of shares is presented as a noncash financing activity.
In the second step, when an employee elects to have shares withheld in order to satisfy its minimum statutory withholding tax obligation, the employer is deemed to have repurchased a portion of the shares that were received by the employee in the first step. While the employee does not receive cash directly, the employer has in substance repurchased shares from the employee and remitted the cash consideration to the taxing authority on the employee’s behalf. Because the cash payment relates to a repurchase of stock, it is presented as a financing cash outflow.

In some circumstances, an exercise of the award may occur in one reporting period while the amount withheld for tax purposes may not be remitted to the taxing authority by an employer, on behalf of the employee, until a subsequent reporting period. In these circumstances, for the second step of the transaction, the financing cash outflow is reported in the period in which the cash is paid to the taxing authority. In the initial reporting period, the employer has issued the gross amount of shares and is deemed to have repurchased the requisite number of shares needed to satisfy the employee’s minimum statutory tax withholding requirement by issuing a note payable to the employee. The note payable issued for the repurchase amount is viewed as a noncash event having no impact on the statement of cash flows. In the subsequent reporting period, the employer remits the payment for the note payable; however, the employee requests that the amount be remitted to the taxing authority on the employee’s behalf instead of directly to the employee. This results in the financing cash outflow.

Example
An entity grants 1,000 nonvested shares to an employee. The plan allows the employer to net-settle the award to cover the minimum statutory tax withholding requirement. Upon vesting, the entity withholds 250 shares to cover the minimum statutory withholding requirement and issues the employee the remaining 750 shares. For cash flow purposes, the entity must account for this transaction as (1) the gross issuance of 1,000 shares and (2) the repurchase of 250 shares to satisfy the minimum statutory withholding requirement. Because no cash is received from the employee for the nonvested share award, the gross issuance of the 1,000 shares is classified as a noncash financing activity. The “repurchase,” through the net settlement feature, of the 250 shares to satisfy the minimum statutory withholding requirement is classified as a financing cash outflow. The contemporaneous “receipt of cash,” through the net settlement feature, from the employee and the remittance of cash by the entity to the taxing authority have no net impact on the statement of cash flows.

Earnings per Share

ASC 718-10

45-1 Topic 260 requires that employee equity share options, nonvested shares, and similar equity instruments granted to employees be treated as potential common shares in computing diluted earnings per share (EPS). Diluted EPS shall be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting in or the ability to exercise (or retain) an award is contingent on a performance or market condition, such as the level of future earnings, the shares or share options shall be treated as contingently issuable shares in accordance with paragraphs 260-10-45-48 through 45-57. If equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments are outstanding.

45-2 Paragraphs 260-10-45-29 through 45-34 and Example 8 (see paragraphs 260-10-55-68) provide guidance on applying the treasury stock method for equity instruments granted in share-based payment transactions in determining diluted EPS.

6-08 Application of the Treasury Stock Method to Share-Based Payment Awards — Example

ASC 260-10-45-28A through 45-29A describe the application of the treasury stock method to share-based payment awards in the computation of diluted EPS. ASC 260-10-45-29 states, in part:

In applying the treasury stock method described in paragraph 260-10-45-23, the assumed proceeds shall be the sum of all of the following:

a. The amount, if any, the employee must pay upon exercise.

b. The amount of compensation cost attributed to future services and not yet recognized. (This provision applies only to those share-based awards for which compensation cost will be recognized in the financial statements in accordance with Topic 718.)
c. The amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the options. . . . Paragraph 718-740-35-5 states that the amount deductible on an employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.

The following examples demonstrate the application of the treasury stock method to share-based payment awards in the computation of diluted EPS.

**Example 1**

Assume the following:

- Company A has net income of $5 million for the year ended December 31, 20X2.
- Company A has 1 million common shares outstanding for the entire year ended December 31, 20X2.
- As of December 31, 20X2, A has 100,000 employee share options outstanding. All the share options were granted on January 1, 20X1, and vest solely on the basis of a service condition. On December 31, 20X1, 50,000 share options vested. The remaining 50,000 share options vest on December 31, 20X2.
- All the share options have an exercise price of $10 per option and a grant-date fair value of $2 per option.
- Company A recognizes the compensation cost for these share options on a straight-line basis over the service period from January 1, 20X1, to December 31, 20X2.
- The average market price of A’s common stock for the year ended December 31, 20X2, was $15 per share.
- Company A’s applicable tax rate is 35 percent.
- For simplicity, the effect of forfeitures has been ignored.

The calculation of diluted EPS is as follows:

<table>
<thead>
<tr>
<th>Proceeds:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exercise price (100,000 options × $10 per option)</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>Average unrecognized compensation cost ([unrecognized compensation cost at beginning of year ($100,000) + unrecognized compensation cost at end of year ($0)] ÷ 2)</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Excess tax benefit ([$15 average market price – $10 exercise price) – $2 grant-date fair value] × 100,000 options) × 35% tax rate</td>
<td>$ 105,000</td>
</tr>
<tr>
<td>Total hypothetical proceeds</td>
<td>$ 1,155,000</td>
</tr>
<tr>
<td>Average market price</td>
<td>$ 15</td>
</tr>
<tr>
<td>Number of shares reacquired ($1,155,000 hypothetical proceeds ÷ $15 average market price)</td>
<td>77,000</td>
</tr>
<tr>
<td>Incremental number of shares issued (100,000 shares issued upon exercise – 77,000 shares reacquired)</td>
<td>23,000</td>
</tr>
<tr>
<td>Weighted-average number of common shares outstanding during the year — basic</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Shares included in diluted EPS computation</td>
<td>1,023,000</td>
</tr>
<tr>
<td>Net income available to common shareholders</td>
<td>$ 5,000,000</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>$ 4.89</td>
</tr>
</tbody>
</table>
Note that in the above computation of diluted EPS, it is assumed that A does not prepare interim financial statements. ASC 260-10-55-3 states, in part, “For year-to-date diluted EPS, the number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation.” For example, assume that when applying the treasury stock method, an entity determined that it must include 10,000 and 15,000 incremental shares in the denominator of diluted EPS for its first and second quarter, respectively. When computing the number of incremental shares to include in the denominator of diluted EPS for the year-to-date six-month period, the entity would weight the 10,000 and 15,000 incremental shares equally. Therefore, 12,500 incremental shares \[10,000 + 15,000 + 2\] are included in the denominator of diluted EPS for the year-to-date six-month period.

**Example 2**

The following example demonstrates the application of the treasury stock method to share-based payment awards when a portion of the awards was exercised during the period. Once the awards are exercised, the shares issued are considered outstanding common shares and are included in the weighted-average number of common shares (i.e., the denominator in the computation of basic EPS). ASC 718-10-45-1 states, in part:

If equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments are outstanding.

Assume the same facts as Example 1, except for the following:

- The 50,000 employee share options that vested on December 31, 20X1, were exercised on June 30, 20X2.

The calculation of diluted EPS is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted-average number of share options outstanding for the quarter ended</td>
<td>75,000 share options outstanding at the beginning of the year plus share</td>
<td>75,000</td>
</tr>
<tr>
<td>December 31, 20X2*</td>
<td>options outstanding at the end of the year divided by two equals the</td>
<td></td>
</tr>
<tr>
<td>Proceeds:</td>
<td>weighted-average number of share options outstanding × $10 per option</td>
<td></td>
</tr>
<tr>
<td>Exercise price</td>
<td></td>
<td>$750,000</td>
</tr>
<tr>
<td>Average unrecognized compensation cost:</td>
<td>[(Unrecognized compensation cost at beginning of year ($100,000) +</td>
<td>50,000</td>
</tr>
<tr>
<td>unrecognized compensation cost at end of year ($0)) ÷ 2</td>
<td>unrecognized compensation cost at end of year ($0)) ÷ 2)</td>
<td></td>
</tr>
<tr>
<td>Excess tax benefit:</td>
<td>([(Average market price per share – Exercise price – $2 grant-date fair</td>
<td>78,750</td>
</tr>
<tr>
<td></td>
<td>value) × 75,000 options) × 35% tax rate</td>
<td></td>
</tr>
<tr>
<td>Total hypothetical proceeds</td>
<td></td>
<td>$878,750</td>
</tr>
<tr>
<td>Average market price (year ended December 31, 20X2)</td>
<td></td>
<td>$15</td>
</tr>
<tr>
<td>Number of shares reacquired ($878,750 hypothetical proceeds ×</td>
<td></td>
<td>58,583</td>
</tr>
<tr>
<td>$15 average market price)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incremental number of shares issued (75,000 shares issued upon</td>
<td></td>
<td>16,417</td>
</tr>
<tr>
<td>exercise – 58,583 shares reacquired)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted-average number of common shares outstanding during the year –</td>
<td></td>
<td>1,025,000</td>
</tr>
<tr>
<td>basic [1 million shares outstanding at the beginning of the year + (50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>options exercised × 1/2 weighted for half a year]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares included in diluted EPS computation</td>
<td></td>
<td>1,041,417</td>
</tr>
<tr>
<td>Net income available to common shareholders</td>
<td></td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td></td>
<td>$4.80</td>
</tr>
</tbody>
</table>

* Share options outstanding at the beginning of the year (100,000) plus share options outstanding at the end of year (50,000) divided by two equals the weighted-average number of share options outstanding for the year ended December 31, 20X2. This weighting assumes that exercises occur ratably throughout the year.
Note that in the above computation of diluted EPS, it is assumed that A does not prepare interim financial statements. ASC 260-10-55-3 states, in part, “For year-to-date diluted EPS, the number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation.” For example, assume that when applying the treasury stock method, an entity determined that it must include 10,000 and 15,000 incremental shares in the denominator of diluted EPS for its first and second quarter, respectively. When computing the number of incremental shares to include in the denominator of diluted EPS for the year-to-date six-month period, the entity would weight the 10,000 and 15,000 incremental shares equally. Therefore, 12,500 incremental shares \((10,000 + 15,000) ÷ 2\) are included in the denominator of diluted EPS for the year-to-date six-month period.

6-09 Use of the Two-Class Method to Calculate Basic and Diluted Earnings per Share — Examples

Entities with a capital structure that includes common stock and either (1) participating securities or (2) common stock with a different dividend rate are required to use the two-class method in calculating basic and diluted EPS. See Q&A 6-10 for guidance on the definition of a participating security.

Question
Under the two-class method, how do entities calculate basic and diluted EPS?

Answer
Entities use the following three-step process to calculate basic and diluted EPS:

**Step 1** — Use the two-class method to compute basic EPS. As indicated in ASC 260-10-45-60, “[t]he two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders.” See Example 6 in ASC 260-10-55-62 for an illustration of the calculation of basic EPS using the two-class method.

**Step 2** — Use the total earnings allocated to the common stock in step 1 to determine diluted EPS. If the participating security is also a potential common share, separately perform steps 2a and 2b to determine the dilutive effect.

**Step 2a** — Assume that the participating security has been exercised, converted, or issued; that is, apply the treasury stock method, the if-converted method, or the contingently issuable share method.

**Step 2b** — Add back the undistributed earnings allocated to the participating security (or securities) in arriving at basic EPS, and assume that all other dilutive potential common shares have been exercised, converted, or issued in order of antidilution. Next, reallocate the undistributed earnings, including any additional income that would result from the exercise, conversion, or issuance of potential common shares, to the (1) common shares and potential common shares and (2) participating security (or securities).

**Step 3** — Determine which step — 2a or 2b — results in the more dilutive effect.

Examples 1–4 below illustrate (1) the calculation of basic and diluted EPS under the two-class method and (2) the use of this three-step process to determine diluted EPS.

**Example 1 — Participating Convertible Preferred Stock**
Assume that Entity A has 1 million weighted-average shares of common stock outstanding for the fiscal year ended December 31, 20X1; a current-period net income of $5 million; and an effective tax rate of 40 percent.

On January 1, 20X1, A issued 100,000 convertible preferred securities. Each preferred share is convertible into two shares of A’s common stock. The preferred shareholders are entitled to a noncumulative annual dividend of $5 per share before any dividend is paid to the common shareholders. After the common shareholders are paid a dividend of $2 per share, the preferred shareholders participate in any remaining undistributed earnings on a 40:60 per-share basis with the common shareholders. Accordingly, the preferred securities are participating securities for which A must use the two-class method in calculating basic and diluted EPS. In fiscal year 20X1, A declared and paid $2.5 million in dividends (or a $5 dividend for preferred shareholders and a $2 dividend for common shareholders).
Step 1 — Use the two-class method to determine basic EPS.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$ 5,000,000</td>
<td></td>
</tr>
<tr>
<td>Less dividends to preferred shareholders</td>
<td></td>
<td>500,000(^a)</td>
</tr>
<tr>
<td>Net income available to common shareholders</td>
<td>4,500,000</td>
<td></td>
</tr>
<tr>
<td>Less dividends to common shareholders</td>
<td></td>
<td>2,000,000(^a)</td>
</tr>
<tr>
<td>Undistributed 20X1 earnings</td>
<td>$ 2,500,000</td>
<td></td>
</tr>
</tbody>
</table>

\(^a\) The dividends would be based on the number of common stock and preferred stock outstanding as of the declaration date. For simplicity, the weighted average and the shares outstanding are assumed to be consistent.

Allocation of undistributed earnings:

To participating convertible preferred shares:

\[
\frac{(0.4 \times 100,000 \text{ preferred shares}^1) + (0.6 \times 1,000,000 \text{ common shares}^3)}{(0.4 \times 100,000 \text{ preferred shares}^2) + (0.6 \times 1,000,000 \text{ common shares}^3)} \times 2,500,000 \text{ undistributed earnings}^4 = 156,250
\]

\[156,250 \div 100,000 \text{ preferred shares}^5 = 1.56 \text{ per share}\]

To common shares:

\[
\frac{(0.6 \times 1,000,000 \text{ common shares}^6) + (0.4 \times 100,000 \text{ preferred shares}^7)}{(0.4 \times 100,000 \text{ preferred shares}^2) + (0.6 \times 1,000,000 \text{ common shares}^3)} \times 2,500,000 \text{ undistributed earnings}^9 = 2,343,750
\]

\[2,343,750 \div 1,000,000 \text{ common shares}^{10} = 2.34 \text{ per share}\]

Basic EPS amounts:

<table>
<thead>
<tr>
<th></th>
<th>Common Shares</th>
<th>Participating Convertible Preferred Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributed earnings</td>
<td>$ 2.00</td>
<td>$ 5.00</td>
</tr>
<tr>
<td>Undistributed earnings</td>
<td>2.34</td>
<td>1.56</td>
</tr>
<tr>
<td>Total</td>
<td>$ 4.34</td>
<td>$ 6.56</td>
</tr>
</tbody>
</table>

Step 2 — Determine diluted EPS.

Step 2a — Use the treasury stock method, the if-converted method, or the contingently issuable share method to determine diluted EPS.

Determine the antidilution sequencing:

Since there are no potential common shares other than the participating convertible preferred shares, antidilution sequencing is not required.

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\(^1\) Weighted-average number of participating convertible preferred shares outstanding.

\(^2\) See footnote 1.

\(^3\) Weighted-average number of common shares outstanding.

\(^4\) Total undistributed earnings for the period.

\(^5\) See footnote 1.

\(^6\) See footnote 3.

\(^7\) See footnote 1.

\(^8\) See footnote 3.

\(^9\) See footnote 4.

\(^10\) See footnote 3.
Calculation of diluted EPS for the common shares in which the use of the if-converted method for the participating convertible preferred shares is assumed:

<table>
<thead>
<tr>
<th></th>
<th>Distributed/ Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$ 4,343,750\textsuperscript{a}</td>
<td>1,000,000</td>
<td>$ 4.34</td>
</tr>
<tr>
<td>Convertible preferred</td>
<td>656,250\textsuperscript{b}</td>
<td>200,000\textsuperscript{c}</td>
<td>—</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>$ 5,000,000</td>
<td>1,200,000</td>
<td>$ 4.16</td>
</tr>
</tbody>
</table>

\textsuperscript{a} Amount represents the aggregate of the distributed ($2,000,000) and undistributed earnings ($2,343,750) allocated to the common shareholders.

\textsuperscript{b} Amount represents the aggregate of the distributed ($500,000) and undistributed earnings ($156,250) allocated to the participating convertible preferred shares.

\textsuperscript{c} Number of common shares that would be issued upon conversion of the participating convertible preferred shares.

**Step 2b — Use the two-class method to determine diluted EPS.**

Because A’s capital structure only includes common shares and participating convertible preferred shares (i.e., there are no other potential common shares), basic and diluted EPS under the two-class method would be the same ($4.34).

**Step 3 — Determine which step — 2a or 2b — results in the more dilutive effect.**

In this example, A would disclose an amount of diluted EPS per common share that would result from applying the if-converted method ($4.16) because that amount is more dilutive than the amount that would result from applying the two-class method ($4.34). In accordance with ASC 260-10-45-60, A would be permitted, but not required, to present basic and diluted EPS for the participating convertible preferred shares on the face of the income statement.

**Example 2 — Participating Convertible Preferred Stock With Convertible Debt and Warrants**

Assume all the same facts as in Example 1. In addition, assume the following:

- On January 1, 20X1, Entity A issued warrants to purchase 100,000 shares of its common stock at $50 per share for a period of five years. The average market price of A’s stock price for 20X1 was $60 per share.
- On January 1, 20X1, A issued 10,000 units of convertible bonds with an aggregate par value of $1 million. Each bond is convertible into 10 shares of A’s common stock and bears an interest rate of 3 percent.

**Step 1 — Use the two-class method to determine basic EPS.**

Entity A’s basic EPS would remain unchanged at $4.34 since the warrants and convertible debt would not affect the computation of basic EPS.
Step 2 — Determine diluted EPS.

Step 2a — Use the treasury stock method, the if-converted method, or the contingently issuable share method to determine diluted EPS.

Determine the antidilution sequencing:

<table>
<thead>
<tr>
<th></th>
<th>Increase in Earnings Available to Common Shareholders</th>
<th>Increase in Number of Common Shares</th>
<th>Earnings per Incremental Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warrants</td>
<td>$ —</td>
<td>16,667a</td>
<td>$ —</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>18,000b</td>
<td>100,000b</td>
<td>0.18</td>
</tr>
<tr>
<td>Participating convertible preferred shares</td>
<td>$ 656,250c</td>
<td>200,000d</td>
<td>$ 3.28</td>
</tr>
</tbody>
</table>

| Amount represents the incremental number of common shares for the assumed exercise of the warrants [($60 average market price – $50 exercise price) × 100,000 warrants] ÷ $60 average market price = 16,667. |
| Assumed conversion of the convertible bonds would result in 100,000 incremental common shares and the add-back of $18,000 [$1,000,000 × 3% interest rate × (1 – 40% tax rate)] in after-tax interest expense to undistributed earnings for the period. |
| Amount represents the aggregate of the distributed ($500,000) and undistributed earnings ($156,250) allocated to the participating convertible preferred shares. |
| Number of common shares that would be issued upon conversion of the participating convertible preferred shares. |

Calculation of diluted EPS for the common shares in which the use of the if-converted method for the participating convertible preferred shares is assumed:

<table>
<thead>
<tr>
<th></th>
<th>Distributed/ Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$ 4,343,750</td>
<td>1,000,000</td>
<td>$ 4.34</td>
</tr>
<tr>
<td>Warrants</td>
<td>$ 4,343,750</td>
<td>1,016,667</td>
<td>4.27</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>$ 4,361,750</td>
<td>1,116,667</td>
<td>$ 3.91</td>
</tr>
<tr>
<td>Participating convertible preferred shares</td>
<td>$ 656,250</td>
<td>200,000</td>
<td>3.81</td>
</tr>
</tbody>
</table>

| Amount represents the incremental number of common shares for the assumed exercise of the warrants [($60 average market price – $50 exercise price) × 100,000] ÷ $60 average market price = 16,667. |
| Assumed conversion of the convertible bonds would result in 100,000 incremental common shares and the add-back of $18,000 [$1,000,000 × 3% interest rate × (1 – 40% tax rate)] in after-tax interest expense to undistributed earnings for the period. |
| Amount represents the aggregate of the distributed ($500,000) and undistributed earnings ($156,250) allocated to the participating convertible preferred shares. |
| Number of common shares that would be issued upon conversion of the participating convertible preferred shares. |
Step 2b — Use the two-class method to determine diluted EPS.

<table>
<thead>
<tr>
<th>Distributed/ Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$4,343,750</td>
<td>$4.34</td>
</tr>
<tr>
<td>Add back: undistributed earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>allocated to the participating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>convertible preferred shares</td>
<td>156,250</td>
<td></td>
</tr>
<tr>
<td>Warrants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: undistributed earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>reallocated to participating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>convertible preferred shares</td>
<td>(153,846)</td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td>$4,346,154</td>
<td>$4.28</td>
</tr>
<tr>
<td>Add back: undistributed earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>allocated to the participating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>convertible preferred shares</td>
<td>153,846</td>
<td></td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>18,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Less: undistributed earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>reallocated to participating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>convertible preferred shares</td>
<td>(141,859)</td>
<td></td>
</tr>
<tr>
<td>Diluted EPS for common stock</td>
<td>$4,376,141</td>
<td>$3.92</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Amount represents the incremental number of common shares for the assumed exercise of the warrants [(60 average market price – $50 exercise price) × 100,000 warrants] ÷ $60 average market price = 16,667.</th>
</tr>
</thead>
<tbody>
<tr>
<td>b 0.4 × 100,000 preferred shares ÷ [(0.4 × 100,000 preferred shares) + (0.6 × (1,000,000 common shares + 16,667 incremental shares from warrants)]) × $2,500,000 undistributed earnings = $153,846.</td>
</tr>
<tr>
<td>c Assumed conversion of the convertible bonds would result in 100,000 incremental common shares and the add-back of $18,000 ($1,000,000 × 3% interest rate × (1 – 40% tax rate)) in after-tax interest expense to undistributed earnings for the period.</td>
</tr>
<tr>
<td>d 0.4 × 100,000 preferred shares ÷ [(0.4 × 100,000 preferred shares) + (0.6 × (1,000,000 common shares + 16,667 incremental shares from warrants + 100,000 incremental shares from the convertible bonds)]) × ($2,500,000 undistributed earnings + $18,000 interest add-back) = $141,859.</td>
</tr>
</tbody>
</table>

Step 3 — Determine which step — 2a or 2b — results in the more dilutive effect.

In this example, A would disclose an amount of diluted EPS per common share that would result from applying the if-converted method ($3.81) because that amount is more dilutive than the amount that would result from applying the two-class method ($3.92). In accordance with ASC 260-10-45-60, A would be permitted, but not required, to present basic and diluted EPS for the participating convertible preferred shares on the face of the income statement.

Example 3 — Participating Nonvested Share-Based Payment Awards

Assume that Entity A has 1 million weighted-average shares of common stock outstanding for the fiscal year ended December 31, 20X1; a current-period net income of $5 million; and an effective tax rate of 40 percent.

On January 1, 20X1, A issued 250,000 nonvested share-based payment awards to its employees. The nonvested shares had a grant-date fair-value-based measure of $50 per share and vest at the end of the fourth year of service (i.e., cliff vesting). The average market price of A’s stock price for 20X1 was $60 per share.
Holders of nonvested shares have a nonforfeitable right to receive cash dividends on a 1:1 per-share basis with the common shareholders. Accordingly, the nonvested shares are participating securities for which A must use the two-class method in calculating basic and diluted EPS. In fiscal year 20X1, A declared and paid $2.5 million in dividends for both the common shares and the nonvested shares.

**Step 1 — Use the two-class method to determine basic EPS.**

| Net income | $ 5,000,000 |
| Less dividends paid |  |
| Nonvested shareholders | 500,000 |
| Common shareholders | $ 2,000,000 | $ 2,500,000 |
| Undistributed 20X1 earnings | $ 2,500,000 |

**Allocation of undistributed earnings:**

To nonvested shares:

\[
\frac{250,000 \text{ nonvested shares}^{11} \div (250,000 \text{ nonvested shares}^{12} + 1,000,000 \text{ common shares}^{13})}{\text{undistributed earnings}^{14}} \times 2,500,000 = 500,000
\]

$500,000 ÷ 250,000 nonvested shares\(^{15}\) = $2.00 per share

To common shares:

\[
\frac{1,000,000 \text{ common shares}^{16} \div (250,000 \text{ nonvested shares}^{17} + 1,000,000 \text{ common shares}^{18})}{\text{undistributed earnings}^{19}} \times 2,500,000 = 2,000,000
\]

$2,000,000 ÷ 1,000,000 common shares\(^{20}\) = $2.00 per share

**Basic EPS amounts:**

<table>
<thead>
<tr>
<th></th>
<th>Common Shares</th>
<th>Participating Nonvested Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributed earnings</td>
<td>$ 2.00</td>
<td>$ 2.00</td>
</tr>
<tr>
<td>Undistributed earnings</td>
<td>2.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Total</td>
<td>$ 4.00</td>
<td>$ 4.00</td>
</tr>
</tbody>
</table>

**Step 2 — Determine diluted EPS.**

**Step 2a — Use the treasury stock method, the if-converted method, or the contingently issuable share method to determine diluted EPS.**

**Determine the antidilution sequencing:**

Because there are no potential common shares other than the participating nonvested shares, antidilution sequencing is not required.

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11 Weighted-average number of participating nonvested shares.
12 See footnote 11.
13 See footnote 3.
14 See footnote 4.
15 See footnote 11.
16 See footnote 3.
17 See footnote 11.
18 See footnote 3.
19 See footnote 4.
20 See footnote 3.
Calculation of diluted EPS for the common shares in which the use of the treasury stock method for the participating nonvested shares is assumed:

<table>
<thead>
<tr>
<th></th>
<th>Distributed/Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$4,000,000(^a)</td>
<td>1,000,000</td>
<td>$4.00</td>
</tr>
<tr>
<td>Participating nonvested shares</td>
<td>1,000,000(^b)</td>
<td>51,042(^c)</td>
<td>—</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>$5,000,000</td>
<td>1,051,042</td>
<td>$4.76</td>
</tr>
</tbody>
</table>

\(^a\) Amount represents the aggregate of the distributed earnings ($2,000,000) and undistributed earnings ($2,000,000) allocated to the common shareholders.

\(^b\) Amount represents the aggregate of the distributed earnings ($500,000) and undistributed earnings ($500,000) allocated to the participating nonvested shares.

\(^c\) Incremental number of shares for assumed conversion of nonvested shares:
- Exercise price = 0.
- Average unrecognized compensation cost = $10,937,500.
  - $12,500,000 – [(250,000 shares × $50) ÷ 4 years] = $9,375,000.
  - ($12,500,000 + $9,375,000) ÷ 2 = $10,937,500.
- Excess tax benefit of $1,000,000 = [($60 – $50) × 250,000 shares] × 40% tax rate.
- Assumed proceeds of $11,937,500 = $1,000,000 excess tax benefit + $10,937,500 average unrecognized compensation cost.
- Shares repurchased = 198,958 = $11,937,500 assumed proceeds ÷ $60 average share price.
- Incremental shares = 51,042 = 250,000 shares – 198,958 shares repurchased.

**Step 2b — Use the two-class method to determine diluted EPS.**

Because A’s capital structure only includes common shares and the participating nonvested shares (i.e., there are no other potential common shares), basic and diluted EPS under the two-class method would be the same ($4.00).

**Step 3 — Determine which step — 2a or 2b — results in the more dilutive effect.**

In this example, A would disclose an amount of diluted EPS per common share that would result from applying the two-class method ($4.00) because that amount is more dilutive than the amount that would result from applying the treasury stock method ($4.76). In accordance with ASC 260-10-45-60, A would be permitted, but not required, to present basic and diluted EPS for the participating nonvested shares on the face of the income statement.

**Example 4 — Participating Nonvested Share-Based Payment Awards With Convertible Debt and Warrants**

Assume all the same facts as in Example 3. In addition, assume the following:
- On January 1, 20X1, Entity A issued warrants to purchase 100,000 shares of its common stock at $40 per share for a period of five years.
- On January 1, 20X1, A issued 10,000 units of convertible bonds with an aggregate par value of $1 million. Each bond is convertible into 10 shares of A’s common stock and bears an interest rate of 3 percent.

**Step 1 — Use the two-class method to determine basic EPS.**

Entity A’s basic EPS would remain unchanged at $4.00 because the warrants and convertible debt would not affect the computation of basic EPS.
Step 2 — Determine diluted EPS.

Step 2a — Use the treasury stock method, the if-converted method, or the contingently issuable share method to determine diluted EPS.

Determine the antidilution sequencing:

<table>
<thead>
<tr>
<th></th>
<th>Increase in Earnings Available to Common Shareholders</th>
<th>Increase in Number of Common Shares</th>
<th>Earnings per Incremental Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warrants</td>
<td>$</td>
<td>33,333a</td>
<td>$ —</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>18,000b</td>
<td>100,000b</td>
<td>0.18</td>
</tr>
<tr>
<td>Participating nonvested shares</td>
<td>$ 1,000,000c</td>
<td>51,042d</td>
<td>$ 19.59</td>
</tr>
</tbody>
</table>

a Amount represents the incremental number of common shares for the assumed exercise of the warrants \( \frac{($60 \text{ average market price} - $40 \text{ exercise price}) \times 100,000 \text{ warrants}}{$60 \text{ average market price}} = 33,333 \).

b Assumed conversion of the convertible bonds would result in 100,000 incremental common shares and the add-back of $18,000 \( ($1,000,000 \times 3\% \text{ interest rate} \times (1 - 40\% \text{ tax rate}) \) in after-tax interest expense to undistributed earnings for the period.

c Amount represents the aggregate of the distributed earnings ($500,000) and undistributed earnings ($500,000) allocated to the participating nonvested shares.

d Incremental number of shares for assumed conversion of nonvested shares:
  - Exercise price = 0.
  - Average unrecognized compensation cost = $10,937,500.
    - $12,500,000 – [(250,000 shares × $50) ÷ 4 years] = $9,375,000.
    - $(12,500,000 + $9,375,000) ÷ 2 = $10,937,500.
  - Excess tax benefit of $1,000,000 = \( ($60 - $50) \times 250,000 \text{ shares} \) × 40\% tax rate.
  - Assumed proceeds of $11,937,500 = $1,000,000 excess tax benefit + $10,937,500 average unrecognized compensation cost.
  - Shares repurchased = 198,958 = $11,937,500 assumed proceeds ÷ $60 average share price.
  - Incremental shares = 51,042 = 250,000 shares – 198,958 shares repurchased.
Calculation of diluted EPS for the common shares in which the use of the treasury stock method for the participating nonvested shares is assumed:

<table>
<thead>
<tr>
<th></th>
<th>Distributed/Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$ 4,000,000</td>
<td>1,000,000</td>
<td>$ 4.00</td>
</tr>
<tr>
<td>Warrants</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,000,000</td>
<td>1,033,333</td>
<td>3.87</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>18,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,018,000</td>
<td>1,133,333</td>
<td>$ 3.55</td>
</tr>
<tr>
<td>Participating nonvested shares</td>
<td>1,000,000</td>
<td>51,042</td>
<td></td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>$ 5,018,000</td>
<td>1,184,375</td>
<td>$ 4.24</td>
</tr>
</tbody>
</table>

a Amount represents the incremental number of common shares for the assumed exercise of the warrants [($60 average market price – $40 exercise price) × 100,000 warrants] ÷ $60 average market price = 33,333.

b Assumed conversion of the convertible bonds would result in 100,000 incremental common shares and the add-back of $18,000 [$1,000,000 × 3% interest rate × (1 – 40% tax rate)] in after-tax interest expense to undistributed earnings for the period.

c Amount represents the aggregate of the distributed ($500,000) and undistributed earnings ($500,000) allocated to the participating nonvested shares.

d Incremental number of shares for assumed conversion of nonvested shares:
  • Exercise price = 0.
  • Average unrecognized compensation cost = $10,937,500.
    o $12,500,000 − [(250,000 shares × $50) ÷ 4 years] = $9,375,000.
    o ($12,500,000 + $9,375,000) ÷ 2 = $10,937,500.
  • Excess tax benefit of $1,000,000 = [($60 – $50) × 250,000 shares] × 40% tax rate.
  • Assumed proceeds of $11,937,500 = $1,000,000 excess tax benefit + $10,937,500 average unrecognized compensation cost.
  • Shares repurchased = 198,958 = $11,937,500 assumed proceeds ÷ $60 average share price.
  • Incremental shares = 51,042 = 250,000 shares – 198,958 shares repurchased.
Step 2b — Use the two-class method to determine diluted EPS.

<table>
<thead>
<tr>
<th>Distributed/Undistributed Earnings (Numerator)</th>
<th>Weighted-Average Number of Common Shares (Denominator)</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported, basic</td>
<td>$ 4,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Add back: undistributed earnings</td>
<td>allocated to the participating nonvested shares</td>
<td>500,000</td>
</tr>
<tr>
<td>Warrants</td>
<td>—</td>
<td>33,333</td>
</tr>
<tr>
<td>Less: undistributed earnings</td>
<td>reallocated to participating nonvested shares</td>
<td>(487,013)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$ 4,012,987</td>
<td>1,033,333</td>
</tr>
<tr>
<td>Add back: undistributed earnings</td>
<td>allocated to the participating convertible preferred shares</td>
<td>487,013</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>18,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Less: undistributed earnings</td>
<td>reallocated to participating convertible preferred shares</td>
<td>(455,060)</td>
</tr>
<tr>
<td>Diluted EPS for common stock</td>
<td>$ 4,062,940</td>
<td>1,133,333</td>
</tr>
</tbody>
</table>

a Amount represents the incremental number of common shares for the assumed exercise of the warrants [($60 average market price – $40 exercise price) × 100,000 warrants] ÷ $60 average market price = 33,333.
b $2,500,000 undistributed earnings = $487,013.
c $18,000 [$1,000,000 × 3% interest rate × (1 – 40% tax rate)] in after-tax interest expense to undistributed earnings for the period.
d $500,000 undistributed earnings + $18,000 interest add-back = $455,060.

Step 3 — Determine which step — 2a or 2b — results in the more dilutive effect.

In this example, A would use the two-class method to disclose diluted EPS per common share ($3.59) because that amount is more dilutive than the amount that would result from applying the if-converted method ($4.24). In accordance with ASC 260-10-45-60, A would be permitted, but not required, to present basic and diluted EPS for the participating nonvested shares on the face of the income statement.

6-10 Definition of a Participating Security

Question

What is a participating security?

Answer

Assuming that an instrument’s participation feature is nondiscretionary and objectively determinable, the instrument’s classification as a participating security requiring the use of the two-class method depends on the participation mechanism and the nature of the potentially participating instrument. The table below includes some commonly encountered instruments.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt and preferred stock, convertible and nonconvertible</td>
<td>Potential participation is paid in cash (or the contractual maturity amount is reduced) according to a formula tied to dividends.</td>
<td>Yes.</td>
<td></td>
</tr>
<tr>
<td>Convertible debt and preferred stock</td>
<td>Potential participation is achieved through a reduction of the conversion price, an increase in the conversion ratio, or an increase in the liquidation preference.</td>
<td>No.</td>
<td>May represent a beneficial conversion feature under ASC 470-20.</td>
</tr>
<tr>
<td>Options or warrants</td>
<td>Potential participation is paid in cash according to a formula tied to dividends.</td>
<td>Generally, yes. However, see Q&amp;A 6-11 for instruments granted to employees that have not vested.</td>
<td></td>
</tr>
<tr>
<td>Forward contract to issue a fixed number of shares at a fixed price</td>
<td>Potential participation is achieved through a reduction of the forward price or an increase in the number of shares under the forward contract. However, “fixed” adjustments to reflect anticipated dividends do not represent participation features.</td>
<td>It depends.</td>
<td>Also see variable share forward contracts below.</td>
</tr>
<tr>
<td>Variable share forward contracts (e.g., those issued as a component of a PRIDES or DECS offering)</td>
<td>A formula that adjusts the forward price and the number of shares under the forward contract, depending on the market price of the stock at the date the forward contract settles.</td>
<td>Requires a facts-and-circumstances analysis.</td>
<td></td>
</tr>
</tbody>
</table>

Participation does not necessarily need to be in the form of a dividend. Any participation in the undistributed earnings of a company would constitute participation by a security, regardless of whether a cash payment is, or would be accounted for as, a dividend.

**Example**

A company issues a warrant, exercisable for one share of common stock that entitles the holder to a yield right, payable in cash, equal to 25 percent of the dividends paid on common stock. Even though the yield right is not labeled a dividend, it is a participation right because the holder is entitled to share in dividends declared and has a participation right in undistributed earnings.
6-11 Impact of Dividend-Paying Share-Based Payment Awards on Earnings per Share

**Question**
How do dividend-paying share-based payment awards affect the computation of EPS?

**Answer**

**Dividend-Paying Share-Based Payment Awards Before the Completion of the Requisite Service Period**

ASC 260-10-45-61A concludes that all outstanding unvested awards “that contain nonforfeitable rights to dividends or dividend equivalents” are participating securities. That is, awards that accrue cash dividends (whether paid or unpaid) any time the common shareholders receive dividends — when those dividends do not need to be returned to the entity if the employee forfeits the award — are considered participating securities. Because the awards are considered participating securities, the entity issuing the awards is required to apply the two-class method discussed in ASC 260-10-45-59A through 45-60B when computing basic and diluted EPS.

**Dividend-Paying Share-Based Payment Awards After the Completion of the Requisite Service Period**

ASC 260-10-45-61 states:

> Fully vested stock-based compensation subject to the provisions of Topic 718, including fully vested options and fully vested stock, that contain a right to receive dividends declared on the common stock of the issuer, are subject to the guidance in paragraph 260-10-45-60A.

On the basis of this guidance, after the requisite service period of a share-based payment award (i.e., generally the vesting period), awards that contain a right to receive dividend distribution with common shareholders are participating securities. Therefore, an entity must apply the two-class method discussed in ASC 260-10-45-59A through 45-60B when computing basic and diluted EPS unless the shares become outstanding common shares. The two-class method does not apply to nonvested share awards after the employee receives outstanding common shares at the end of the requisite service period. That is, once the share awards become outstanding common shares, the entity includes those shares in the weighted-average number of common shares (i.e., the denominator in the computation of basic EPS). (See Q&A 6-17 for a more detailed discussion of the effect that nonvested share awards have on EPS.)

6-12 Impact of Share-Based Payment Awards That Cannot Be Settled in an Entity’s Shares on Earnings per Share

**Question**
Are share-based payment awards that are based on the price of an entity’s shares (e.g., cash-settled SARs and certain formula plans), but that cannot be settled in the entity’s shares (i.e., that must be settled entirely in cash and that therefore will be classified as share-based liabilities), included in the computation of basic or diluted EPS?

**Answer**

No. Share-based payment awards that **always must be settled** in cash are not included in the computation of basic or diluted EPS other than for the effect of the compensation cost recorded in net income.

6-13 Impact of Forfeitures on Diluted Earnings per Share

**Question**
How do forfeitures affect the computation of diluted EPS?
Answer

ASC 718 requires an entity to **estimate** the number of share-based payment awards that are expected to forfeit when determining the amount of compensation cost to recognize in its financial statements. For EPS purposes, that amount of compensation cost is incorporated into net income or income available to common shareholders (i.e., the numerator in the computation of EPS). In contrast, the denominator of diluted EPS is based on the **actual** number of awards outstanding (i.e., actual forfeitures) in a given reporting period, provided that the effect is dilutive. An outstanding award will have a dilutive effect when the average market price of the entity’s common stock during the period exceeds the exercise price of the award (i.e., the award is in-the-money). (See Q&A 6-20 for a more detailed discussion of out-of-the-money awards that could have a dilutive effect on the computation of diluted EPS.) Once an entity has determined the number of outstanding awards that will have a dilutive effect on the computation of diluted EPS, the entity then uses the treasury stock method to determine the number of incremental shares to include in the denominator of the computation of diluted EPS.

For example, an entity may estimate that only 90 percent of the share-based payment awards granted to its employees will eventually vest, although none have actually forfeited yet. Accordingly, only 90 percent of the awards’ grant-date fair value is recognized as compensation cost over the requisite service period. However, in the computation of the number of incremental shares to include in the denominator of the computation of diluted EPS, it is assumed that all outstanding dilutive awards will become exercisable. Therefore, when computing diluted EPS, the entity must (1) determine the number of all outstanding awards that are dilutive (i.e., in-the-money) and (2) apply the treasury stock method.

When the treasury stock method is applied, the hypothetical assumed proceeds are calculated on the basis of the actual number of outstanding dilutive awards regardless of whether certain of those awards are not expected to eventually vest. The amount of average unrecognized compensation cost is therefore based on the total number of outstanding dilutive awards at the beginning of the period and at the end of the period, not on 90 percent of the total grant-date fair value in the example above. Furthermore, the (1) exercise price and (2) excess or deficient tax benefits that would be recorded in APIC (if exercise of all outstanding dilutive awards is assumed) are based on the number of dilutive awards outstanding at the end of the reporting period.

**Example — Computing Assumed Proceeds Under the Treasury Stock Method When Share-Based Payment Awards Are Forfeited During the Reporting Period**

Assume the following:

- Company A has net income of $1 million for the quarter ended March 31, 20X1.
- Company A has 100,000 common shares outstanding for the entire period from January 1, 20X1, to March 31, 20X1.
- On January 1, 20X1, A granted 10,000 employee share options to 10 employees (1,000 share options each).
- All the share options have an exercise price of $5 per option and a grant-date fair value of $1 per option, and cliff vest after two years of service.
- The average market price of A’s common stock for the three-month period ended March 31, 20X1, was $6.50 per share.
- Company A’s applicable tax rate is 40 percent.
- Company A estimates that 8,000 of the share options will eventually vest and therefore has accrued compensation cost on the basis of this forfeiture estimate.21
- On February 1, 20X1, an employee terminates and forfeits his or her 1,000 share options.

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21 An entity must base the computation of diluted EPS on the actual number of awards outstanding (i.e., actual forfeitures) in a given reporting period rather than on an entity’s estimate of the number of awards expected to forfeit.
The number of incremental shares to include in the denominator of the computation of diluted EPS (for the three-month period ended March 31, 20X1) under the treasury stock method is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted-average number of share options outstanding for the quarter ended March 31, 20X1</td>
<td>9,333 share options outstanding</td>
<td>9,333</td>
</tr>
<tr>
<td>Proceeds:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercise price (9,333 weighted-average share options outstanding x $5 per option)</td>
<td>$46,665</td>
<td></td>
</tr>
<tr>
<td>Average unrecognized compensation cost:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrecognized compensation cost at beginning of period</td>
<td>(10,000 actual options outstanding x $1 grant-date fair value)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Unrecognized compensation cost at end of period</td>
<td>(9,000 actual options outstanding x $1 grant-date fair value x (21 months/24 months services to be rendered))</td>
<td>$7,875</td>
</tr>
<tr>
<td>Average unrecognized compensation cost</td>
<td>($10,000 unrecognized compensation cost at beginning of period + 7,875 unrecognized compensation cost at end of period) / 2</td>
<td>$8,938</td>
</tr>
<tr>
<td>Excess tax benefit</td>
<td>($6.50 average market price – $5.00 exercise price – $1 grant-date fair value) x 9,333 options x 40% tax rate</td>
<td>$1,867</td>
</tr>
<tr>
<td>Total hypothetical proceeds</td>
<td></td>
<td>$57,470</td>
</tr>
<tr>
<td>Average market price (January 1, 20X1, to March 31, 20X1)</td>
<td></td>
<td>$6.50</td>
</tr>
<tr>
<td>Number of shares reacquired</td>
<td>($57,470 hypothetical proceeds / $6.50 average market price)</td>
<td>8,842</td>
</tr>
<tr>
<td>Incremental number of shares issued</td>
<td>(9,333 shares issued upon exercise – 8,842 shares reacquired)</td>
<td>491</td>
</tr>
<tr>
<td>Weighted-average number of common shares outstanding during the year — basic</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Shares included in diluted EPS computation</td>
<td></td>
<td>100,491</td>
</tr>
<tr>
<td>Net income available to common shareholders</td>
<td></td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td></td>
<td>$9.95</td>
</tr>
</tbody>
</table>

* Share options outstanding for the month of January (10,000) plus share options outstanding for the month of February (9,000) plus share options outstanding for the month of March (9,000) divided by three equals the weighted-average number of share options outstanding for the quarter ended March 31, 20X1.

6-14 Impact of Redeemable Share-Based Payment Awards on Earnings per Share

SAB Topic 14.E requires that public entities consider the requirements of ASR 268 (FRR Section 211) and ASC 480-10-S99-3A for redeemable share-based payment awards. See Q&A 2-21 for a more detailed discussion of the recognition and measurement requirements for redeemable share-based payment awards.

**Question**

How do redeemable share-based payment awards that are classified in temporary equity affect the computation of EPS?

**Answer**

**Share-Based Payment Awards Redeemable at Fair Value**

Share-based payment awards redeemable at fair value are accounted for in the same manner as common shares redeemable at fair value. In ASC 480-10-S99-3A, the SEC staff clarified that increases or decreases in the carrying amount of common shares that are redeemable at fair value do not affect earnings available to common shareholders. That is, changes in the redemption amount do not affect earnings available to common shareholders (the numerator in the computation of basic EPS) if the redemption value of redeemable shares is based on the fair value of the shares.
When computing diluted EPS, an entity must apply the treasury stock method to determine the number of incremental shares to include in the denominator of the computation. See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.

**Share-Based Payment Awards Redeemable at an Amount Other Than Fair Value**

Share-based payment awards redeemable at an amount other than fair value are accounted for in the same manner as common shares redeemable at an amount other than fair value (e.g., fixed price). That is, increases or decreases in the carrying amount of the redeemable share-based payment award are reflected in EPS under the two-class method, as discussed in ASC 260-10-45-59A through 45-60B. The increase or decrease in the carrying amount of a redeemable share-based payment award is treated similarly to the reduction in income from continuing operations (or net income) from current-period distributions (ASC 260-10-45-60B(a)).

In computing diluted EPS, an entity must determine whether it is more dilutive to apply either (1) the treasury stock method or (2) the two-class method. See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.

**Share-Based Payment Awards Redeemable at Intrinsic Value**

ASC 480-10-S99-3A does not provide guidance on the EPS treatment of share-based payment awards with a redemption amount that is based on an award’s intrinsic value. In the absence of further SEC guidance, entities may make a policy decision to (1) analogize to ASC 480-10-S99-3A for common shares redeemable at fair value or (2) treat the increases or decreases in the carrying amount of these awards as an additive or subtractive amount in arriving at earnings available to common shareholders.

Under the first alternative, the increase or decrease in the carrying amount of the redeemable share-based payment award does not affect earnings available to common shareholders. That is, changes in the redemption amount will not affect earnings available to common shareholders (the numerator in the computation of basic EPS). In contrast, under the second alternative the increase or decrease in the carrying amount of the redeemable share-based payment award is treated similarly to the treatment of a preferential distribution. That is, the current-period change in the carrying amount of the redeemable share-based payment award is an additive or subtractive amount in arriving at earnings available to common shareholders (the numerator in the computation of basic EPS).

Regardless of whether an entity excludes the change in the carrying amount of a redeemable share-based payment award from earnings available to common shareholders or treats it as additive or subtractive amount in arriving at earnings available to common shareholders, in computing diluted EPS an entity must apply the treasury stock method to determine the number of incremental shares to include in the denominator of diluted EPS. See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.

**Contingently Redeemable Share-Based Payment Awards**

Share-based payment awards that are contingently redeemable at fair value or at an amount other than the fair value of the award (e.g., redeemable upon a change in control) do not affect earnings available to common shareholders (the numerator in the computation of basic EPS) until it is probable that the contingency will occur. That is, awards that are contingently redeemable are not remeasured to their redemption amount until it is deemed probable that the contingency will occur.

In computing diluted EPS, an entity must apply the treasury stock method to determine the number of incremental shares to include in the denominator of the computation of diluted EPS. See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.

**Impact on EPS Calculation of Share-Based Payment Awards That Can Be Settled in Cash or Shares**

**Question**

How do share-based payment awards that can be settled in cash or shares affect the computation of basic and diluted EPS?


**Answer**

A share-based payment award that can be settled in cash or shares is evaluated under ASC 260-10-45-45 through 45-47. ASC 260-10-45-30 states, in part:

> If stock-based compensation arrangements are payable in common stock or in cash at the election of either the entity or the employee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 260-10-45-45.

In accordance with ASC 260-10-45-45 through 45-47, a share-based payment award that may be settled in cash or shares at the election of either the entity or the holder must be based on the facts available each period. In addition, it must be presumed that the share-based payment award will be settled in shares. If settlement is presumed to be in shares, the entity must include the incremental number of shares that result from applying the treasury stock method in the denominator of the computation of diluted EPS provided that the result will be dilutive. (See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.)

The presumption of share settlement may be overcome if it is reasonable to assume, on the basis of an entity’s past practice or stated policy, that the award will be settled partially or wholly in cash. If an entity is able to overcome the presumption of share settlement, the substantive terms of the award must suggest that the entity will cash-settle the award. Therefore, the entity will be **required** to classify the award as a share-based liability pursuant to ASC 718-10-25-15.

**6-16 Impact of Share-Based Payment Awards With Performance or Market Conditions on Earnings per Share**

**Question**

How do share-based payment awards with performance and market conditions affect the computation of basic and diluted EPS?

**Answer**

Performance and market conditions of a share-based payment award are considered contingencies under ASC 260. Therefore, for share-based payment awards with a performance or market condition, entities must first use the guidance on contingently issuable shares in ASC 260-10-45-48 through 45-54 to determine whether the awards should be included in the computation of diluted EPS for the reporting period. That is, for all outstanding performance- and market-based awards, an entity needs to determine the number of shares, if any, that would be issuable at the end of the reporting period if the end of the reporting period were the end of the contingency period (e.g., the number of shares that would be issued on the basis of current-period earnings or period-end market price).

ASC 260-10-45-55 through 45-57 indicate that once an entity has determined that the award should be included in the computation of diluted EPS for the reporting period, the entity must then use the treasury stock method (as described in ASC 260-10-45-28A through 45-29A) to determine the number of incremental shares to include in the denominator of diluted EPS. (See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to share-based payment awards.)

**Performance-Based Awards**

Assume that an award legally vests only if the entity’s cumulative net income at the end of the third annual reporting period exceeds $10 million. At the end of each reporting period, the entity would assess whether cumulative net income has exceeded $10 million as if that reporting date were the end of the third annual reporting period. If the performance condition has been met at the end of a reporting period, the entity includes the awards in the computation of diluted EPS. To determine the number of incremental shares to include in the denominator of diluted EPS, the entity applies the treasury stock method, assuming that the result will be dilutive.

Note that an entity may be recording compensation cost for an award that only contains a performance condition because the entity believes it is probable that the award will vest (i.e., it is probable that the performance target will be achieved). (See Q&A 3-18 for a more detailed discussion of the measurement and recognition requirements of an award with only a performance condition.) However, the incremental shares that would be included in the denominator of the computation of diluted EPS are excluded because the performance condition (i.e., the contingency) has not been achieved as of the end of that particular reporting period.
Market-Based Awards
Assume that an award legally vests only if the entity’s share price increases by more than 20 percent after the grant date. At the end of each reporting period, the entity would assess whether the entity’s share price has, in fact, increased by more than 20 percent after the grant date. If the market condition has been met at the end of a reporting period, the entity includes the awards in the computation of diluted EPS. To determine the number of incremental shares to include in the denominator of the computation of diluted EPS, the entity applies the treasury stock method, assuming that the result will be dilutive.

Note that an entity may be recording compensation cost for an award that only contains a market condition because the entity believes the employee will remain employed for the derived service period. (See Q&A 3-20 for a more detailed discussion of the measurement and recognition requirements of an award with only a market condition and Q&A 4-03 for a more detailed discussion of a derived service period.) However, the incremental shares that would be included in the denominator of the computation of diluted EPS are excluded because the market condition (i.e., the contingency) has not been achieved as of the end of that particular reporting period.

Moreover, if an employee does remain employed for the derived service period, the employee is deemed to have earned (i.e., vested in) the award. In this circumstance, the entity will not reverse any previously recognized compensation cost even if the market condition is never satisfied. If the market condition is never satisfied, then the shares issuable pursuant to the award will never become issued and outstanding. Therefore, the shares will never be included in the weighted-average number of common shares (i.e., the denominator in the computation of basic EPS).

Example — Performance-Based Awards
Assume the following:

- Company A has net income of $12 million for the year ended December 31, 20X1.
- Company A has 5 million common shares outstanding for the entire year ended December 31, 20X1.
- On January 1, 20X1, A granted 1 million employee share options. The share options vest on December 31, 20X2 (as long as the employees remain employed at A), if the cumulative net income of A for the two-year period ended December 31, 20X2, equals or exceeds $10 million.
- As of December 31, 20X1, all the share options remain outstanding and A asserts that it is probable that the cumulative performance target will be attained.
- All the share options have an exercise price of $10 per option and a grant-date fair value of $2 per option.
- The average market price of A’s common stock for the year ended December 31, 20X1, was $15 per share.
- Company A’s applicable tax rate is 35 percent.
- For simplicity, the effect of forfeitures has been ignored.

In this example, assuming that the end of the reporting period is the end of the contingency period, the performance target is deemed to be met. As a result, A includes the employee share options described above in the computation of diluted EPS. To determine the number of incremental shares to include in the denominator of the computation of diluted EPS, A must then apply the treasury stock method, assuming that the result will be dilutive.
The treasury stock method is used to calculate diluted EPS as follows:

<table>
<thead>
<tr>
<th>Shares to be issued upon exercise of employee share options outstanding as of December 31, 20X1</th>
<th>1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds:</td>
<td></td>
</tr>
<tr>
<td>Exercise price (1,000,000 options × $10 per option)</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Average unrecognized compensation cost: ((\text{unrecognized compensation cost at beginning of year ($2,000,000)} + \text{unrecognized compensation cost at end of year ($1,000,000)}) ÷ 2)</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Excess tax benefit (\left(\left[(\text{average market price} – \text{exercise price}) – \text{grant-date fair value}\right] × 1,000,000 \text{ options}\right) × 35% \text{ tax rate})</td>
<td>$1,050,000</td>
</tr>
<tr>
<td>Total hypothetical proceeds</td>
<td>$12,550,000</td>
</tr>
<tr>
<td>Average market price</td>
<td>$15</td>
</tr>
<tr>
<td>Number of shares reacquired ($12,550,000 hypothetical proceeds ÷ $15 average market price)</td>
<td>836,667</td>
</tr>
<tr>
<td>Incremental number of shares issued (1,000,000 shares issued upon exercise – 836,667 shares reacquired)</td>
<td>163,333</td>
</tr>
<tr>
<td>Weighted-average number of common shares outstanding during the year — basic</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Shares included in diluted EPS computation</td>
<td>5,163,333</td>
</tr>
<tr>
<td>Net income available to common shareholders</td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>$2.32</td>
</tr>
</tbody>
</table>

* If the intrinsic value upon hypothetical exercise is less than the grant-date fair value, the resultant tax deficiency would reduce the hypothetical proceeds to the extent that an APIC pool exists to offset such a deficiency.

Alternatively, assume that A had generated net income of less than $10 million for the year ended December 31, 20X1. In that case, the employee share options are excluded from the computation of diluted EPS because the contingency is not deemed to have been met as of the end of the reporting period. Therefore, A is not required to determine the number of incremental shares to include in the denominator of the computation of diluted EPS under the treasury stock method. However, as long as A continues to believe it is probable that the performance target will be attained by the end of the contingency period (December 31, 20X2), A continues to recognize compensation cost over the requisite service period for the number of awards expected to vest.

### 6-17 Impact of Nonvested Shares on Earnings per Share

**Question**

How do nonvested shares that vest solely on the basis of a service condition affect the computation of basic and diluted EPS?

**Answer**

**Basic EPS**

Nonvested shares that vest solely on the basis of a service condition are not included in the denominator of the computation of basic EPS during their requisite service period, even if the shares have been legally issued. Such shares are considered contingently returnable shares as described in ASC 260-10-45-13. That is, if the employee does not render the requisite service, the shares are returned to the entity. Once the requisite service period is complete, the shares are considered outstanding common shares and therefore are included in the weighted-average number of common shares (i.e., the denominator in the computation of basic EPS).
However, ASC 260-10-45-61A concludes that before the completion of a nonvested share’s requisite service period (i.e., generally during the vesting period), all outstanding nonvested shares that contain rights to nonforfeitable dividends or dividend equivalents that participate in undistributed earnings with common stock are participating securities. That is, nonvested shares that accrue cash dividends (whether paid or unpaid) any time the common shareholders receive dividends — when those dividends do not need to be returned to the entity if the employee forfeits the nonvested shares — are considered participating securities. Because the nonvested shares are considered participating securities, the entity issuing the nonvested shares is required to apply the two-class method discussed in ASC 260-10-45-59A through 45-60B when computing basic and diluted EPS.

**Diluted EPS**

Nonvested shares that vest solely on the basis of a service condition are included in the denominator of the computation of diluted EPS during their requisite service period under the treasury stock method, in accordance with the guidance on share-based payment arrangements in ASC 260-10-45-28 through 45-29A. (See Q&A 6-08 for a detailed example of the application of the treasury stock method to share-based payment awards.) Because there is no exercise price for nonvested share awards, in applying the treasury stock method, an entity includes in the assumed proceeds only (1) the average amount of unrecognized compensation cost attributed to future service not yet recognized and (2) the amount of excess tax benefits, if any, that would be credited to APIC if the award is exercised.23

When computing diluted EPS for nonvested shares that are considered participating securities, an entity must determine whether it is more dilutive to apply (1) the treasury stock method or (2) the two-class method.

### 6-18 Impact of Share-Based Payment Awards of a Consolidated Subsidiary on Earnings per Share

**Question**

How do share-based payment awards of a subsidiary affect the computation of consolidated diluted EPS?

**Answer**

**Share-Based Payment Awards Issued by a Consolidated Subsidiary and Settled in the Subsidiary’s Common Shares**

Share-based payment awards issued by a consolidated subsidiary that are settled by issuing the subsidiary’s common shares affect not only the subsidiary’s computation of diluted EPS (if the subsidiary is a public entity24) but also the computation of the parent’s diluted EPS, as described in ASC 260-10-55-20 through 55-22 and illustrated in Example 7 in ASC 260-10-55-64 through 55-67.

While such awards do not affect the weighted-average number of common shares (i.e., the denominator in the computation of basic EPS of either the subsidiary or the parent), the compensation cost associated with these awards (during the requisite service period) will affect the net income or loss of both the subsidiary and the parent.

To calculate the parent’s diluted EPS, the subsidiary must first calculate its own diluted EPS (regardless of whether the subsidiary is a public entity). The subsidiary’s diluted EPS amount is then multiplied by the number of the subsidiary’s shares that the parent is assumed to own (after the hypothetical exercise of the awards is taken into consideration). The product of those two amounts is then included in the numerator (as a substitute for the parent’s proportionate share of the subsidiary’s earnings) of the calculation of the parent’s diluted EPS.

As noted in ASC 260-10-55-21, the guidance in ASC 260-10-55-20 also applies to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

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23 When the amount of tax benefit resulting from the hypothetical exercise of the award reduces APIC, that amount is treated as a reduction of assumed proceeds. For example, if the intrinsic value upon hypothetical exercise of the award (i.e., the tax deduction) is less than the grant-date fair value of the award, the resultant tax deficiency reduces the assumed proceeds to the extent that an entity has a sufficient hypothetical APIC pool to offset such a deficiency.

24 Pursuant to ASC 260-10-15-2 and 15-3, an entity that does not have common stock or potential common stock that trades in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market is not required to present EPS. An entity that is permitted, but not required, to present EPS must comply with the requirements of ASC 260.
Share-Based Payment Awards Issued by a Subsidiary but Settled in the Parent’s Common Shares

Share-based payment awards issued by a consolidated subsidiary that are settled by issuing the parent’s common shares will not affect the subsidiary’s denominator in the computation of diluted EPS (if the subsidiary is a public entity25) because the awards do not represent potential common shares of the subsidiary. However, during the requisite service period of the award, the compensation cost associated with the awards will affect the net income or loss of the subsidiary. (See Q&A 1-08 for a more detailed discussion of the accounting for share-based payment awards issued by a subsidiary but settled in the parent’s common shares.)

In contrast, for the parent, the share-based payment awards do represent a potential common share in the computation of diluted EPS. Therefore, the awards are included in the parent’s denominator in the computation of diluted EPS under the treasury stock method. (See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to a share-based payment award.) Because the subsidiary is recording compensation cost for these awards during the requisite service period in its financial statements, the parent’s proportionate share of the compensation cost will have been included in the net income or loss of the parent.

Example — Share-Based Payment Awards Issued by a Consolidated Subsidiary and Settled in the Subsidiary’s Common Shares

For the parent entity, assume that:

- Its net income is $100, excluding any net income or loss of Subsidiary A (i.e., as if A is unconsolidated).
- Throughout the period, 100 shares of its common stock were outstanding. No other securities have been issued.
- It owns 90 common shares (out of 100 outstanding) of A.

For A, assume that:

- Its net income is $100 (after intercompany eliminations, etc.).
- Throughout the period, 100 shares of its common stock were outstanding.
- At the beginning of the period, it granted 10 fully vested ISOs to its employees to purchase 10 shares of its common stock at $1 per share.
- The average market price of its common stock during the period is $2 per share.
- For simplicity, the effect of forfeitures has been ignored.

The calculation of A’s diluted EPS is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average number of shares of A’s common stock outstanding</td>
<td>100.00</td>
</tr>
<tr>
<td>Incremental number of shares from ISOs from applying the treasury stock method (assumed proceeds of $10) ÷ (average market price of $2)</td>
<td>5.00</td>
</tr>
<tr>
<td>Weighted-average number of shares — diluted</td>
<td>105.00</td>
</tr>
<tr>
<td>Subsidiary A’s net income</td>
<td>$ 100.00</td>
</tr>
<tr>
<td>Diluted EPS — A ($100 net income ÷ 105 shares)</td>
<td>$ 0.95</td>
</tr>
</tbody>
</table>

* As noted in the assumptions above, the employee share options are ISOs. Therefore, no tax effect would be included for these options in the assumed proceeds of the treasury stock computation unless the options were disqualified for income tax purposes. (See Q&A 6-08 for a more detailed illustration of the application of the treasury stock method to a share-based payment award.)

25 See footnote 24.
The calculation of consolidated diluted EPS is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent entity’s net income (unconsolidated)</td>
<td>$100.00</td>
</tr>
<tr>
<td>Parent entity’s proportionate interest in A’s earnings attributable to common stock (100 A shares outstanding × $0.95 A’s diluted EPS × (90 A shares owned ÷ 100 A shares outstanding))</td>
<td>85.50</td>
</tr>
<tr>
<td>Parent entity’s income available to common shareholders (excluding income attributable to the noncontrolling interest)</td>
<td>$185.50</td>
</tr>
<tr>
<td>Weighted-average number of shares — diluted (100 parent entity shares)</td>
<td>100.00</td>
</tr>
<tr>
<td>Consolidated diluted EPS ($185.50 of parent entity’s income available to common shareholders ÷ 100 shares)</td>
<td>$1.86</td>
</tr>
</tbody>
</table>

6-19 Inclusion of “Out-of-the-Money” Share-Based Payment Awards Under the Treasury Stock Method

ASC 260-10-45-28A requires an entity to apply the treasury stock method when calculating the number of incremental shares to include in the denominator of the computation of diluted EPS for share-based payment awards, provided that the result will be dilutive.

**Question**

When calculating the number of incremental shares to include in the denominator of the computation of diluted EPS pursuant to the treasury stock method, should an entity include “out-of-the-money” share-based payment awards (i.e., awards whose exercise price exceeds the average market price of the entity’s common stock for the reporting period)?

**Answer**

No. The treasury stock method only applies to “in-the-money” awards on an award-by-award basis. That is, an entity must perform a separate treasury stock method computation for each individual in-the-money award. However, the same treasury stock method computation is used for awards that are granted to employees on the same day with the same terms and conditions (i.e., the awards will presumably have the same grant-date fair value). Out-of-the-money awards are excluded from the treasury stock method computation because their effect would be antidilutive. ASC 260-10-45-25 states, in part:

> Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). [Emphasis added]

See Q&A 6-20 for a more detailed discussion of out-of-the-money awards that may have had a dilutive effect on the computation of diluted EPS even though they are out-of-the-money because of the tax benefit component of assumed proceeds.

**Example**

An entity is using the treasury stock method for its employee share options to calculate the number of incremental shares to include in the denominator of the computation of diluted EPS for the year ended December 31, 20X3. The average market price of the entity’s common stock for the year ended December 31, 20X3, was $20. The following employee stock options are outstanding as of December 31, 20X3:

<table>
<thead>
<tr>
<th>Grant Date</th>
<th>Options</th>
<th>Exercise Price</th>
<th>Average Unrecognized Compensation Cost</th>
<th>Excess Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>200</td>
<td>$10</td>
<td>$400</td>
<td>$400</td>
</tr>
<tr>
<td>March 15, 20X1</td>
<td>100</td>
<td>17</td>
<td>700</td>
<td>0</td>
</tr>
<tr>
<td>November 15, 20X1</td>
<td>300</td>
<td>25</td>
<td>800</td>
<td>0</td>
</tr>
<tr>
<td>March 15, 20X2</td>
<td>200</td>
<td>30</td>
<td>900</td>
<td>0</td>
</tr>
</tbody>
</table>
When calculating the number of incremental shares to include in the denominator of the computation of diluted EPS for the year ended December 31, 20X3, the entity only applies the treasury stock method to the January 1, 20X1, and March 15, 20X1, grants because they are in-the-money.

6-20 Inclusion of “Out-of-the-Money” Share-Based Payment Awards With a Dilutive Effect Under the Treasury Stock Method Because of Tax Benefit Deficiencies

**Question**

When calculating the number of incremental shares to include in the denominator of the computation of diluted EPS pursuant to the treasury stock method, should an entity include “out-of-the-money” share-based payment awards if the hypothetical tax benefit deficiency causes such an award to be dilutive?

**Answer**

No. When determining whether to include share-based payment awards in the computation of diluted EPS under the treasury stock method, an entity must first determine whether the award is “in the money.” ASC 260-10-45-25 states, in part:

> Options and warrants will have a dilutive effect under the treasury stock method **only when** the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). [Emphasis added]

That is, the treasury stock method is only intended to capture awards that a holder economically would exercise on the basis of a comparison of the stated exercise price of the award with the average market price of the entity’s common stock for the reporting period. If an award is in the money, only then would an entity use the treasury stock method to determine the number of incremental shares to include in the denominator of the computation of diluted EPS for the reporting period. Therefore, out-of-the-money awards are not included in the treasury stock calculation regardless of whether the tax benefit deficiency causes the award to have a dilutive effect when the treasury stock method is applied.

**Example**

This example demonstrates how a hypothetical tax benefit deficiency that will be created upon the assumed exercise of a share-based payment award could cause an out-of-the-money award to have a dilutive effect on diluted EPS when the treasury stock method is applied. However, as stated above, application of the treasury stock method would not be required for this award, since the award is out-of-the-money.

Assume the following:

- On January 1, 20X1, an entity granted 1,000 employee share options.
- The entity has no other outstanding share-based payment awards.
- The options have an exercise price of $21 and a grant-date fair-value-based measure of $10, and cliff vest after four years of service.
- The average market price of the entity’s common stock for the year ended December 31, 20X4, was $20 per share.
- The entity’s applicable tax rate is 40 percent.
- The entity has $5,000 of excess tax benefits in its APIC pool.
- For simplicity, the effect of forfeitures has been ignored.
The number of incremental shares that would have been included (but that are excluded because the award is out-of-the-money) in the denominator of the computation of diluted EPS (for the year ended December 31, 20X4) under the treasury stock method is calculated as follows:

<table>
<thead>
<tr>
<th>Shares to be issued upon exercise of employee share options outstanding as of December 31, 20X4</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds:</td>
<td></td>
</tr>
<tr>
<td>Exercise price (1,000 options × $21 per option)</td>
<td>$21,000</td>
</tr>
<tr>
<td>Average unrecognized compensation cost:</td>
<td></td>
</tr>
<tr>
<td>{[(unrecognized compensation cost at beginning of year ($2,500) + unrecognized compensation cost at end of year ($0)) ÷ 2]}</td>
<td>1,250</td>
</tr>
<tr>
<td>Excess tax benefit (tax benefit deficiency) {[$(20 \text{ average market price} – $21 \text{ exercise price}) – $10 \text{ grant-date fair value}] × 1,000 options} × 40% \text{ tax rate}</td>
<td>(4,400)</td>
</tr>
<tr>
<td>Total hypothetical proceeds</td>
<td>$17,850</td>
</tr>
<tr>
<td>Average market price</td>
<td>$20</td>
</tr>
<tr>
<td>Number of shares reacquired {$17,850 \text{ hypothetical proceeds} ÷ $20 \text{ average market price}}</td>
<td>892.50</td>
</tr>
<tr>
<td>Incremental number of shares that would be issued but excluded from diluted EPS (1,000 shares issued upon exercise – 892.5 shares reacquired)</td>
<td>107.50</td>
</tr>
</tbody>
</table>

6-21 Tax Benefit Component of Assumed Proceeds

ASC 260-10-45-29 indicates that excess tax benefits, and sometimes tax benefit deficiencies, of share-based payment awards are included in the computation of assumed proceeds under the treasury stock method. ASC 260-10-45-29 states, in part:

The excess tax benefit is the amount resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes. . . . Paragraph 718-740-35-5 states that the amount deductible on an employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.

Question

How should an entity compute the tax benefit component of assumed proceeds under the treasury stock method?

Answer

As mentioned in ASC 260-10-45-29, there are two aspects of the tax benefit component of assumed proceeds under the treasury stock method — hypothetical excess tax benefits and tax benefit deficiencies.

Hypothetical Excess Tax Benefits

An entity determines the amount of hypothetical excess tax benefits for all outstanding “in-the-money” awards on the basis of the intrinsic value of the award as of the reporting date for an unvested share award, by comparing the average market price of the entity’s common stock for the reporting period (i.e., the hypothetical tax deduction of the award if vesting of the award is assumed) with its grant-date fair-value-based measure. For an award whose intrinsic value is greater than its grant-date fair-value-based measure (i.e., a hypothetical excess tax benefit), the entity includes the tax effect of that difference as an additive item in the tax benefit component of assumed proceeds.
Hypothetical Tax Benefit Deficiencies

In contrast, for an award whose intrinsic value is less than its grant-date fair-value-based measure (i.e., a hypothetical tax benefit deficiency), the entity potentially includes the tax effect of that difference as a subtractive item in the tax benefit component of assumed proceeds. As indicated in ASC 260-10-45-29, hypothetical tax benefit deficiencies are subtractive items in the tax benefit component of assumed proceeds only to the extent that they are deducted from APIC. When determining the outstanding in-the-money awards that would be deducted from APIC, assuming exercise of the awards, an entity must first determine whether its APIC pool available for recognition purposes is sufficient to offset the hypothetical tax benefit deficiencies. If the APIC pool available for recognition purposes is sufficient to offset the hypothetical tax benefit deficiencies, the tax effect of the hypothetical tax benefit deficiencies is included as a subtractive item in the tax benefit component of assumed proceeds.

If the APIC pool available for recognition purposes is not sufficient to offset the hypothetical tax benefit deficiencies, an entity must begin to construct a hypothetical APIC pool. Depending on the sufficiency of the hypothetical APIC pool, some or all of the tax effects of the hypothetical tax benefit deficiencies are included as a subtractive item in the tax benefit component of assumed proceeds. The hypothetical APIC pool is developed by combining the APIC pool available for recognition purposes with the hypothetical excess tax benefits and hypothetical tax benefit deficiencies if exercise of all in-the-money awards is assumed.

To construct the hypothetical APIC pool, an entity needs to set an accounting policy for ordering the hypothetical excess tax benefits and hypothetical tax benefit deficiencies. That is, an entity may conclude that all hypothetical excess tax benefits are (1) included first, (2) included last, or (3) scheduled on the basis of some reasonable and rational approach when the hypothetical APIC pool is calculated. In addition to scheduling, an entity must consider the same realization concepts that apply to the APIC pool for recognition purposes. (See Q&A 6-22 for a more detailed discussion of the realization of hypothetical excess tax benefits in the construction of an entity’s hypothetical APIC pool.)

6-22 Realization of Excess Tax Benefits in the Calculation of the Tax Benefit Component of Assumed Proceeds

An entity expects that its unexercised share-based payment awards will create an excess tax benefit upon assumed exercise for EPS purposes. In the first two quarters of the fiscal year, the entity has incurred taxable losses, but it expects to generate taxable income for the last two quarters and for the fiscal year.

Question
Can the entity include the excess tax benefit that will be created upon the assumed exercise of a share-based payment award (i.e., the hypothetical excess tax benefit) in the tax benefit component of assumed proceeds under the treasury stock method when computing diluted EPS in the first two quarters in which tax losses have been incurred?

Answer
When determining whether an excess tax benefit that will be created upon the assumed exercise of a share-based payment award (i.e., the hypothetical excess tax benefit) is included in the tax benefit component of assumed proceeds in accordance with the treasury stock method, an entity must apply the realizability concept in ASC 718-740-25-10. (See Q&A 8-19 for a more detailed discussion of the realizability concept in ASC 718-740-25-10.) When assessing the realizability of the excess tax benefit, an entity must choose an accounting policy for determining whether the excess tax benefit will be realized as of each interim and annual reporting period. If the excess tax benefit is considered realized, it is included as an additive item in the tax benefit component of assumed proceeds under the treasury stock method in the computation of the entity’s diluted EPS.

Neither the EPS guidance in ASC 260 nor the stock compensation guidance in ASC 718 provides guidance on assessing the realizability of the excess tax benefit that is created upon the assumed exercise of the award for EPS purposes. In the absence of further guidance, we believe there are at least four acceptable approaches to applying the realizability concept to the hypothetical excess tax benefits:

1. Quarterly-period assessment — An entity may perform an assessment each quarter (i.e., a strict reporting-period approach) to determine whether it could realize the excess tax benefits if all of its outstanding share-based payment awards were exercised at the end of the period.
2. **Annual-period assessment** — An entity may determine the realizability of the excess tax benefits on the basis of the annual reporting period. ASC 740-270-25-8 through 25-11 lists provisions to help an entity assess whether the excess tax benefits are realizable.

3. **Scheduling** — An entity may schedule all of its outstanding share-based payment awards to determine whether the hypothetical excess tax benefit computed as of the current reporting period would be realized in the period in which the awards become exercisable.

4. **More likely than not** — Because ASC 260-10-45-29 is unclear regarding the tax benefit component of assumed proceeds, an entity may assess whether it is more likely than not (i.e., a likelihood of more than 50 percent) that some or all of the excess tax benefits computed in the current reporting period will ever be realized. ASC 740-10-30-18 lists provisions to help an entity assess whether the excess tax benefits are realizable.

As always, an entity’s accounting policies must be applied consistently and must be disclosed if they are material to the financial statements, in accordance with the disclosure guidance in ASC 235-10-50.

6-23 **Estimating Expected Disqualifying Dispositions in the Calculation of the Tax Benefit Component of Assumed Proceeds**

**Question**

ISOs do not result in a tax deduction for an entity unless an employee makes a disqualifying disposition. (See Q&A 8-02 for a more detailed discussion of ISOs.) If an entity has determined that employees have a history of making disqualifying dispositions, can the entity then estimate expected disqualifying dispositions in calculating the tax benefit component of assumed proceeds under the treasury stock method?

**Answer**

No. The EPS guidance in ASC 260-10-45-29 states that assumed proceeds include:

> The amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming **exercise** of the options... Paragraph 718-740-35-5 states that the amount deductible on an employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph **assuming exercise** of the options, that amount shall be treated as a reduction of assumed proceeds. [Emphasis added]

Because the tax benefit component of assumed proceeds is based on an assumed exercise of the options and the tax benefit associated with a disqualified ISO does not occur upon exercise but at some later date when the employee takes an action that disqualifies the option, no amount for ISOs is included as a tax benefit component of assumed proceeds under the treasury stock method.

Further, ASC 718-740-25-3 states that an employee’s disqualifying disposition of stock under existing U.S. tax law can “give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction,” and that the “tax effects of such an event shall be recognized only when it occurs.” Thus, although ASC 718-740-25-3 does not address the EPS implications of such a situation, it does indicate that the tax benefit associated with a disqualifying event must not be recorded until it occurs. By analogy, the expected effect of disqualifying dispositions that will occur in the future should not be estimated when an entity calculates the tax benefit component of assumed proceeds under the treasury stock method, because such dispositions have not yet occurred.

6-24 **Impact of Early-Exercised Share-Based Payment Awards on Earnings per Share**

**Question**

Should the shares issued upon an early exercise of a share-based payment award be included in the computation of basic or diluted EPS?

**Answer**

**Basic EPS**

Regardless of whether the early exercise of the share-based payment award allows an employer to repurchase the shares, if the employee terminates employment before the end of the original requisite service period for either (1) the lesser of the fair value of the shares on the repurchase date or the original exercise price of the award or (2) the original exercise price of the award, the shares issued to the employees upon exercise would not be considered
outstanding for basic EPS purposes until the services have been provided to earn the awards. This conclusion is consistent with the intent of ASC 260-10-45-13 that shares issued subject to a contingent repurchase provision are excluded from the computation of basic EPS until the shares are no longer contingently returnable (i.e., the employer’s call option lapses).

However, in accordance with ASC 260-10-45-61A, if the shares subject to repurchase “contain nonforfeitable rights to dividends or dividend equivalents,” such shares are participating securities. That is, awards that accrue cash dividends (whether paid or unpaid) any time the common shareholders receive dividends — when those dividends do not need to be returned to the entity if the employee forfeits the award — are considered participating securities. If the legally issued shares are considered participating securities, then the entity must apply the two-class method in computing basic EPS. The two-class method is described in more detail in ASC 260-10-45-59A through 45-60B and is illustrated in Q&A 6-09.

Diluted EPS

Regardless of whether the early exercise of the share-based payment award allows an employer to repurchase the shares, if the employee terminates employment before the end of the original requisite service period for either (1) the lesser of the fair value of the shares on the repurchase date or the original exercise price of the award or (2) the original exercise price of the award, the entity continues to apply the treasury stock method to the award in computing diluted EPS. In using the treasury stock method to calculate the number of incremental shares to be included in diluted EPS, the entity is required to include the exercise price of the award (among other things) in the computation of assumed proceeds in accordance with ASC 260-10-45-29. See Q&A 6-08 for a detailed example of the application of the treasury stock method to share-based payment awards. However, in this case, because the employee has already paid the cash to early exercise the award, (1) there is no cash that will be received from the employee in the future and (2) the cash received hypothetically could have been used to repurchase shares during the requisite service period. As a result, the cash received is not included in the computation of assumed proceeds.

When computing diluted EPS for early exercised awards that are considered participating securities, an entity must determine whether it is more dilutive to apply (1) the treasury stock method or (2) the two-class method.

6-25 Impact of Employee Share Purchase Plans on Earnings per Share

Question

How do ESPPs affect the computation of diluted EPS?

Answer

The guidance on accounting for contingently issuable shares in ASC 260-10-45-48 through 45-57 must be used in the EPS calculation for certain ESPPs with look-back options. (That guidance also must be considered for ESPPs without look-back options.) That is, the existence of a contingency in an ESPP is dependent on whether the employee can choose to purchase the shares underlying the ESPP (i.e., either (1) an employee’s withholdings are refundable or (2) shares will not be issued if the employee fails to provide the requisite service).

If the employee cannot choose to purchase the shares (i.e., the employee is not entitled to a refund of amounts previously withheld, regardless of whether he or she is terminated), then the guidance on contingently issuable shares applies. Under this guidance, the number of shares, if any, that would be issuable at the end of the reporting period, if the end of the reporting period were the end of the purchase period (this number is based on the amounts withheld by the employer to date), is included in the weighted-average number of common shares (i.e., the denominator in the computation of basic and diluted EPS).

If the employee can choose to purchase the shares (i.e., the employee is entitled to a refund of amounts previously withheld), then the awards are essentially employee share options. Accordingly, the shares underlying the ESPP are included in the denominator in the computation of diluted EPS under the treasury stock method, as described in ASC 260-10-45-28A through 45-29A. See Q&A 6-08 for a detailed illustration of the application of the treasury stock method to a share-based payment award.
Chapter 7 — Employee Share Purchase Plans

ESPPs are share-based payment plans that are usually offered to a broad base of employees so that they can participate in the ownership of the entity at a discounted price. Employees contribute to the plan through payroll deductions over a period (e.g., six months), which is referred to as the purchase period. At the end of the purchase period, the employees purchase the employer’s stock at the discounted price.

Determination of Whether the ESPP Is Compensatory or Noncompensatory

From an accounting perspective, the most important determination is whether an entity’s ESPP plan is considered compensatory or noncompensatory. ASC 718-50-25-1 lists specific criteria that must be met for an ESPP to be considered noncompensatory. If a plan does not meet these criteria, compensation cost must be recognized for the plan.

Recognition

As with any other share-based payment award, compensation cost for an ESPP is recognized over the requisite service period. The service inception date is the date at which the requisite service period begins and is usually the grant date but sometimes precedes it. ASC 718-50-25-3 defines the requisite service period for an ESPP as the period over which employees participate in the plan and pay for the shares. Accordingly, the requisite service period (and therefore the period over which compensation cost is recognized for an ESPP) will typically be the purchase period, which may begin before or after the grant date.

If the ESPP contains multiple purchase periods, the award in effect has a graded vesting schedule. Accordingly, an entity would record compensation cost in accordance with its policy on the treatment of awards with only service conditions that have a graded vesting schedule. Under ASC 718-10-35-8, an entity can make a policy decision about whether to recognize compensation cost for its awards with only service conditions that have a graded vesting schedule on either (1) an accelerated basis as though each separately vesting portion of the award was, in substance, a separate award or (2) a straight-line basis over the requisite service period for the entire award (i.e., over the requisite service period of the last separately vesting portion of the award). See Q&A 4-10 for examples illustrating the graded vesting attribution method. Once an entity establishes a method for recognizing compensation cost for an award with only a service condition that has a graded vesting schedule, that method should be consistently applied.

Overview and Scope

**ASC 718-50**

| 05-1 | This Subtopic provides guidance to entities that use employee share purchase plans. The entity must first determine whether the plan is compensatory or noncompensatory. This is determined by the terms of the plan (see paragraphs 718-50-25-1 through 25-2). A plan with an option feature, for example a look-back feature, is considered compensatory. For a compensatory plan the calculation of the amount of the compensation is important (see Section 718-50-55). |
| 15-1 | This Subtopic has its own discrete scope, which is separate and distinct from the pervasive scope for this Topic as outlined in Section 718-10-15. |
| 15-2 | The guidance in this Subtopic applies to all entities. |
Chapter 7 — Employee Share Purchase Plans
A Roadmap to Accounting for Share-Based Payment Awards

Recognize

**ASC 718-50**

**25-1** An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation cost (that is, the plan is noncompensatory):

a. The plan satisfies either of the following conditions:
   1. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.
   2. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:
   1. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.
   2. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

**25-2** A plan provision that establishes the purchase price as an amount based on the lesser of the equity share’s market price at date of grant or its market price at date of purchase, commonly called a look-back plan, is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share’s market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory. Section 718-50-55 provides guidance on determining whether an employee share purchase plan satisfies the criteria necessary to be considered noncompensatory.

**25-3** The requisite service period for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

**7-01 Determining Whether an Employee Share Purchase Plan Is Noncompensatory — Favorability of Terms**

ESPPs are considered noncompensatory if all the conditions in ASC 718-50-25-1 are met. One of these conditions is in ASC 718-50-25-1(a), which states, in part, that an ESPP must satisfy either of the following criteria to be noncompensatory:

1. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement. (Emphasis added)

2. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering.

This Q&A discusses ASC 718-50-25-1(a)(1). For guidance on ASC 718-50-25-1(a)(2) regarding discounts from the market price of an entity’s shares, see Q&A 7-02.

**Question**

When might the terms of an ESPP be more favorable than those available to all shareholders of the same class of shares?
Answer

The example in ASC 718-50-55-35 states, in part:

Entity B has a dividend reinvestment program [DRIP] that permits shareholders of its common stock the ability to reinvest dividends by purchasing shares of its common stock at a 10 percent discount from its market price on the date that dividends are distributed and Entity B offers all full-time employees the right to purchase annually up to $10,000 of its common stock at a 10 percent discount from its market price on the date of purchase. Entity B’s common stock is widely held; hence, many shareholders will not receive dividends totaling at least $10,000 during the annual period.

In this example, because all other shareholders are not likely to receive dividends totaling $10,000, their participation in the DRIP will not be the same as that of employees in the ESPP. That is, while the terms of the ESPP provided to employees and the DRIP provided to all other shareholders are similar (i.e., B’s shares may be purchased at a 10 percent discount from the market price), employees can participate by contributing up to $10,000, whereas all other shareholders can participate by contributing only up to the amount of dividends they receive, which may not total $10,000. Accordingly, the terms available to employees under the ESPP may be more favorable.

The share purchase plan may still be noncompensatory with respect to the discounted shares offered to employees if B can justify that the discount does not exceed the share issuance costs that the entity would have incurred to raise a significant amount of capital in a public market (assuming the plan meets the remaining conditions in ASC 718-50-25-1). However, as discussed in ASC 718-50-25-1(a)(2), the entity must continue to assess the discount percent at least annually, and no later than the first share purchase offer during the fiscal year, to justify continued use of the discount percentage on subsequent offerings. See Q&A 7-02 for further discussion of this condition.

Note that ASC 718-50-25-1(a)(1) states that “a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.” This anti-abuse provision prevents an entity from creating a separate class of shares solely for the purpose of meeting the condition in ASC 718-50-25-1(a)(1) by issuing such separate class of shares only to employees in connection with its share purchase plan and thereby in form providing the same terms to all shareholders of the same class of shares.

7-02 Determining Whether an Employee Share Purchase Plan Is Noncompensatory — Discount From the Market Price of an Entity’s Shares

ESPPs are considered noncompensatory if all the conditions in ASC 718-50-25-1 are met. One of these conditions is in ASC 718-50-25-1(a), which states, in part, that an ESPP must satisfy either of the following criteria to be noncompensatory:

1. The terms of the plan are no more favorable than those available to all holders of the same class of shares. . . .
2. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering.

Under the “safe harbor” provision in ASC 718-50-25-1, a purchase discount of 5 percent or less from the market price of the entity’s shares does not result in a compensatory ESPP. Many IRC Section 423 plans, however, provide for a discount of 15 percent from the market price of the entity’s shares to be purchased.

Question

Under ASC 718-50-25-1(a)(2), would a 15 percent discount from the market price of an entity’s shares (i.e., the discount offered in most current IRC Section 423 plans) result in a compensatory ESPP in accordance with ASC 718?
Answer

Generally, yes. A discount from the market price of an entity’s shares in excess of 5 percent may result in a compensatory ESPP under ASC 718-50-25-1. However, if an entity can justify that the discount (e.g., the 15 percent discount provided by IRC Section 423) is equivalent to the share issuance costs that the entity would have incurred to raise a significant amount of capital in a public offering, the ESPP may be considered noncompensatory (provided the plan meets the remaining conditions in ASC 718-50-25-1). ASC 718-50-25-1(a)(2) states, in part:

A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

In addition, if an entity can justify that a discount in excess of 5 percent is appropriate, the ESPP may be considered noncompensatory (as long as the plan meets the remaining conditions in ASC 718-50-25-1). AICPA TIS Section 4110.01 provides guidance on what amounts should be considered for inclusion in the share issuance cost. It states, in part:

Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers’ salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance.

However, as discussed in ASC 718-50-25-1(a)(2), the entity must continue to justify the appropriateness of the discount percentage at least annually and no later than the first share purchase offer during the fiscal year. If an entity is no longer able to justify a discount in excess of 5 percent, subsequent grants using that discount rate would be considered compensatory (unless the “terms of the plan are no more favorable than those available to all holders of the same class of shares” and the other conditions in ASC 718-50-25-1 are satisfied). The inability to justify a discount on a current offering would not affect the noncompensatory nature of previous offerings. That is, an entity would not record compensation cost for purchase offers made before the entity is unable to justify a discount in excess of 5 percent.

Example

On January 1, 20X1, Entity A establishes an ESPP under which employees can purchase A’s shares at a 7 percent discount. Entity A can justify that the 7 percent discount is not greater than the costs A would have incurred in a significant offering of A’s shares in a public market. Therefore, the ESPP is not considered compensatory (provided all the other criteria in ASC 718-50-25-1 also have been met).

On July 1, 20X1, A has a second offering under its ESPP, also with a 7 percent discount. Entity A is not required to reassess the 7 percent discount used in the second ESPP offering in 20X1. As long as all the other criteria in ASC 718-50-25-1 continue to be met, the plan is not considered compensatory.

On January 1, 20X2, A has a third offering under its ESPP and again offers a 7 percent discount. In accordance with ASC 718-50-25-1(a)(2), A would have to justify that the 7 percent discount remains appropriate for this offering. If, for this offering, A can no longer justify the 7 percent discount, the plan is considered compensatory (unless the “terms of the plan are no more favorable than those available to all holders of the same class of shares” and the other conditions in ASC 718-50-25-1 have been met). Entity A’s inability to justify the discount on the current offering would not affect the noncompensatory nature of prior offerings. That is, A would record no compensation cost for purchase offers made before A is unable to justify the discount (i.e., for the January 1, 20X1, and the July 1, 20X1, offerings). Further, for the third offering, A must recognize the entire amount of the discount (i.e., 7 percent) in determining the amount of compensation cost over the requisite service period, not just the discount in excess of 5 percent.

7-03 Determining Whether an Employee Share Purchase Plan Is Noncompensatory — Option Features

ESPPs are considered noncompensatory if all the conditions in ASC 718-50-25-1 are met. One of these conditions is that the plan must not incorporate option features, with limited exceptions.

Question

What types of option features may not necessarily result in a compensatory ESPP?
**Answer**

ASC 718-50-25-1(c) lists two option features that can be incorporated into the terms of an ESPP without resulting in a compensatory plan (as long as the remaining conditions in ASC 718-50-25-1 are met). The first option feature is that an employee is “permitted a short period of time — not exceeding 31 days — after the purchase price has been fixed to enroll in the plan.” However, a plan with this option feature may have an additional option feature that could cause the plan to be compensatory. For example, if the plan sets the purchase price on the date the employee begins participating in the plan and is having money withheld to pay for the shares, but allows the employee to cancel participation after enrollment and receive a refund of the amount previously withheld from his or her pay, this additional feature would be considered an option feature that results in a compensatory plan. This is because the employee begins to benefit from, or to be adversely affected by, subsequent changes in the entity’s share price once the purchase price is set, and allowing cancellation of participation after enrollment provides the employee with benefits similar to a stock option.

The second option feature that does not result in a compensatory plan is that the “purchase price is based solely on the market price of the [entity’s] shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid” (emphasis added). Unlike the example above, in which the employee can cancel participation in the plan after the purchase price has been set (and therefore after beginning to benefit from, or to be adversely affected by, subsequent changes in the entity’s share price), in this situation the option feature does not provide the employee with a benefit similar to those provided by a stock option because an employee can cancel participation before the purchase price is set.

Note that many existing ESPPs include a look-back feature that allows the purchase price to be set at the lower of the (1) market price of the entity’s shares on the date the employee begins participating in the plan and is having money withheld to pay for the shares or (2) the market price of the shares on the purchase date. This look-back feature would be considered an option feature that results in a compensatory plan under ASC 718-50-25-1.

**7-04 Determining the Service Inception Date and Grant Date of an Employee Share Purchase Plan When There Is No Look-Back Feature**

Under the terms of some ESPPs, an employee is entitled to purchase a specified dollar amount of an entity’s shares at a future date at an established discount from the market price of the entity’s shares at that future date (i.e., a variable number of shares for a fixed monetary amount). In addition, the ESPP may not include a look-back feature in its terms. That is, the purchase price would not be the lower of the purchase-date price of the entity’s shares or the enrollment-date price of the entity’s shares.

**Question**

What is the service inception date and grant date of an ESPP when there is no look-back feature in its terms?

**Answer**

Provided all other conditions for grant date have been met (see ASC 718-50-20 for a discussion of the conditions that must be met for a grant date to have occurred), the grant date would be the date the employee purchases the shares (i.e., the purchase date) because the employee does not begin to benefit from, or is not adversely affected by, subsequent changes in the employer’s share price until that date. The service inception date would be the enrollment date if the employee began participating in the plan and is having money withheld to pay for the shares on that date.

Since the terms of the ESPP require the employee to purchase a specific dollar amount of the employer’s shares on the purchase date, the amount of compensation cost is fixed and known on the service inception date. That compensation cost is recognized over the requisite service period, which is the period over which the employee participates in the plan and has money withheld to pay for the shares on the purchase date. See Q&A 7-05 for a discussion of how to determine the requisite service period for ESPPs.

In addition, because the employee is entitled to purchase a variable number of shares for a fixed monetary amount, the award would be classified as a share-based liability and recorded at its fair-value-based measure each reporting period until settlement (i.e., the purchase date).
**Example**

On January 1, 20X1, an employee enrolls in an ESPP in which the employee elects to have withheld from his or her pay an aggregate amount of $850 over the course of the next six months (i.e., until June 30, 20X1). The $850 will be used to purchase a variable number of the employer’s shares at a 15 percent discount from their market price on June 30, 20X1. In accordance with ASC 718-50-25-3, the service inception date is January 1, 20X1, and the grant date is June 30, 20X1. Accordingly, compensation cost of $150 ([$850 withheld from the employee’s pay ÷ 85% discounted market price of the employer’s shares] – $850 withheld from the employee’s pay), an approximation of the fair-value-based measure of the award, is recognized over the period from the service inception date (enrollment date or January 1, 20X1) to the grant date (purchase date or June 30, 20X1). Because the plan’s terms specify that the employee purchases a variable number of shares worth a fixed monetary amount, the amount of the benefit conveyed to the employee is known on the service inception date (i.e., it is based on the discount provided from the market price of the employer’s shares and the amount of cash the employee elects to withhold to purchase the employer’s shares) and is unaffected by the number of the employer’s shares ultimately purchased.

Further, if on June 30, 20X1 (the purchase date), the employer’s shares are traded at $2 per share, the employee would purchase 500 of the employer’s shares [$850 withheld from the employee’s pay ÷ ($2 market price of the employer’s shares × 85% discounted market price of the employer’s shares)] for $850, resulting in a discount of $150 from the market value of the employer’s shares. Alternatively, if on June 30, 20X1, the employer’s shares traded at $4 per share, the employee would purchase 250 of the employer’s shares [$850 withheld from the employee’s pay ÷ ($4 market price of the employer’s shares × 85% discounted market price of the employer’s shares)] for $850, still resulting in a discount of $150 from the market value of the employer’s shares.

In addition, because the award entitles the employee to purchase a variable number of the employer’s shares for a fixed dollar amount, a share-based liability is recorded as the offsetting entry to compensation cost.

**7-05 Determining the Requisite Service Period of an Employee Share Purchase Plan**

**Question**

How is compensation cost recognized for an ESPP?

**Answer**

Compensation cost for a share-based payment award is recognized over the requisite service period. The service inception date is the date at which the requisite service period begins and is usually the grant date. However, sometimes the service inception date can precede the grant date. See Q&A 7-04 for a discussion of, and an example illustrating, the determination of the service inception date and grant date of an ESPP when there is no look-back feature. ASC 718-50-25-3 specifically defines the requisite service period of an ESPP as “the period over which the employee participates in the plan and pays for the shares” (i.e., purchase period). Accordingly, the requisite service period, and therefore the period over which compensation cost is recognized for an ESPP, will typically be the purchase period, which may begin before or after the grant date.

If the ESPP contains multiple purchase periods, the award in effect has a graded vesting schedule. Accordingly, an entity would record compensation cost in accordance with its policy on the treatment of awards with only service conditions that have a graded vesting schedule. For awards with only service conditions that have a graded vesting schedule, ASC 718-10-35-8 allows entities to make a policy decision about whether to recognize compensation cost on either (1) an accelerated basis as though each separately vesting portion of the award was, in substance, a separate award or (2) “a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).” (See Q&A 4-10 for examples illustrating the accelerated recognition method.) An entity should consistently apply its method for recognizing compensation cost for awards with only a service condition that have a graded vesting schedule.

Note that regardless of the valuation technique used to value an ESPP award, even though the valuation technique may directly or indirectly result in each portion of a graded vesting award being valued as an individual award, it does not affect an entity’s ability to make a policy decision about how to recognize compensation cost (i.e., on an accelerated or straight-line basis). See Q&A 4-08 for a discussion of the interaction between valuation techniques and the graded vesting attribution methods.
**Example 1 — Recognizing Compensation Cost for an ESPP Over a Single Purchase Period**

Entity A offers an ESPP to all eligible employees. To participate in the offering for the following year, A’s employees must enroll by December 15, 20X1. On that date, all the terms of the ESPP (including the purchase price) are determined and a grant date is established in accordance with ASC 718. The purchase period for all employees enrolled in the ESPP, which is the period in which actual payroll withholdings are made, is January 1, 20X2, through June 30, 20X2. In accordance with ASC 718-50-25-3, the requisite service period, and therefore the period over which compensation cost will be recognized, is January 1, 20X2, through June 30, 20X2, even though a grant date was established as of December 15, 20X1.

**Example 2 — Recognizing Compensation Cost for an ESPP With a Single Look-Back Feature Over Multiple Purchase Periods**

Assume all the same facts as in Example 1, except that A provides its employees with a two-year offering period in which they can purchase A’s shares on June 30, 20X2; December 31, 20X2; June 30, 20X3; or December 31, 20X3. The purchase price of A’s shares is based on a look-back feature that is tied to the lesser of A’s share price on January 1, 20X2, or its share price on the purchase date. Because the grant date cannot be established until all terms of the ESPP are determined (i.e., the purchase price is not determined until January 1, 20X2), the grant date is January 1, 20X2.

Because the ESPP provides for multiple six-month purchase periods that all have a look-back feature tied to A’s share price at the beginning of the offering period (i.e., January 1, 20X2, or the grant date), the award in effect has a graded vesting schedule. In addition, because each six-month purchase period has the same grant date (i.e., January 1, 20X2), there are four separate tranches with a 6-month, 12-month, 18-month, and 24-month requisite service period. Accordingly, A would recognize compensation cost on the basis of its established policy for recognizing compensation cost for awards with only a service condition that have a graded vesting schedule. That is, A would recognize compensation cost for this ESPP on either (1) an accelerated basis as though each portion of the award for each separate purchase period was, in substance, a separate award or (2) a straight-line basis over the purchase period from January 1, 20X2, through December 31, 20X3.

**Example 3 — Recognizing Compensation Cost for an ESPP With Multiple Look-Back Features Over Multiple Purchase Periods**

Assume all the same facts as in Example 1, except that A provides its employees with a two-year offering period in which they can purchase A’s shares on June 30, 20X2; December 31, 20X2; June 30, 20X3; or December 31, 20X3. For each six-month purchase period, the purchase price of A’s shares is based on a look-back feature that is tied to the lesser of A’s share price at the beginning of the purchase period (i.e., January 1, 20X2; July 1, 20X2; January 1, 20X3; or July 1, 20X3) or its share price at the date of purchase.

Because the ESPP provides for multiple six-month purchase periods that have a look-back feature tied to A’s share price at the beginning of each purchase period, each purchase period is, in effect, a separate award, with the grant date at the beginning of each purchase period. Accordingly, A would measure and recognize compensation cost separately and sequentially for each of the four six-month purchase periods.

**Measurement**

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<thead>
<tr>
<th><strong>ASC 718-50</strong></th>
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<tr>
<td><strong>Initial Measurement</strong></td>
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<tr>
<td><strong>30-1</strong> Paragraph 718-10-30-6 states that the objective of the fair value measurement method is to estimate the fair value of the equity instruments, based on the share price and other measurement assumptions at the grant date, that are issued in exchange for employee services. That objective also applies to the fair value measurements associated with grants under a compensatory employee share purchase plan and is the basis for the approach described in Example 1, Case A (see paragraph 718-50-55-10).</td>
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<td><strong>30-2</strong> Many employee share purchase plans with a look-back option have features in addition to or different from those of the plan described in Example 1, Case A (see paragraph 718-50-55-10). For example, some plans contain multiple purchase periods, others contain reset mechanisms, and still others allow changes in the withholding amounts or percentages after the grant date (see Example 1, Cases B through E [see paragraphs 718-50-55-22 through 55-33]).</td>
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<td><strong>30-3</strong> In some circumstances, applying the measurement approaches described in this Subtopic at the grant date may not be practicable for certain types of employee share purchase plans. Paragraph 718-20-35-1 provides guidance on the measurement requirements if it is not possible to reasonably estimate fair value at the grant date.</td>
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Chapter 7 — Employee Share Purchase Plans
A Roadmap to Accounting for Share-Based Payment Awards

ASC 718-50 (continued)

Subsequent Measurement

35-1 Changes in total employee withholdings during a purchase period that occur solely as a result of salary increases, commissions, or bonus payments are not plan modifications if they do not represent changes to the terms of the award that was offered by the employer and initially agreed to by the employee at the grant (or measurement) date. Under those circumstances, the only incremental compensation cost is that which results from the additional shares that may be purchased with the additional amounts withheld (using the fair value calculated at the grant date). For example, an employee may elect to participate in the plan on the grant date by requesting that 5 percent of the employee’s annual salary be withheld for future purchases of stock. If the employee receives an increase in salary during the term of the award, the base salary on which the 5 percent withholding amount is applied will increase, thus increasing the total amount withheld for future share purchases. That increase in withholdings as a result of the salary increase is not considered a plan modification and thus only increases the total compensation cost associated with the award by the grant date fair value associated with the incremental number of shares that may be purchased with the additional withholdings during the period. The incremental number of shares that may be purchased is calculated by dividing the incremental amount withheld by the exercise price as of the grant date (for example, 85 percent of the grant date stock price).

35-2 Any decreases in the withholding amounts (or percentages) shall be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost shall be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the requirement in paragraph 718-10-35-3 that the total amount of compensation cost that must be recognized for an award 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).

7-06 Accounting for Changes in Employee Withholdings in Connection With an Employee Share Purchase Plan

Question

How does an entity account for a change (i.e., an increase or decrease) in an employee’s withholdings in connection with an ESPP?

Answer

Decrease in Withholdings

If the employee elects to irrevocably withdraw from the offering before the purchase date for a complete refund of all amounts withheld from the employee’s pay, the withdrawal should be accounted for as a cancellation if the employee continues employment with the entity. The employee has, in essence, canceled the award associated with that offering. That is, the employee does not have the ability to purchase the entity’s shares under the ESPP since the withdrawal is irrevocable. In accordance with ASC 718-20-35-9, a cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration is accounted for as a repurchase for no consideration. Accordingly, any unrecognized compensation cost should be recognized immediately for the canceled awards.

The period over which compensation cost is recognized is different for complete withdrawals than it is for partial withdrawals. Under a partial withdrawal, employees decrease the amount of future payroll withholdings during a purchase period. A decrease in the amount of future payroll withholdings will result in fewer of the entity’s shares being purchased by the employee on the purchase date. Such decreases are disregarded under ASC 718-50-35-2. As a result, compensation cost continues to be recognized over the requisite service period on the basis of the grant-date fair-value-based measure of the award unless the award is forfeited. Decreases in the amount of future payroll withholdings are the equivalent of a failure of the employee to exercise a stock option that has been earned (i.e., vested). Compensation cost can only be reversed when the employee forfeits the award (i.e., the employee fails to provide the requisite service).

Increase in Withholdings

The accounting for an increase in an employee’s withholding in connection with an ESPP depends on whether it is the result of an increase in (1) the employee’s compensation (i.e., an increase in the total dollar amount of the withholdings, but not the percentage) or (2) the percentage of the employee’s compensation to be withheld.
In accordance with ASC 718-50-35-1, an increase in an employee’s withholding solely as a result of an increase in an employee’s compensation (i.e., salary, commission, or bonus) is not accounted for as a modification of the award (provided no other changes to the terms of the ESPP have been made). The only incremental compensation cost results from the additional shares that will be purchased with the additional amounts withheld (under the fair-value-based measure calculated as of the grant date). In other words, the increase in the withholding amount does not change the grant-date fair-value-based measure per share of the award. Rather, it changes the quantity of shares that will be purchased in connection with the total award.

In contrast, as indicated in ASC 718-50-55-29, an increase in the percentage of the employee’s compensation to be withheld is accounted for as a modification of the award even though it is not a change to the terms of the ESPP. Therefore, total recognized compensation cost attributable to the award is (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned) or is expected to be provided and (2) the incremental compensation cost conveyed to the holder of the award as a result of the modification. The incremental compensation cost is the excess of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification. See ASC 718-50-55-30 and 55-31 for an example of how modification accounting is applied to determine incremental compensation cost resulting from an increase in the percentage of an employee’s withheld compensation.

7-07 Accounting for Forfeitures of an Employee Share Purchase Plan

Because of the maximum purchase-period constraints required for tax qualification under IRC Section 423, ESPPs typically have shorter requisite service periods than other share-based payment awards. The most common purchase period (i.e., the requisite service period) for ESPPs is six or twelve months.

**Question**

Given the relatively short requisite service period for a typical ESPP, is an entity required to use an estimated forfeiture rate in determining the compensation cost associated with the plan?

**Answer**

Yes. As with any share-based payment award, an entity must estimate forfeitures in recognizing compensation cost for the ESPP (and must update its estimate if it receives new information indicating that actual forfeitures will differ from previous estimates). When employee turnover is limited, it may be appropriate for an entity to use a minimal forfeiture estimate in determining compensation cost associated with an ESPP. See Q&A 4-01 for an example illustrating the accounting for forfeited awards and Q&A 4-02 for a discussion of information that an entity may use in estimating forfeitures.

Note that when an employee elects to completely withdraw from an ESPP, the withdrawal should be accounted for as a cancellation rather than as a forfeiture. Accordingly, any unrecognized compensation cost should be recognized immediately for the awards canceled. See Q&A 7-06 for a discussion of the accounting for increases and decreases in an employee’s withholdings (including a complete withdrawal).
Chapter 8 — Income Taxes

Under U.S. tax law, stock option awards can generally be categorized into two groups: (1) statutory options (ISOs) and ESPPs that are qualified under IRC Section 423 and (2) nonstatutory options (also known as NQSOs or NSOs).

Under ASC 718-740, only awards that ordinarily result in a tax deduction for the entity granting the awards result in a temporary difference whose tax effects must be accounted for in the entity’s financial statements. If the awards do not result in a tax deduction for the entity, the cumulative amount of compensation cost recorded in the financial statements would be a permanent difference and those related costs would be an item or part of an item that reconciles the entity’s statutory tax rate to its effective tax rate. For public entities, disclosure of this reconciliation is required by ASC 740-10-50-12.

The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the employer unless an employee or former employee makes a disqualifying disposition. As a result, until or unless a disqualifying disposition is made, recognition of income tax benefits is not permitted when ISOs or ESPPs have been granted. See Q&A 8-04 for guidance on how to account for the tax effects when a disqualifying disposition of an award occurs.

The exercise of an NQSO does result in a tax deduction for the grantor that is equal to the intrinsic value of the option when exercised. As a result, income tax accounting is required when compensation cost is recorded in the financial statements for NQSOs that are granted.

Income Tax Considerations for Awards That Ordinarily Result in a Tax Deduction

Under ASC 718, the “cumulative amount of compensation cost recognized for [awards] that ordinarily would result in a future tax deduction [is] considered to be a deductible temporary difference in applying [ASC 740].” Accordingly, for such awards, DTAs (and related tax benefits) are recognized as the related compensation cost is recognized. Further, under ASC 718-740-05-4, “tax deductions [for equity-classified awards] may arise in different amounts and in different periods from compensation cost recognized in financial statements.” This is because, for NQSO plans, the entity usually receives a deduction for the excess of the market price of its stock over the exercise price of the award on the exercise date (i.e., the intrinsic value) rather than the grant-date fair-value-based measure of the award.

As of the exercise date (or vesting date for nonvested awards), entities should record the tax benefit of any excess tax deduction over compensation cost recognized in net income (i.e., the excess tax benefit) as an increase (credit) to paid-in capital. This is true as long as the excess tax benefit has been realized under ASC 718. Tax benefit deficiencies (i.e., tax effects when compensation cost recognized in the income statement is greater than the tax deduction) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the “APIC pool”). In the absence of an APIC pool, tax benefit deficiencies must be recorded as a current-period income tax expense in the period of the tax deduction.
Overview and Scope

ASC 718-740

Overview and Background

05-1 Topic 740 addresses the majority of tax accounting issues and differences between the financial reporting (or book) basis and tax basis of assets and liabilities (basis differences).

05-2 This Subtopic addresses the accounting for current and deferred income taxes that results from share-based payment arrangements, including employee stock ownership plans.

05-3 This Subtopic specifically addresses the accounting requirements that apply to the following:

a. The determination of the basis differences which result from tax deductions arising in different amounts and in different periods from compensation cost recognized in financial statements

b. The recognition of tax benefits when tax deductions differ from recognized compensation cost

c. The presentation required for income tax benefits from share-based payment arrangements.

05-4 Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity’s income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation cost recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

ASC 718-740

Scope and Scope Exceptions

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 718-10-15, with specific transaction qualifications noted below.

15-2 The guidance in this Subtopic applies to share-based payment transactions with both employees and nonemployees.

Recognition

ASC 718-740

Determination of Temporary Differences

25-1 This guidance addresses how temporary differences are recognized for share-based payment arrangement awards that are classified either as equity or as liabilities under the requirements of paragraphs 718-10-25-7 through 25-19. Incremental guidance is also provided for issues related to employee stock ownership plans.

Instruments Classified as Equity

25-2 The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of Subtopic 740-10. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

25-3 Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee’s sale of shares obtained from an award before meeting a tax law’s holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Instruments Classified as Liabilities

25-4 The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.
ASC 718-740 (continued)

8-01 Tax Effects of Share-Based Compensation

**Question**

Will all grants of share-based payment awards result in tax effects being recorded in the financial statements?

**Answer**

No. Only awards that ordinarily would result in a tax deduction for the grantor (or subsidiary) give rise to a temporary difference whose tax effects must be accounted for. Otherwise, the cumulative amount of compensation cost recorded in the financial statements is a permanent difference and those related costs would be an item or a part of an item that reconciles the grantor’s statutory tax rate to its effective tax rate, as required by ASC 740-10-50-12.

Under U.S. tax law, stock option awards can generally be categorized into two groups:

- **Statutory Options (ISOs) and ESPPs that are qualified under IRC Sections 422 and 423** — The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the grantor unless the employee or former employee makes a disqualifying disposition. Thus, until or unless a disqualifying disposition is made, recognition of income tax benefits is not permitted when ISOs or ESPPs have been granted. See Q&A 8-02 for the definition of an ISO.

- **Nonstatutory Options (also known as NQSOs or NSOs)** — The exercise of an NQSO results in a tax deduction for the grantor that is equal to the intrinsic value of the option when exercised. Therefore, a DTA is recognized for the cumulative compensation cost recorded in the financial statements for NQSOs that are granted. See Q&A 8-03 for the definition of an NQSO.
8-02  Incentive Stock Options

Question
What is an ISO?

Answer
An ISO is a stock option that is subject to the rules of IRC Sections 421, 422, and 424. In general, an option is considered an ISO if:

- The option is granted within 10 years of adoption of the plan or, if earlier, the date on which the stockholders approve the plan.
- The maximum term of the option is 10 years from the grant date. For employees that own more than 10 percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the maximum term is five years.
- The option price is not less than the fair market value of the stock at the time the option is granted. For employees that own more than 10 percent of the total combined voting power of the employer or of its parent or subsidiary corporation, the option price must not be less than 110 percent of the fair market value.
- The option is transferable only in the event of death.
- The employee is employed by the employer (or its parent or subsidiary) for the entire period up to three months before the exercise date of the option.

Generally, ISOs are not taxable to the employee (or former employee) for “regular” tax purposes until the stock acquired through exercise of the ISO has been disposed of. At that time, the employee will be subject to long-term capital gains tax for the difference between the proceeds received upon disposal and the exercise price, as long as the employee has held the stock for the required periods. If the employee holds the stock for the required periods, the employer does not receive a tax deduction related to the ISO.

To receive the favorable tax treatment, the individual acquiring the stock upon exercising the option may not dispose of the stock within two years of grant date or within one year of the exercise date. If these requirements are violated, a disqualifying disposition occurs, and the option no longer qualifies for ISO treatment. If a disqualifying disposition occurs, the lesser of the excess of the fair market value of the stock on the exercise date over the strike price or the actual gain on sale is included in the employee’s income as compensation in the year of disposition. The employer receives a tax deduction for the amount of income included by the individual.

The maximum amount of ISOs that may first become exercisable in a calendar year is $100,000. Generally, any amounts in excess of $100,000 should be treated as NQSOs. See Q&A 8-03 for a discussion of NQSOs. The $100,000 is calculated based on the fair market value of the underlying shares (not the grant-date fair value of the options) when granted, not the fair market value on the vesting date.

Under the tax law, to exercise an ISO, an individual must recognize a “tax preference” item that is equal to the difference between the exercise price and the fair market value of the underlying shares on the exercise date. This tax preference item may cause the individual to owe AMT. Generally, the AMT may be avoided by selling the ISO shares in the same calendar year in which they were purchased (a disqualifying disposition; the tax consequences are noted above).

8-03  Nonqualified Stock Options

Question
What is an NQSO?

Answer
An NQSO is an option that does not qualify as an ISO under IRC Sections 421–424. The taxation of NQSOs is generally governed by IRC Section 83. The terms of an NQSO can be more flexible than those of an ISO. For example, with an NQSO:

- The option price may be less than fair value.
- The option term may extend longer than 10 years (but generally is limited to 10 years by the plan).
• The option may be granted to nonemployees.
• Shareholder approval is not required for tax purposes (but may be required for other purposes).

An employee’s exercise of an NQSO results in ordinary income for the employee. The amount of ordinary income is calculated as the difference between the option exercise price and the fair market value of the underlying shares on the exercise date. The recipient of the employee’s services is entitled to a tax deduction equal to the ordinary income included in income by the employee at the same time the employee recognizes the income (provided that the stock is not subject to restrictions). The employer is required to include the income on the employee’s W-2 and to withhold applicable income and payroll tax.

8-04  Change in Tax Status of an Award

Some share-based payment awards (e.g., ISOs or awards granted under a qualified employee stock purchase plan) are not tax-deductible to the grantor unless a disqualifying disposition occurs. Therefore, when compensation cost related to such awards is recorded, no DTA is recognized, and, accordingly, no corresponding tax benefit is recorded in the income statement.

Question
Can a company record a tax benefit in the income statement for non-tax-deductible awards (e.g., ISOs) that are expected to be subject to disqualifying dispositions, and what is the appropriate accounting for the tax effects when a disqualifying disposition of an award occurs?

Answer
No. ASC 718-740-25-3 explains that the tax effects of an event (e.g., a disqualifying disposition) that gives rise to a tax deduction for awards that ordinarily do not result in tax deductions should not be accounted for until the event occurs. Therefore, no DTA and related tax benefit can be recognized in connection with such an award until a disqualifying disposition occurs.

When a disqualifying disposition occurs, a deduction is available to be taken in the employer’s tax return. If the tax deduction exceeds the cumulative compensation cost recorded, a tax benefit would be recorded in the income statement on the basis of the compensation cost of that award (e.g., the ISO) recorded in the financial statements. The tax benefit of any excess of the amount of the deduction taken over the cumulative compensation cost recorded would be recorded in APIC and included in the employer’s “APIC pool” when realized. See Q&A 8-18 for a discussion of the APIC pool and the accounting for income tax effects of share-based payment awards.

If the tax deduction is less than the cumulative compensation cost recorded in the financial statements, the tax benefit to be recorded should be based on the actual tax deduction resulting from the disqualifying disposition of the award. Therefore, when a disqualifying disposition occurs, the amount of the tax benefit recorded in the income statement is based on the lesser of the (1) actual deduction taken and (2) cumulative compensation cost recorded in the financial statements.

Example 1
A company grants an ISO with a grant-date fair-value-based measure of $100, which is recorded in the income statement as compensation cost. Since the award is an ISO, no corresponding DTA or related tax benefit is recorded because the award does not ordinarily result in a tax deduction for the company.

Assume that a disqualifying disposition occurs and results in the company’s taking a deduction of $120 in its tax return. If the company’s applicable tax rate is 40 percent, the company would record a tax benefit of $40 in the income statement and an increase to APIC (which would also serve to increase its APIC pool) of $8 ($120 deduction taken in the tax return – $100 grant-date fair-value-based measure) × 40% tax rate].

Example 2
A company grants an ISO with a grant-date fair-value-based measure of $100, which is recorded in the income statement as compensation cost. Since the award is an ISO, no corresponding tax benefit or DTA is recorded because the award does not result in a tax deduction to the company.

Assume a disqualifying disposition occurs and results in the company taking a deduction of $80 in its tax return. If the company’s applicable tax rate is 40 percent, the company would record a tax benefit of $32 in the income statement ($80 × 40% tax rate).
8-05  Recharge Payments Made by Foreign Subsidiaries

Generally, a U.S. parent company is not entitled to a share-based compensation tax deduction (in the United States) for awards granted to employees of a foreign subsidiary. Likewise, for most jurisdictions, a foreign subsidiary that does not bear the cost of the compensation will not be able to deduct the award in the foreign jurisdiction. Accordingly, some arrangements may specify that a foreign subsidiary will make a “recharge payment” to the U.S. parent company that is equal to the intrinsic value of the stock options upon its exercise so that the foreign subsidiary is entitled to take a local tax deduction equal to the amount of the recharge payment. Under such an arrangement, the U.S. parent company is not taxed for the payment made by the foreign subsidiary.

Question

How does the “recharge payment” arrangement between the U.S. parent company and the foreign subsidiary impact the tax accounting under ASC 718?

Answer

At its July 21, 2005, meeting, the FASB Statement 123(R) Resource Group agreed that, in this case, the direct tax effects of share-based compensation awards should be accounted for under the ASC 718 income tax accounting model. Because the U.S. parent company does not receive a deduction in its U.S. tax return for awards granted to employees of the foreign subsidiary, DTAs and excess tax benefits and tax benefit deficiencies recorded by the foreign subsidiary in accordance with ASC 718 are measured by using the foreign subsidiary’s applicable tax rate. Any indirect effects of the recharge payment are not accounted for under ASC 718. For example, any benefit that the recharge payment may have on the accounting for the outside basis difference under ASC 740-30 (if earnings of the foreign subsidiary are not permanently reinvested) will be recognized in the income statement.

8-06  Impact of Research and Development Cost-Sharing Arrangements

The discussion document for the FASB Statement 123(R) Resource Group’s July 23, 2005, meeting states, in part:

Related companies that plan to share the cost of developing intangible property may choose to enter into what is called a cost-sharing agreement whereby one company bears certain expenses on behalf of another company and is reimbursed for those expenses. U.S. tax regulations specify the expenses that must be included in a pool of shared costs; such expenses include costs related to stock-based compensation awards granted in tax years beginning after August 26, 2003.

The tax regulations provide two methods for determining the amount and timing of share-based compensation that is to be included in the pool of shared costs: the “exercise method” and the “grant method.” Under the exercise method, the timing and amount of the allocated expense is based on the intrinsic value that the award has on the exercise date. Companies that elect to follow the grant method use grant-date fair values that are determined based on the amount of U.S. GAAP compensation costs that are to be included in a pool of shared costs. Companies must include such costs in U.S. taxable income regardless of whether the options are ultimately exercised by the holder and result in an actual U.S. tax deduction.

Question

How does a cost-sharing agreement affect a U.S. company’s accounting for the income tax effects of share-based compensation?

Answer

Companies should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election they have made or plan to make, the initial DTA and future excess amount.

The following example, reprinted from the FASB Statement 123(R) Resource Group’s July 23, 2005, meeting discussion document, illustrates the tax accounting for cost-sharing payments:

Company A, which is located in the United States, enters into a cost-sharing arrangement with its subsidiary, Company B, which is located in Switzerland. Under the arrangement, the two companies share costs associated with the research and development of certain technology. Company B reimburses Company A for 30 percent of the research-and-development costs incurred by Company A. The U.S. tax rate is 40 percent. Cumulative book compensation for a fully vested option is $100 for the year ending on December 31, 2006. The award is exercised during 2007, when the intrinsic value of the option is $150.

The tax accounting-impact is as follows:

Exercise method: On December 31, 2006, Company A records $28 as the deferred tax asset related to the option ($100 [book compensation expense] \times 70\% \text{ [percentage not subject to reimbursement]} \times 40\% \text{ [tax rate]}). When, in 2007, the option is exercised, any net tax benefit that exceeds the deferred tax asset is an excess tax benefit.
and credited to APIC. The company is entitled to a U.S. deduction (net of the inclusion) of $42 ($150 intrinsic value when the option is exercised) × 70% (percentage not reimbursed) × 40%). Accordingly, $14 ($42 – $28) would be recorded in APIC.

Grant method: The cost-sharing impact is an increase of currently payable U.S. taxes each period; however, in contrast to the exercise method, the cost-sharing method should have no direct impact on the carrying amount of the U.S. deferred tax asset related to share-based compensation. If there was $100 of stock-based compensation during 2006, the impact on the December 31, 2006, current tax provision would be $12 ($100 book compensation expense) × 30% (percentage reimbursed) × 40%). If the stock-based charge under [ASC 718] is considered a deductible temporary difference, a deferred tax asset also should be recorded in 2006 for the financial statement expense, in the amount of $40 ($100 book compensation expense) × 40%). The net impact on the 2006 income statement is a tax benefit of $28 ($40 – $12). At settlement, the excess tax deduction of $20 ($50 × 40%) would be recorded in APIC.

8-07 Interaction Between ASC 740 and 718-740-25-10

ASC 718-740-25-10 states the following:

A share option exercise may result in a tax deduction before the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable. [Emphasis added]

Therefore, if an excess tax benefit is not “realized” in accordance with ASC 718 a credit is not recorded in APIC and is not available to offset future tax benefit deficiencies. See Q&A 8-19 for additional guidance on applying ASC 718-740-25-10.

Question

Does the recognition of a liability for unrecognized tax benefits allow an unrealized excess tax benefit associated with share-based payment awards to become realized under ASC 718-740-25-10?

Answer

No. Unrecognized tax benefits recorded in connection with the application of ASC 740 represent an entity’s potential future obligation to the tax authority. The tax benefit related to the excess stock compensation deduction should not be recognized before the deduction reduces taxes that are actually payable. However, upon the disallowance of all or a portion of the tax position by the tax authority, taxes payable would increase, which may allow an entity to realize all or a portion of the excess tax benefit.

Example

At the beginning of 20X8, an entity has (1) $1,000 of off-balance-sheet excess tax benefit that has not been realized in accordance with ASC 718-740-25-10 and (2) a $500 liability for a tax position that did not meet the more-likely-than-not recognition criterion. During the year, the tax authority disallows the entire uncertain tax position. As a result of the disallowance of the tax position, the entity reclasses the liability to current taxes payable. As long as the entity does not have an NOL carryforward or another tax credit carryforward to offset the increased tax liability, the entity would realize $500 of the excess tax benefit by reducing taxes payable and increasing APIC.

8-08 Permanent Differences Related to an Exchange of Awards

The issuance of share-based awards can sometimes create permanent book-to-tax differences. One common example is an ISO award. (See Q&A 8-02 for more information about ISOs.) The entity will record compensation expense as the award is earned but will not receive a tax deduction upon the holder’s exercise of the award (a deduction will only result if the holder subsequently disposes of the shares). Since a deduction does not result from an exercise, the award is not considered to give rise to a tax deduction; thus, no DTA can be recognized and the resulting book expense is considered a permanent book-to-tax difference.

A permanent difference also may result from a business combination. To incentivize a key employee of an acquiree, an acquirer may permit or require that employee to surrender fully vested shares for nonvested shares (restricted stock award). In this situation, the employee may make an election under Section 83(b) of the IRC. The original restricted stock award resulted in a tax liability for the employee and a tax deduction for the acquiree on the
vesting date. Typically, the exchange is for equal value; therefore, the employee making the Section 83(b) election would not owe any additional tax on the exchange and would then pay more favorable capital gains tax on any appreciation when the shares are sold. Similarly, the employer would not get a tax deduction for the new award, even though it would recognize book compensation cost over the award’s vesting period.

For more information about a Section 83(b) election, see Q&A 8-15.

**Question**
How would the entity (the acquirer) account for the exchange if the employee makes the Section 83(b) election?

**Answer**
The entity (the acquirer) would continue to account for the grant of the new unvested stock in accordance with ASC 718. Therefore, compensation cost would be measured on the basis of the fair-value-based measure of the new restricted stock award and would be recognized over the remaining vesting period. However, since the employee made the Section 83(b) election and the predecessor company already received a deduction upon the vesting of the original award, the company would not receive a future tax deduction. Therefore, the recognition of the compensation expense for book purposes would result in a permanent difference that would affect the entity’s effective tax rate.

**8-09 Accounting for Excess Tax Benefits Included in a Net Operating Loss Carryforward Acquired in a Business Combination**

Under ASC 718-740-25-10, the tax benefit for an excess deduction that would otherwise be credited to APIC is not recognized until the tax benefit is realized (i.e. the excess deduction reduces taxes payable). This postponed recognition of APIC might occur, for example, when the excess deduction becomes part of a NOL carryforward.

**Question**
Does the prohibition in ASC 718-740-25-10 apply to NOL carryforwards acquired in a business combination if the NOL was due, in part, to excess tax benefits?

**Answer**
No. The prohibition in ASC 718-740-25-10 does not apply to excess tax benefits included in NOL carryforwards that are acquired in a business combination. At its July 21, 2005, meeting, the FASB Statement123(R) Resource Group concluded that in instances in which a business combination results in a new basis of accounting for financial reporting, the acquired company’s NOL carryforwards that resulted partly from the acquired company’s excess tax benefits would lose their “character” or “taint” after the acquisition and should be recorded in accordance with ASC 805.

This conclusion would not apply, however, to a transaction in which the assets acquired and liabilities assumed are recorded at historical cost, as in a combination of entities under common control or a spin-off. In such a case, the unrealized excess tax benefits do not lose their “character” or “taint” and must be recognized only when realized in accordance with ASC 718-740-25-10.

**8-10 Accounting for Income Taxes Related to Capitalized Share-Based Payment Compensation Cost**

**Question**
What is the appropriate accounting treatment for income taxes related to share-based compensation that is capitalized as part of an asset?

**Answer**
Under U.S. GAAP, compensation is capitalized for employees who spend time on production of inventory or construction of fixed assets. In accordance with ASC 718-740-25-2 (for instruments classified as equity) and ASC 718-740-25-4 (for instruments classified as liabilities), the “cumulative amount of compensation cost recognized for instruments . . . that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference.” ASC 718-740-25-2 and ASC 718-740-25-4 also highlight that any deductible temporary differences should be based on the recognized compensation cost and that, for financial reporting purposes, *capitalized* compensation cost should be considered part of the tax basis of the related asset.
Upon realizing a tax deduction for awards for which the related compensation cost was capitalized, a company should apply the same income tax accounting method it used for awards whose compensation costs were expensed when determining (1) excess tax benefits and shortfalls, (2) corresponding net income and APIC presentation, and (3) the impact of tax benefit shortfalls on the amount of previous net excess tax benefits (known as the “APIC pool”).

**Example**

In year 1, Company A grants nonqualified stock options to the employees involved in the construction of a fixed asset, resulting in the capitalization of $1,500 of share-based compensation cost. Other key facts include the following:

- The asset is placed into service at the beginning of year 2 and has a 10-year life.
- Awards are fully vested on the grant date.
- Company A will receive a tax deduction for the intrinsic value of the option when it is exercised.
- Company A’s tax rate is 40 percent, and the company has sufficient taxable income to realize the deduction.
- Employees exercise the options with an intrinsic value of $4,000 at the end of year 3.

**Journal Entry: Grant Date in Year 1**

On the grant date, the share-based compensation cost related to the NQSOs increases the carrying amount of A’s fixed asset under construction by $1,500. The offsetting entry is a credit to APIC.

\[
\begin{array}{c}
\text{Fixed asset} \\
\text{APIC}
\end{array}
\begin{array}{c}
1,500 \\
1,500
\end{array}
\]

In year 2, A records $150 of depreciation expense and has a $1,350 remaining book basis in the portion of the equipment’s carrying amount related to the share-based compensation cost. In accordance with ASC 718-740-25-2, A’s corresponding tax basis is presumed to be $1,500, which is not depreciated for tax-return purposes. As a result, A recognizes a $60 DTA: \([($1,500 \text{ tax basis} – $1,350 \text{ book basis}) \times 40\% \text{ tax rate}]\).

**Journal Entries: Year 2**

\[
\begin{array}{c}
\text{Depreciation expense (}$1,500/10$\text{)} \\
\text{Accumulated depreciation} \\
\text{DTA} \\
\text{Deferred tax expense}
\end{array}
\begin{array}{c}
150 \\
150 \\
60 \\
60
\end{array}
\]

In year 3, A first records an additional $150 of book depreciation expense and the corresponding DTA (in a manner similar to its year-2 accounting). As a result of the employees’ exercise of the options, A receives a tax deduction of $4,000. At this point, the tax basis of the options is zero and the book basis is $1,200; therefore, A records a $480 DTL ($1,200 \times 40\%). This DTL will be reduced as book depreciation continues to be recognized.

**Journal Entries: Year 3**

*Record Depreciation and DTA (Same as Year 2)*

\[
\begin{array}{c}
\text{Depreciation expense} \\
\text{Accumulated depreciation} \\
\text{DTA} \\
\text{Deferred tax expense}
\end{array}
\begin{array}{c}
150 \\
150 \\
60 \\
60
\end{array}
\]
When accounting for the impact of exercising the options, the company must (1) record a reduction in taxes payable of $1,600 resulting from the employees’ exercise of the options ($4,000 × 40%), (2) record a $600 reduction in current tax expense based on the grant-date fair value ($1,500 × 40%), and (3) increase the APIC pool by $1,000 for excess tax benefits associated with the excess $2,500 deduction ($2,500 × 40%). In addition, the company adjusts the DTA to eliminate the $120 accumulated through the end of year 2.

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<tr>
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<td>600</td>
</tr>
<tr>
<td>APIC</td>
<td>1,000</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>600</td>
</tr>
<tr>
<td>DTA (year 2 + year 3)</td>
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</tr>
<tr>
<td>DTL ($600 – total DTA)</td>
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</tr>
</tbody>
</table>

In years 4 through 11, A would continue to record depreciation expense. In addition, the company would reduce the DTL and record a corresponding deduction in the deferred tax expense over the same period.

**Journal Entries: Years 4 Through 11**

<table>
<thead>
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<th>Description</th>
<th>Amount</th>
</tr>
</thead>
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<tr>
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<td>Accumulated depreciation</td>
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</tr>
<tr>
<td>DTL</td>
<td>60</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>60</td>
</tr>
</tbody>
</table>

**Initial Measurement**

**ASC 718-740**

**30-1** The deferred tax benefit (or expense) that results from increases (or decreases) in the recognized share-based payment temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an award, shall be recognized in the income statement.

**30-2** Subtopic 740-10 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 718-740-25-2 through 25-3 and the tax deduction that would result based on the current fair value of the entity’s shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

**8-11 Measuring Deferred Tax Assets in Reference to the Current Stock Price**

**Question**

In assessing whether (1) a valuation allowance should be provided on DTAs relating to stock-based compensation cost or (2) the gross amount of the DTA should be adjusted, should the current price of the grantor’s stock be considered?

**Answer**

No. ASC 718-740-30-2 prohibits an entity from considering the current price of the grantor’s stock when assessing whether (1) a valuation allowance should be provided on a DTA related to stock-based compensation cost or (2) the gross amount of the DTA should be adjusted.
**Valuation Allowance**

As noted above, when an entity is evaluating the need for a valuation allowance, it should not consider the risk that the deduction will not be realized on the basis of current stock prices. Instead, the entity should apply the guidance in ASC 740-10-30-17 through 30-23 in assessing whether a valuation allowance is needed. That is, whether the entity needs to record a valuation allowance depends on whether it is more likely than not that there is sufficient taxable income to realize the DTA.

Therefore, even if the award is deep out-of-the-money such that its exercise is unlikely or the award’s intrinsic value on the exercise date is most likely less than its grant-date fair value, a valuation allowance should not be recorded unless or until it is more likely than not that future taxable income will not be sufficient to realize the related DTAs.

**Gross Deferred Tax Assets**

The gross DTA is computed on the basis of gross temporary difference (i.e., the cumulative amount of stock-based compensation cost recorded in the financial statements) and is not affected by the grantor’s current stock price. Gross DTAs should not be remeasured or written off because the stock price has declined so significantly that an award’s exercise is unlikely to occur or that the intrinsic value on the exercise date will most likely be less than the cumulative compensation cost recorded in the financial statements.

However, for share-based payment awards classified as liabilities, the measurement of the gross DTAs does implicitly take into account the grantor’s current stock price, since liability awards are remeasured at the end of each reporting period. The DTA resulting from compensation cost on liability awards would change as the fair-value-based measure of the award changes.

**Example**

On January 1, 20X6, an entity grants 1,000 “at-the-money” employee share options, each with a grant-date fair-value-based measure of $7. The awards vest at the end of the third year of service (cliff vesting), have an exercise price of $23, and expire after the fifth year from the grant date. The entity’s applicable tax rate is 40 percent. On December 31, 20Y0, the entity’s share price is $5. The entity has generated taxable income in the past and expects to continue to do so in the future.

In each reporting period, the entity would record compensation cost on the basis of the number of awards expected to vest, the grant-date fair-value-based measure of the award, and the amount of services rendered. Contemporaneously, a DTA would be recorded on the basis of the amount of compensation cost recorded and the entity’s applicable tax rate. On December 31, 20Y0, even though the likelihood that the employee will exercise the award is remote (i.e., the award is “deep out-of-the-money”) and the DTA therefore will not be realized, the entity would not be allowed to write off any part of the gross DTA or to provide a valuation allowance against the DTA until the award expires unexercised (January 1, 20Y1) (if there is sufficient future taxable income to realize that DTA). The entity would only be able to record a valuation allowance against the DTA when it is more likely than not that the entity will not generate sufficient taxable income to realize the DTA.

**Subsequent Measurement**

**ASC 718-740**

35-1 Section 718-740-30 addresses initial measurement issues related to share-based payment temporary differences. The requirements of that Section also apply to subsequent measurements of share-based payment temporary differences. The guidance in this Section is incremental to the guidance for initial measurement.

**Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost**

35-2 This Section addresses the accounting required when actual tax deductions for compensation expense taken by an entity on its tax return for share-based payment arrangements differ in amounts and timing from those recorded in the financial statements. This Section establishes the methodology for identifying those amounts and specifies different treatment for excess tax deductions as compared to deficiencies in tax deductions.

**Excess Tax Benefit**

35-3 If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

35-4 See Examples 1, Case A (paragraph 718-20-55-10); 8 (paragraph 718-20-55-71); 15, Case A (paragraph 718-20-55-123); and Example 1 (paragraph 718-30-55-1), which provide illustrations of accounting for the income tax effects of various awards.
**ASC 718-740 (continued)**

**Tax Deficiency**

35-5 The amount deductible for an award of equity instruments on the employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits arising from previous awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, and measured in accordance with a fair value based method of accounting.

35-6 An entity may have continued to use a permitted intrinsic value method to measure and recognize share-based payment awards after 1994 when the first fair value based method of accounting and disclosure for share-based payment awards was effective. Use of an intrinsic value method before the adoption of a fair value based method for recognition purposes may have resulted in amounts actually recorded as additional paid-in capital from excess tax benefits being different from amounts that would have been recorded had such awards been recognized based on their fair values.

35-7 An entity that continued to use the intrinsic value method for measuring and recognizing awards permitted prior to the requirements of this Subtopic shall calculate the amount available for offset as the net amount of excess tax benefits that would have qualified as such had it instead adopted the fair value based method of accounting used in the entity’s fair value disclosures for its intrinsic value based awards. In determining that amount, no distinction shall be made between excess tax benefits attributable to different types of equity awards, such as restricted shares or share options. An entity shall exclude from that amount excess tax benefits from share-based payment arrangements that are outside the scope of this Subtopic, excess tax benefits from employee stock ownership plans, and excess tax benefits that have not been realized pursuant to the requirements established in paragraph 718-740-25-10. See Examples 1, Case A (paragraph 718-20-55-10); 8 (paragraph 718-20-55-7); 15, Case A (paragraph 718-20-55-123); and Example 1 (paragraph 718-30-55-1), which provide illustrations of accounting for the income tax effects of various awards.

35-8 An alternative method for determining the amount available for offset by entities that had continued to use the intrinsic value method for measurement and recognition of awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, was available for a limited period of time when entities were required to change to the fair value based method of accounting for share-based payment transactions. Paragraph 718-740-45-4 addresses the accounting for any deficiency remaining after the offset to additional paid-in capital has exhausted any available excess tax benefits.

### 8-12 Basic Income Tax Effects of Share-Based Payment Awards

**Question**

How does an entity recognize the income tax effects related to share-based payment awards?

**Answer**

ASC 718-740-25-2 explains that the “cumulative amount of compensation cost recognized for [awards] that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying [ASC 740].” Accordingly, for such awards, DTAs and related tax benefits are recognized as the related compensation cost is recognized. Further, under ASC 718-740-05-4, “tax deductions [for equity-classified awards] may arise in different amounts and in different periods from compensation cost recognized in financial statements.” An award’s excess tax benefits are recorded as an increase (credit) to paid-in capital (excess benefits arise when the ultimate tax deduction is greater than recorded book expense). Tax benefit deficiencies (which occur when the book expense is greater than the ultimate tax deduction) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the “APIC pool”). In the absence of an APIC pool, tax benefit deficiencies must be recorded as an expense in the income statement in the period of the tax deduction. This discussion and the following example both assume that any excess tax benefit has been “realized,” as described in ASC 718-740-25-10.

**Example**

A company grants to its employees 1,000 “at-the-money” nonqualified stock options, each of which has a grant-date fair-value-based measure of $1. The awards vest at the end of the fourth year of service (cliff vesting). The company’s applicable tax rate is 40 percent. As the $1,000 (1,000 awards × $1 fair-value-based measure) of compensation cost is recognized over the service period, the company records a DTA in accordance with ASC 740; this DTA is equal to the book compensation cost multiplied by the corporation’s applicable tax rate. Assume no forfeitures.

If the tax deduction1 on exercise is greater than the $1,000 of compensation cost (e.g., $1,200), the excess benefit is credited to equity.

---

1 The tax deduction is computed as the difference between the company’s share price on the date of exercise and the exercise price stated in the award, multiplied by the number of options awarded.
If the tax deduction is less than the $1,000 of compensation cost (e.g., $800), the accounting for the deficiency (i.e., the amount of the DTA in excess of the actual tax benefit) will depend on the existence of an APIC pool. If a sufficient APIC pool exists, the shortfall is recorded as a reduction to paid-in capital. However, if the APIC pool is insufficient, the shortfall is recorded as an increase to current-period income tax expense.

**Journal Entry: Upon Exercise of Options (Assuming Sufficient APIC Pool Credits)**

```
Deferred tax expense 320
APIC 80
DTA 400
To reverse the DTA and record the tax benefit deficiency in APIC ($320 – $400).
```

If the APIC pool is insufficient, the shortfall is recognized as a current period tax expense in the period in which the award either results in a tax deduction on the tax return or expires unexercised. ASC 718-740-30-2 precludes recognition of that shortfall in earlier periods either through an adjustment to the deductible temporary difference (remains at $1,000 in the example) or through a valuation allowance.

**8-13 Tax Effects of Awards With Graded Vesting**

As discussed in ASC 718-10-35-8, an entity makes a policy decision about whether to recognize compensation cost for its share-based payment awards with only service conditions that have a graded vesting schedule on either (1) an accelerated basis (i.e., as though each separately vesting portion of the award was, in substance, a separate award) or (2) a straight-line basis over the total requisite service period for the entire award. See Q&A 4-08 and Q&A 4-10 for additional information.

**Question**

Does an entity’s policy decision about the recognition of compensation cost for a share-based payment award with only service conditions that have a graded vesting schedule affect the recognition of the DTA for that award?

**Answer**

Yes. There has been confusion about whether ASC 718-20-55-34 prohibits the use of the straight-line method to recognize the tax effects of stock-based compensation cost (i.e., compensation cost could be recognized on a straight-line basis over the total requisite service period for the entire award but the tax effects must be recognized on an accelerated basis). Informal discussions with the FASB staff have indicated that the method of recognizing the DTA should be consistent with the method of recognizing compensation cost. That is, if an entity elects to recognize compensation cost on a straight-line basis, the recognition of the DTA should also be recognized on a straight-line basis.

**8-14 Recognizing Income Tax Effects on an Award-by-Award Basis**

At any given time, an entity may have awards outstanding that relate to different grants that have occurred at different points in time. Thus, an entity’s DTA associated with stock-based compensation will be composed of DTAs related to grants of awards with different exercise prices and different grant-date fair-value-based measures.

**Question**

When determining whether or how much of an excess tax benefit or tax benefit deficiency exists, does the employer consider only the individual awards exercised, or does the employer consider the entire pool of outstanding awards as of the date of exercise?

**Answer**

An entity should determine whether the exercise of an award creates an excess tax benefit or tax benefit deficiency on an award-by-award basis. That is, the DTA that is “relieved” from the balance sheet when an award is exercised should be the amount that relates to that award only. Since the accounting is on an award-by-award basis, the entity should not consider the tax consequences related to other awards that have not yet been exercised in accounting for the income tax effects of awards that are exercised. Furthermore, when a portion of an award is exercised, only the portion of the DTA that relates to the portion of the award that was exercised should be relieved from the balance sheet.
Therefore, it is important for a company to keep track of the source of the different components of its DTA balance related to each share-based payment award.

**Example**

Assume the following:

- In 20X6, a company grants three separate awards of “at-the-money” fully vested employee share options, which are nonqualified stock options.
- All of the awards expire on December 31, 20Y5.
- These awards are the company’s only grants.
- The company’s applicable tax rate is 40 percent.

The following table contains more specific information about the three awards:

<table>
<thead>
<tr>
<th>Number of Options</th>
<th>Grant Date</th>
<th>Exercise Price (per Option)</th>
<th>Grant-Date Fair-Value-Based Measure (per Option)</th>
<th>Compensation Cost Recorded</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>February 1, 20X6</td>
<td>$16</td>
<td>$2</td>
<td>$200</td>
</tr>
<tr>
<td>100</td>
<td>April 1, 20X6</td>
<td>13</td>
<td>3</td>
<td>300</td>
</tr>
<tr>
<td>100</td>
<td>May 1, 20X6</td>
<td>10</td>
<td>4</td>
<td>400</td>
</tr>
</tbody>
</table>

On June 1, 20X6, the company’s deferred tax balance related to stock-based compensation is $360 ([$200 + $300 + $400] × 40% tax rate). On June 10, 20X6, 75 of the 100 options that were granted on April 1, 20X6, were exercised and the stock price of the company was $20 per share. The deduction the company would claim on its tax return would be $525 ([$20 fair value on date of exercise − $13 exercise price] × 75 options exercised). This will create an excess tax benefit of $120, computed as follows:

| Deduction for tax purposes | $525 |
| Grant-date fair-value-based measure (275 × 75 options exercised) | $(225) |
| Excess deduction | $300 |
| Applicable tax rate | 40% |
| Excess tax benefit | $120 |

The journal entries to record the income tax effect of the exercise of the stock option on June 10, 20X6, would be as follows:

**Journal Entries: Upon Exercise of Options**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td>210</td>
<td></td>
<td>To adjust taxes payable and current tax expense for the stock option deduction ($525 × 40%).</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>210</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>90</td>
<td>DTA</td>
<td>To reverse the DTA ($225 × 40%).</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>120</td>
<td>APIC</td>
<td>To record excess tax benefit in APIC ($210 − $90).</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Therefore, the company’s DTA balance would be $270 ($360 − $90) immediately after the exercise of the option for 75 shares.
Chapter 8 — Income Taxes
A Roadmap to Accounting for Share-Based Payment Awards

8-15 Income Tax Effects of “Early Exercise” of Awards

Under Section 83(b) of the IRC, an employee who receives nonvested stock may, within 30 days after the grant, choose to “early exercise” the award. Early exercise refers to an employee’s election to include in ordinary income the value of the stock as of the grant date, resulting in the employee’s deemed ownership, for tax purposes, of the shares received. Therefore, any subsequent appreciation realized by the employee upon sale of those shares is taxed at capital gains rates. When an employee chooses to early exercise the award, the employer (in the year of early exercise) receives a tax deduction for the value of the stock on the grant date.

Question
How should the income tax effects of an early exercise under Section 83(b) be accounted for?

Answer
When an employee elects to early exercise an award, a DTL should be recorded for the amount of the tax benefit based on the tax deduction that the employer will receive from the award. The DTL is reduced in proportion to the amount of book compensation that is being recognized over the subsequent requisite service period.

8-16 Measuring the Excess Tax Benefit Associated With Share-Based Compensation: Tax Credits and Other Items That Affect the Effective Tax Rate

Entities may receive tax credits or deductions for qualifying expenditures, which often include employee share-based compensation costs (e.g., the research and experimentation credit and the domestic manufacturing deduction) that lower the entity’s effective tax rate and can affect the determination of the “excess tax benefit” or “tax benefit deficiency” that must be accounted for under ASC 718-740-35-3 through 35-9. Accordingly, the excess tax benefit or deficiency of a share-based compensation deduction may differ from the amount computed on the basis of the applicable jurisdiction’s statutory tax rate multiplied by the excess or deficiency of the tax compensation deduction over an award’s corresponding compensation costs recognized for financial reporting purposes (e.g., “direct tax effects”).

Question
Under ASC 718, how should an entity determine the excess tax benefits or deficiencies required to be accounted for under ASC 718-740-35-3 through 35-9?

Answer
Under U.S. GAAP, there are several acceptable approaches to determining the excess tax benefits or deficiencies that must be accounted for under ASC 718-740-35-3 through 35-9. One acceptable approach is to only consider the direct tax effects of the share-based compensation deduction. Under this approach, an entity would multiply its applicable income tax rate, as described in ASC 740-10-30-8, by the amount of cumulative share-based compensation cost and the deduction reported on a tax return to determine the amount of the DTA and the actual tax benefit, respectively. The income tax rate for each award should be computed on the basis of the rates applicable in each tax jurisdiction, as appropriate.

Under this approach, the indirect effects of the deduction are not considered. The actual tax benefit is computed by multiplying the tax deduction by the applicable income tax rate in effect in the period in which the award is settled, which, in the absence of a change in enacted tax rate or tax law, would generally equal the rate used when the associated DTA was recognized (e.g., the jurisdiction’s statutory tax rate).

A second acceptable approach would be to perform a full ASC 740 “with-and-without” computation. Under this approach, the entire incremental tax effect of the actual tax deduction would be compared with the entire incremental tax effect of the cumulative amount of compensation cost recognized for book purposes as if it were the actual tax deduction. The difference would be the amount of excess tax benefit or tax benefit deficiency.

A third acceptable alternative would be to compare the entire incremental tax effect of the actual tax deduction with the DTA recognized to determine the excess tax benefit or tax benefit deficiency.

Use of one of the approaches described above to measure the excess tax benefit or tax benefit deficiency constitutes an accounting policy that should be applied consistently to all awards and related tax effects. If an entity applied a different approach before adopting Statement 123(R) (as codified in ASC 718), it may, upon and as part of this adoption, elect to use one of the above approaches.
Chapter 8 — Income Taxes
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8-17 Change in Tax Rates

**Question**
How should enacted changes in a tax rate affect the deferred taxes related to temporary differences arising from tax-deductible share-based payment awards?

**Answer**
A DTA is adjusted in the period in which the change in the applicable tax rate is enacted into law. To determine the amount of the new DTA, an entity should multiply the new tax rate by the existing temporary difference for outstanding tax-deductible share-based payment awards measured as of the enactment date of the rate change. The difference between the new DTA and the existing DTA should be recorded as a deferred tax benefit or expense and allocated to income from continuing operations.

8-18 Amounts Included in the Excess Tax Benefits Available for Offset (“APIC Pool”)

To the extent that previous net excess tax benefits exist (often referred to as the “APIC pool”), tax benefit “deficiencies” or “shortfalls” (i.e., the book expense is greater than the ultimate tax deduction) are recorded as a decrease to paid-in capital, bypassing the income statement.

**Question**
Upon adoption of Statement 123(R) (as codified in ASC 718), what amounts included in a company’s net excess tax benefits are available for offset against tax benefit deficiencies (i.e., the APIC pool)?

**Answer**
Upon adoption of Statement 123(R) (as codified in ASC 718), amounts included in a company’s APIC pool are determined in accordance with paragraph 81 of Statement 123(R). Further, upon adopting this standard, a company that uses the modified prospective or modified retrospective application method should include in its APIC pool any excess tax benefits from awards that would have been accounted for under the fair-value-based method (i.e., issued, modified, repurchased, or canceled after the effective date of Statement 123), regardless of whether the company has been applying the recognition provisions of Opinion 25 or Statement 123. (Entities that have adopted Statement 123(R) prospectively should refer to Q&A 8-28.) In computing its APIC pool after adopting Statement 123(R) (as codified in ASC 718), a company should be careful to (1) include all excess tax benefits of Statement 123 and Statement 123(R) (as codified in ASC 718) equity awards (e.g., nonvested shares, restricted shares, and stock options), (2) exclude excess tax benefits from awards that are outside of the scope of Statement 123(R) (as codified in ASC 718) (e.g., ESOPs), and (3) exclude excess tax benefits that have not been realized in accordance with ASC 740. (See ASC 718-740-25-10 for more information.)

Since the issuance of Statement 123, companies have been reporting the income tax effects (i.e., the excess tax benefits and tax benefit deficiencies) of their share-based payment awards for either recognition or pro forma disclosure purposes. Given that the amounts included in the APIC pool are an outgrowth of the reported tax effects, an entity should have been able to obtain the amounts that make up the APIC pool by referring back to prior Statement 123 disclosure calculations, prior tax filings, or both. However, for companies that previously may have been recognizing excess tax benefits before their realization, paragraph 81 of Statement 123(R) indicates such amounts should be reduced from their APIC pool.

On November 10, 2005, the FASB issued FSP FAS 123(R)-3, which allowed a company to elect to apply a simplified method, rather than the provisions of Statement 123(R), to compute its transition APIC pool upon adopting this statement. Paragraph 81 of Statement 123(R) stated, that “an entity shall include as available for offset only the net excess tax benefits that would have qualified . . . had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994.”

8-19 Realization of Excess Tax Benefits

ASC 718-740-25-10 states:

> A share option exercise may result in a tax deduction before the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable. [Emphasis added]
Therefore, if an excess tax benefit is not "realized" in accordance with ASC 718, a credit is not recorded in APIC and is not available to offset future tax benefit deficiencies. Questions about when an excess tax benefit is realized and about what is meant by "until that deduction reduces taxes payable," have arisen in practice.

**Question**

When is an excess tax benefit "realized" for the purposes of applying ASC 718?

**Answer**

At its September 13, 2005, meeting, the FASB Statement 123(R) Resource Group discussed this issue and identified two broad methods that would be acceptable for determining when excess tax benefits have been realized. As an accounting policy decision, entities should select a method to use upon adopting Statement 123(R) (as codified in ASC 718) and should apply the method consistently. The two broad methods identified can be described as follows.

**Tax-Law-Ordering Approach**

Entities may choose to determine when an excess tax benefit has been realized on the basis of the ordering provisions of the tax law. Accordingly, an excess tax benefit is considered realized when it has been used for tax purposes (i.e., generally in the year in which it reduces taxable income). When an entity cannot determine ordering in accordance with the tax law, the entity may determine realization of excess tax benefits on a pro rata basis.

**With-and-Without Approach**

In a manner consistent with the intraperiod allocation guidance in ASC 740-20-45, entities may choose a “with-and-without” approach to determine when an excess tax benefit has been realized.

Under this approach, an excess tax benefit is realized when the excess share-based compensation deduction provides the entity with an incremental benefit by reducing the current-year taxes payable that it otherwise would have had to pay in the absence of the share-based compensation deduction. For example, when an entity has NOL carryforwards that are sufficient to offset taxable income (before the effect of share-based compensation deductions is factored in), the excess tax benefit has not yet provided the entity with an incremental benefit (since, had the share-based compensation deduction not been taken in the tax return, the entity would have had enough loss carryforwards to reduce any income tax liability to zero). Accordingly, under a with-and-without approach, share-based compensation deductions are, effectively, always considered last to be realized.

**Example**

An entity generates taxable income of $100 before factoring in the effect of the excess stock option deduction of $20. The entity also has NOL carryforwards in the amount of $10,000 (i.e., in excess of the current-year taxable income before the stock option deduction) that are available to reduce taxable income. The excess stock deduction reduces the entity’s current-year taxable income to $80. Of the entity’s NOL carryforwards, $80 is used to reduce the remaining current-year taxable income to zero.

Under a tax-law-ordering approach, the excess tax benefit associated with the $20 excess stock deduction would be considered "realized." This is because the stock option deduction has been reported in the tax return and reduces the entity’s current-year taxable income that it otherwise would have had to pay tax on. Because the excess tax benefit is considered "realized" under this approach, the excess tax benefit would be recorded as a reduction of taxes payable, with a corresponding increase to APIC and would be available to offset future tax benefit deficiencies.

Under a with-and-without approach, the excess tax benefit would not be considered "realized." This is because the entity would not have had to pay taxes even if the stock option deduction was not taken (because it has sufficient NOL carryforwards to reduce taxable income anyway). Therefore, under this approach, the benefit associated with the excess stock option deduction would not be recorded in APIC.

**8-20 Tax Effects of Expiration of an Award**

**Question**

What is the accounting impact on the DTA recorded relating to a nonstatutory award that has expired unexercised?
When a nonstatutory award has expired unexercised, the tax effects are accounted for as if the tax deduction taken is zero. Thus, the DTA recorded in the financial statements would be reduced to zero through a reduction of APIC to the extent that a sufficient APIC pool exists. The excess of the DTA over the APIC pool would be recorded as tax expense in the income statement. See ASC 718-20-55-23 for more information and an illustration.

Example
A company grants 1,000 “at-the-money” fully vested nonstatutory share options, each of which has a grant-date fair-value-based measure of $4. The company’s applicable tax rate is 40 percent. Further assume that no valuation allowance has been established for the DTA and that the awards subsequently expire unexercised. On the expiration date, the company’s APIC pool is $1,000. The company would record the following journal entries:

| Journal Entries: Upon Grant |  |
|----------------------------|  |
| Compensation cost          | 4,000 |
| APIC                       | 4,000 |
| To record compensation cost upon the grant of the award. |
| DTA                        | 1,600 |
| Income tax expense         | 1,600 |
| To record the tax effects upon the grant of the award. |
| APIC                       | 1,000 |
| Income tax expense         | 600 |
| DTA                        | 1,600 |
| To record the tax effects for a nonstatutory award that has expired unexercised. |

8-21 Combining Employee and Nonemployee APIC Pools

Question
Can excess tax benefits (APIC pools) created by exercises of share-based payment awards granted to employees be combined with APIC pools created by exercises of share-based payment awards granted to nonemployees?

Answer
Yes. APIC pools created by exercises of nonemployee awards can be used to offset tax benefit deficiencies arising from exercises of awards granted to employees and vice versa.

8-22 Effect of Acquisitions, Sales, Spin-Offs, and Investments in Equity Method Investees on the APIC Pool — Parent-Company Awards

It is acceptable to include in the APIC pool, at the consolidated-entity level, the excess tax benefits from awards granted by the parent company to employees of all companies that are included in the consolidated financial statements. Accordingly, questions have arisen about the impact of acquisitions and sales of businesses, spin-off transactions, and investments in equity method investees on the calculation of a company’s APIC pool. The following paragraphs discuss the effect of each of these transactions on the determination of the APIC pool:

Question
When parent-company equity awards are issued, what effects do acquisitions and sales of businesses, spin-off transactions, and investments in equity method investees have on the consolidated entity’s APIC pool?

Answer

Business Combinations

Acquisition method — When a business combination is accounted for under the acquisition method, the acquired entity becomes a new reporting entity with a zero APIC pool as of the acquisition date. The acquired entity’s excess tax benefits recognized before the acquisition are not available to offset future tax benefit shortfalls at the parent level (or the target level, if the parent’s basis is pushed down).
Pooling-of-interests method — Before the issuance of Statement 141, an entity that used the pooling-of-interests method to account for a business combination added the APIC pool of both entities in determining the combined entity’s APIC pool. Accordingly, in determining the historical amounts to be included in a company’s APIC pool upon adoption of Statement 123(R) (as codified in ASC 718), an entity should consider the impact of historical pooling transactions in assessing the amount of excess tax benefits available to offset future tax benefit shortfalls. (Note that the pooling-of-interests method still applies to combinations of businesses under common control.)

Sales of Subsidiaries
When a subsidiary is sold, any existing excess tax benefit related to awards granted in the parent company’s equity should continue to be included in the consolidated APIC pool.

Spin-Offs
One acceptable view is that the APIC pool created before the spin-off “follows the employee.” For example, assume that a subsidiary is spun off by the parent company. Excess tax benefits resulting from exercises in the parent’s equity, exercised by the spinnee’s (i.e., subsidiary’s) employees before the spin-off, may be allocated to the spinnee as of the date of the spin-off. Under this approach, excess tax benefits created by exercises made by employees who are not spinnee employees should not be allocated to the spinnee as of the date of the spin-off.

An alternative view is that excess tax benefits (APIC pool) created before the spin-off follow the entity that issued the equity awards. That is, none of the APIC pool created before the spin-off by awards that are based on parent-company (spinnor) equity awards is allocated to the spinnee. Accordingly, the spinnee’s APIC pool, as of the date of the spin-off, would be zero if all awards were based on the stock of the parent.

Equity Method Investees
Excess tax benefits of an equity method investee (both those created by exercises of an equity method investee’s equity awards and those created by exercises of the investor’s equity awards granted to employees of the equity method investee) should not be included in the consolidated APIC pool.

8-23 Computing the APIC Pool Impact in Interim Financial Statements
Under ASC 718, the write-off of a DTA, net of the related valuation allowance, is first offset to APIC to the extent that the entity has a sufficient “APIC pool.” (See Q&A 8-18 for a discussion of the APIC pool calculation.)

The remaining balance, if any, of the write-off of a DTA related to a tax deficiency is recognized in the income statement.

Question
In determining the amount of tax benefit deficiencies that are recognized in the income statement, can an excess tax benefit that results from subsequent option exercises be used to offset previous tax benefit deficiencies?

Answer
Tax benefit deficiencies that are recognized in the income statement (because of a lack of sufficient APIC pool credits) can only be subsequently reversed if sufficient excess benefits are generated within the same fiscal year. This issue was discussed by the FASB Statement 123(R) Resource Group at its July 21, 2005, meeting. Resource Group members agreed that an acceptable approach would be to consider the APIC pool adjustment as an annual calculation (versus a daily, weekly, or quarterly adjustment). Under this approach, a “tax benefit deficiency” (and the related charge against income) occurring in one quarter can be offset and reversed in a subsequent quarter (within the same fiscal year) if, in that subsequent quarter, a realized excess tax benefit arises that is large enough to absorb the previous deficiency.

For interim reporting purposes, if a tax benefit deficiency occurs in an interim period before the interim period in which the excess tax benefit is realized, the income tax expense recorded for the previous deficiency would be reversed as income tax benefit in the subsequent interim period in which the excess occurred (provided that realization of such an excess deduction is also expected within the year). The entire impact of tax benefit excesses and deficiencies should be accounted for in the respective interim period in which they occur. (That is, they should be treated as discrete items.) See Q&A 8-24 for guidance on whether an entity should anticipate future transactions when estimating an annual effective tax rate for interim reporting purposes.
Example 1
Assume that a company’s APIC pool balance is zero as of January 1, 20X6, the beginning of the fiscal year and the date of adoption of Statement 123(R) (as codified in ASC 718). On January 15, 20X6, a stock option is exercised and results in a tax benefit deficiency of $80, but on January 20, 20X6, a stock option is exercised and results in an excess tax benefit of $100. If it is assumed that these were the only stock option exercises during the year, it would be acceptable for the company to increase its APIC pool by $20 during that year (rather than to record income tax expense of $80 and to increase APIC pool by $100).

Example 2
Assume the same facts as in Example 1 above, except that the second exercise of stock options occurs on April 20, 20X6, instead of on January 20, 20X6. In the quarter ended March 31, 20X6, the company would record an income tax expense in the amount of $80 for the tax benefit deficiency. In the quarter ended June 30, 20X6, it would be acceptable for the company to record an income tax benefit of $80 (reversing the prior deficiency recognized in the income statement) and a $20 increase to paid-in capital. Only the $20 would be available to offset future deficiencies.

8-24 Interim Financial Statements — Anticipating the Tax Effects of Share-Based Payment Awards

Question
Can the income tax effects of anticipated share-based payment transactions (e.g., employee exercises of stock options) be estimated for the purposes of calculating the AETR expected to be applicable for the full fiscal year, for interim reporting purposes?

Answer
No. The effects of expected future excesses and deficiencies should not be anticipated since the exercise and share prices on the exercise date are outside the entity’s control. The tax effects of the expected compensation expense should be included in the AETR.

Example 1
If, in the first quarter, an exercise of stock options results in a tax benefit deficiency, but it is anticipated that in the second quarter a large excess tax benefit will result, an entity should still record an income tax expense related to the tax benefit deficiency in the first quarter. In the second quarter, if an excess tax benefit does result, then the income tax expense recorded in the first quarter resulting from the deficiency can be reversed as income tax benefit. See Q&A 8-23 for a discussion of the computation of the APIC pool on an annual basis.

Example 2
If share-based payment awards are expected to expire unexercised in the second quarter because they are “deep out of the money,” an entity should not consider the anticipated income tax expense as a result of the write-off of the related DTAs when estimating the AETR to compute the tax provision for the first quarter. Instead, the income tax expense related to the write-off of the DTA upon expiration of an award should be recorded in the period the awards expire unexercised (if APIC pool is insufficient to offset the deficiency). The effect of the deficiency on the income statement should be recorded in the period in which it occurs and should not be spread over future interim periods.

8-25 Recording Tax Benefits of Awards Granted Before the Adoption of Statement 123(R)

An entity may use the MPA method to adopt Statement 123(R) (as codified in ASC 718). In such situations, the grant date and exercise date of an award may “straddle” the adoption date. That is, the grant date occurs before the adoption of Statement 123(R) (as codified in ASC 718), all or a portion of the award is vested before adoption, and the award is exercised after the adoption of Statement 123(R) (as codified in ASC 718).

Under the MPA method, awards that were granted before the adoption of Statement 123(R) (as codified in ASC 718) would have been accounted for under Opinion 25. Such accounting may not have resulted in recognition of compensation cost in the financial statements. Accordingly, a DTA and tax benefit would not have been recognized over the vesting period before the adoption of Statement 123(R) (as codified in ASC 718) to the extent that compensation cost was not recognized under Opinion 25.
**Question**
How should the tax benefit resulting from the exercise of options be recorded when the full corresponding DTA does not exist because Statement 123(R) (as codified in ASC 718) was adopted using the MPA method?

**Answer**
When the MPA method was used to adopt Statement 123(R) (as codified in ASC 718), the recognition of the tax benefit resulting from the exercise of options will depend on whether the award was fully or partially vested at adoption.

If the award was fully vested, the entire tax benefit should be recorded as a credit to APIC. If the award was partially vested and there is an excess tax benefit, a portion of the reduction in taxes payable is offset by the reversal of the DTA that was recorded after adoption of Statement 123(R) (as codified in ASC 718). The remainder is recorded as a credit to APIC; however, this credit does not increase the APIC pool.

If the award was partially vested and there is a tax benefit deficiency, the portion of the award that was vested before and after adoption should be analyzed separately. On the basis of the proportion of compensation cost recognized after adoption of Statement 123(R) (as codified in ASC 718) (compared with the total fair-value-based measure of the award), an entity records a portion of the tax benefit deficiency in APIC to the extent that the APIC pool is sufficient; the remainder is recorded as income tax expense in accordance with ASC 718-740-45-4. The portion of the reduction in taxes payable that is associated with compensation cost reflected in the pro forma disclosures for periods before adoption should be recorded as a credit to APIC. However, the entire tax benefit deficiency reduces the APIC pool. For a discussion of the amounts available to offset future tax deficiencies and related examples, see **Q&A 8-26**.

**8-26 Effect on the APIC Pool When the Full Corresponding Deferred Tax Asset Does Not Exist Upon Exercise**

**Question**
For awards granted before and exercised after the effective date of Statement 123(R) (as codified in ASC 718) (as described in **Q&A 8-25**), the amount of the excess tax benefit is credited to APIC. How much of the excess tax benefit credited to APIC is available to offset future tax deficiencies?

**Answer**
It depends on whether the entity has elected to use the simplified method of calculating its APIC pool described in FSP FAS 123(R)-3, and, if so, whether the award is fully vested or partially vested as of the adoption of Statement 123(R) (as codified in ASC 718).

**If the Simplified Method Is Not Elected**
In determining the excess tax benefits available to offset future write-offs of DTAs (APIC pool), an entity that has not elected the simplified method should use only the realized tax benefit of the excess of (1) the tax deduction over (2) the cumulative compensation cost for financial reporting purposes, including amounts reflected in the pro forma disclosures. This would be the same amount as if the company had elected to use the modified retrospective method of adoption and had restated prior periods (i.e., the APIC pool calculated as if Statement 123 had been applied since its required effective date).

Therefore, if the deduction claimed in the tax return was greater than compensation cost for financial reporting purposes, only a portion of the tax benefit recorded as a credit to APIC may offset tax benefit deficiencies that arise in the future. If the deduction claimed in the tax return was less than compensation cost for financial reporting purposes, no amounts from that exercise would be available to offset future tax benefit deficiencies; instead, the entity’s APIC pool would be reduced by the deficiency.

This will result in some amounts being recorded in APIC that, although they relate to a reduction of taxes payable due to the exercise of share-based payment awards, will never be used to offset future tax benefit deficiencies.
If the Simplified Method Is Elected

If the simplified method under FSP FAS 123(R)-3 is elected, the increase in the APIC pool depends on whether the award was fully vested or partially vested upon adoption of Statement 123(R) (as codified in ASC 718). For an award that was fully vested upon adoption, paragraph 6 of FSP FAS 123(R)-3 explains that the entire amount recorded as a credit to equity increases the APIC pool. For an award that was partially vested upon adoption, paragraph 7 of FSP FAS 123(R)-3 explains that the increase in the APIC pool is computed in the same way as if the simplified method had not been elected, as described above. That is, the tax effect of the excess of (1) the tax deduction over (2) cumulative compensation cost for financial reporting purposes, including amounts reflected in the pro forma disclosures, increases the APIC pool, and the tax effect of any deficiencies reduces the APIC pool.

Example 1 — Fully Vested Award at Adoption

On March 31, 20X5, a company grants 1,000 “at-the-money” fully vested employee share options, which are NQSOs, each of the options has a grant-date fair-value-based measure of $4. The options are classified as equity awards. The company’s applicable tax rate is 40 percent. On March 31, 20X5, the company was still accounting for its share-based payment awards in accordance with Opinion 25 and therefore recorded no compensation cost in its financial statements.

The company uses the MPA method to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6. On September 30, 2006, all of the stock options are exercised. In the period of exercise, the deduction taken on the company’s tax return is $5,000 (the intrinsic value of the award on the exercise date).

The journal entries on the exercise date to record the income tax effects of the exercise would appear as follows:

<table>
<thead>
<tr>
<th>Journal Entries</th>
<th>2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td>2,000</td>
</tr>
<tr>
<td>Current tax expense</td>
<td></td>
</tr>
<tr>
<td>To adjust taxes payable and current tax expense for</td>
<td></td>
</tr>
<tr>
<td>the stock option deduction</td>
<td></td>
</tr>
<tr>
<td>($5,000 × 40%).</td>
<td></td>
</tr>
<tr>
<td>Current tax expense</td>
<td>2,000</td>
</tr>
<tr>
<td>APIC</td>
<td></td>
</tr>
<tr>
<td>To record entire tax benefit in APIC.</td>
<td></td>
</tr>
</tbody>
</table>

If the simplified method was not elected, of the $2,000 credited to APIC, only $400 [(5,000 tax deduction – $4,000 compensation cost recognized for Statement 123 pro forma disclosure purposes) × 40% tax rate] can be used to offset future tax benefit deficiencies (i.e., the company’s APIC pool is increased by only $400).

If the simplified method was not elected and the deduction taken in the company’s tax return was, instead, only $3,000 (i.e., an amount less than the compensation cost reflected in the pro forma disclosures), the company’s Statement 123(R) (as codified in ASC 718) APIC pool would be reduced by $400 [(3,000 – 4,000) × 40%], but only to the extent that it does not reduce the APIC pool to below zero.

If the simplified method was elected, the entire $2,000 credited to APIC increases the company’s APIC pool. If the simplified method was elected and the tax deduction was $3,000, the resulting $1,200 reduction in taxes payable credited to APIC would increase the company’s APIC pool.

Example 2 — Partially Vested Award With Excess Tax Benefit

A company grants stock options to an employee on April 1, 20X5. The options have a grant-date fair-value-based measure of $4,000, cliff vest on March 31, 20X6, and are classified as equity awards. The company uses the MPA method to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6. Therefore, the stock options are 75 percent vested upon adoption. Accordingly, after adoption the company records $1,000 of compensation cost and $400 of deferred tax benefit in 20X6 (if a 40 percent tax rate is assumed).
The exercise of the award gives the company a tax deduction of $5,000, resulting in a tax benefit of $2,000. The company records the following journal entries on the exercise date to reflect the income tax effects of the exercise:

**Journal Entries**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Current tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To adjust taxes payable and current tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>for the stock option deduction ($5,000 × 40%).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To reverse the DTA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current tax expense</td>
<td>1,600</td>
<td>1,600</td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record excess tax benefit in APIC</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Only $400 ($2,000 tax benefit less $1,600 total DTA (sum of accrual plus pro forma DTA)) increases the company’s APIC pool (regardless of whether the simplified method was elected or not since the award was partially vested at adoption).

**Example 3 — Partially Vested Award With Tax Benefit Deficiency**

Assume the same facts as in Example 2, except that the tax deduction resulting from exercise of the award is $3,000 compared with a grant-date fair-value-based measure of $4,000 (i.e., a tax benefit of $1,200 compared with a total deferred tax benefit of $1,600).

The company would record the following journal entries on the exercise date to reflect the income tax effects of the exercise:

**Journal Entries**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td>Current tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To adjust taxes payable and current tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>for the stock option deduction ($3,000 × 40%).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To reverse the DTA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current tax expense</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record the effect of the partially vested shares. (The total benefit of $1,200 is reduced for the 75 percent of shares that were vested before adoption ($900 = $3,000 × 40% tax rate × 75%).)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The shortfall is $100, which is recorded as income tax expense ($400 initial DTA – $300 ($3,000 × 25% × 40% tax rate)) or ($400 deferred tax expense + $900 current tax expense) – $1,200 credit to current tax expense.

**8-27 Valuation Allowances on Excess Tax Benefits Established Before the Adoption of Statement 123(R)**

Under Opinion 25 or Statement 123, an entity may have recognized a DTA for NOL carryforwards attributed to excess tax deductions from share-based compensation. Paragraph 81 of Statement 123(R) explains that entities should discontinue such a practice prospectively; rather, they should recognize the excess tax benefit and a corresponding credit to APIC only when the tax benefit is “realized” in accordance with ASC 718-740-25-10.

**Question**

How should an entity that recognized DTAs for excess tax benefits before their realization account for reversals of valuation allowances against those DTAs after adoption of Statement 123(R) (as codified in ASC 718)?
Answer

At its September 13, 2005, meeting, the FASB Statement 123(R) Resource Group agreed that the accounting for reversals of the valuation allowance after adoption of Statement 123(R) (as codified in ASC 718) depends on how the valuation allowance was originally established.

If an entity established the valuation allowance in the same year in which it recognized the DTA associated with the excess tax benefit, the valuation allowance would have originally been recognized through equity (i.e., no net excess tax benefit was recognized in equity). Therefore, when the entity is required to reverse its valuation allowance under ASC 740 after adopting Statement 123(R) (as codified in ASC 718), it should not reverse the portion of the valuation allowance recorded against the DTA until the excess tax benefit is realized. Alternatively, an entity may choose to derecognize both the DTA and corresponding valuation allowance as of adoption of Statement 123(R) (as codified in ASC 718).

However, if the valuation allowance was originally established in a year after the year in which the DTA was recorded, the valuation allowance would have been recorded as income tax expense. Therefore, when the entity is required to reverse its valuation allowance under ASC 740 after adopting Statement 123(R) (as codified in ASC 718), the reversal of the valuation allowance is recorded as a reduction in income tax expense.

8-28 Application of the Prospective Application Method to Nonpublic Entities’ APIC Pool

Question
How should nonpublic companies that adopted Statement 123(R) (as codified in ASC 718) prospectively determine the amount of previous net excess tax benefits (known as the “APIC pool”) available to offset future tax benefit deficiencies as of the date of adoption?

Answer
In accordance with paragraph 83 of Statement 123(R), nonpublic entities that used the minimum value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 must adopt Statement 123(R) (as codified in ASC 718) by using a prospective application method. Accordingly, tax benefit deficiencies are offset against excesses generated by the awards accounted for under the same accounting standard.

Therefore, only excesses generated by awards granted, modified, or repurchased after adoption of Statement 123(R) (as codified in ASC 718) are available to offset future deficiencies related to Statement 123(R) (as codified in ASC 718) awards. In other words, regarding Statement 123(R) (as codified in ASC 718) awards, such nonpublic entities begin with a zero APIC pool upon adopting Statement 123(R) (as codified in ASC 718). However, deficiencies, if any, related to awards not accounted for under Statement 123(R) (as codified in ASC 718) may still be offset by excesses created by awards accounted for under the same standard.

Further, because an entity’s APIC pool calculation “starts over” upon prospective adoption, the simplified method in FSP FAS 123(R)-3 (see paragraph 9 of FSP FAS 123(R)-3) is not relevant to nonpublic entities that adopt Statement 123(R) (as codified in ASC 718) prospectively.

8-29 Calculating the APIC Pool When a Company Becomes Public After Adopting Statement 123

Question
How should a company that became a public entity after adopting Statement 123, but before adopting Statement 123(R) (as codified in ASC 718), compute its APIC pool?
**Answer**

As discussed in Q&A 8-28, companies that use the prospective method to adopt Statement 123(R) (as codified in ASC 718) begin with a zero APIC pool for awards accounted for under Statement 123(R) (as codified in ASC 718). However, deficiencies, if any, related to awards not accounted for under Statement 123(R) (as codified in ASC 718) may still be offset by excesses created by awards accounted for under the same standard.

However, it is acceptable for a company that is a public entity when it adopts Statement 123(R) (as codified in ASC 718), but that became a public entity after adopting Statement 123, to use a different approach, as described below.

According to paragraphs 74 and 76 of Statement 123(R), companies that are considered public entities as of the effective date of Statement 123(R) (as codified in ASC 718) should use either the modified prospective or modified retrospective application method to adopt the statement. Such entities must apply either the long-form method described in paragraph 81 of Statement 123(R) or the shortcut method described in FSP FAS 123(R)-3 to compute their APIC pool.

Paragraph 81 of Statement 123(R) states, in part, that “an entity shall include as available for offset only the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994.” FSP FAS 123(R)-3 explains that entities that use the modified prospective or modified retrospective method to adopt Statement 123(R) (as codified in ASC 718) may make a one-time election to adopt the transition method described in the FSP, which requires consideration of all amounts that apply to periods after the adoption of Statement 123.

Therefore, under the long-form method for computing the APIC pool available to offset future deficiencies of Statement 123(R) (as codified in ASC 718) awards, entities may include excess tax benefits of all Statement 123 awards, including awards granted before they became public entities; excess tax benefits of awards granted while entities were nonpublic should be computed by using the “minimum value” of the awards included in their Statement 123 pro forma disclosures. Under the shortcut method, minimum-value amounts must be used to compute the Statement 123(R) (as codified in ASC 718) APIC pool.

Deficiencies of awards accounted for under Opinion 25 (e.g., those granted before the entity became public but exercised after its adoption of Statement 123(R) (as codified in ASC 718) would be recorded in equity to the extent that the entity has a sufficient Opinion 25 APIC pool. The exercise of such an award would also increase or decrease the entity’s Statement 123(R) (as codified in ASC 718) APIC pool depending on how the tax deduction compares with the minimum value of that award.

These conclusions were based on discussions with the FASB staff.

**Example 1**

Company A, which has a calendar fiscal year, became a public entity on January 1, 20X5. Company A was required to adopt Statement 123(R) (as codified in ASC 718) on January 1, 20X6, and for recognition purposes, applied the provisions of Opinion 25 before adoption. For pro forma disclosures under Statement 123, A used the “minimum value” method to value awards granted before January 1, 20X5. After that date, awards were valued at fair-value-based measure for Statement 123 pro forma disclosures.

On January 1, 20X2, A granted options to an employee to purchase 100 shares of its common stock. The exercise price of the options is equal to the market price of A’s stock on the grant date. Company A computed the “minimum value” of the award to be $1 on the grant date. The options vested on December 31, 20X3, and the employee exercised the option in November 20X4 when the market price of A’s common stock exceeded the option’s exercise price by $10. Because A was applying the provisions of Opinion 25, the entire tax benefit of $4 (a 40 percent tax rate is assumed) would be recognized in APIC (and would increase the company’s Opinion 25 APIC pool by $4). However, for Statement 123 pro forma purposes, the exercise generates an excess tax benefit of $3.60 (i.e., the tax benefit related to the tax deduction in excess of the minimum value calculated on the grant date).

If A elects to calculate the beginning balance of its APIC pool by using the long-form method described in paragraph 81 of Statement 123(R), the excess benefit of $3.60 computed under Statement 123 would be available to offset future deficiencies that result from exercises of awards granted after A became public (including those that are exercised after Statement 123(R) (as codified in ASC 718) has been adopted). In addition, if A elects to use the shortcut method under FSP FAS 123(R)-3 to calculate its APIC pool, the same $3.60 (which is based on application of the formula provided in the FSP) will be available to offset future tax deficiencies.
In contrast, if A was instead a nonpublic entity when it adopted Statement 123(R) (as codified in ASC 718), it would have been required to follow the prospective method of adoption described in paragraph 83 of Statement 123(R). Accordingly, the company would have had a Statement 123(R) (as codified in ASC 718) APIC pool of zero as of its adoption of Statement 123(R) (as codified in ASC 718), as described in Q&A 8-28.

**Example 2**

Assume the same facts as above. However, assume that on January 1, 20X1, the company also granted to an employee fully vested nonqualified stock options with an intrinsic value of $10. The options were fixed awards under Opinion 25. A DTA of $4 was recorded on the balance sheet. Further assume that these stock options had a minimum value of $11 for Statement 123 pro forma disclosure purposes.

In fiscal year 20X6, the employee’s exercise of these options results in a tax deduction of $8, or tax benefit of $3.20. Accordingly, this generates an "Opinion 25 deficiency," for which $0.80 of the corresponding DTA needs to be written off to equity if there are sufficient Opinion 25 APIC pool credits; otherwise, the deficiency would be recorded as an increase to income tax expense. This exercise would also reduce the company’s APIC pool that is available to offset deficiencies of Statement 123(R) (as codified in ASC 718) awards by $1.20 [($11 – $8) × 40%].

**Presentation**

<table>
<thead>
<tr>
<th>ASC 718-740</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Treatment of Tax Consequences When Actual Deductions Differ From Recognized Compensation Cost</strong></td>
</tr>
<tr>
<td><strong>45-1</strong></td>
</tr>
<tr>
<td><strong>45-2</strong></td>
</tr>
<tr>
<td><strong>45-3</strong></td>
</tr>
<tr>
<td><strong>Tax Deficiency</strong></td>
</tr>
<tr>
<td><strong>45-4</strong></td>
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<td><strong>Employee Stock Ownership Plans</strong></td>
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<td><strong>45-5</strong></td>
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<td><strong>45-6</strong></td>
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<td><strong>45-7</strong></td>
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<tr>
<td><strong>Tax Benefits of Dividends on Share-Based Payment Awards to Employees</strong></td>
</tr>
<tr>
<td><strong>45-8</strong></td>
</tr>
<tr>
<td>a. Nonvested equity shares</td>
</tr>
<tr>
<td>b. Nonvested equity share units</td>
</tr>
<tr>
<td>c. Outstanding equity share options</td>
</tr>
</tbody>
</table>
Chapter 8 — Income Taxes
A Roadmap to Accounting for Share-Based Payment Awards

ASC 718-740 (continued)

45-9 The amount recognized in additional paid-in capital for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards (as described in Section 718-740-35 and this Section).

45-10 Dividends or dividend equivalents paid to employees for the awards identified in paragraph 718-740-45-8 may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. Paragraph 718-740-25-10 requires the income tax benefit of those dividends not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

45-11 Paragraph 718-10-55-45 requires dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests be charged to retained earnings. If the related award is not expected to vest, that paragraph requires the dividends or dividend equivalents to be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between retained earnings and compensation cost in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

45-12 Adjustments to additional paid-in capital for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity’s pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from additional paid-in capital to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity’s estimate of forfeitures increases (or actual forfeitures exceed the entity’s estimates) shall be limited to the entity’s pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

8-30 Balance Sheet Classification of Deferred Tax Assets Related to Nonqualified Stock Options

An NQSO is an option that does not qualify for treatment as an ISO under the provisions of IRC Sections 421 through 424. As discussed in Q&A 8-03, NQSOs give employers more flexibility than ISOs.

Question
Should a DTA associated with an NQSO be classified on the balance sheet as a current or noncurrent asset?

Answer
The classification of the DTA associated with an NQSO on the balance sheet as a current or noncurrent asset will depend on whether the share-based payment award is classified as an equity award or a liability award. In accordance with ASC 740-10-45-4, if an NQSO is considered a liability award, an entity must classify the related DTA as either current or noncurrent on the basis of the financial accounting classification of the related liability for which the temporary difference exists. For example, if the NQSO is classified as a noncurrent liability, the related DTA should also be classified as noncurrent.

There are two alternatives for classifying the DTA related to an equity award. ASC 740-10-45-9 states that if a DTA “is not related to an asset or liability for financial reporting, [the DTA] shall be classified according to the expected reversal date of the temporary difference.” Therefore, a DTA related to an equity award may be classified in accordance with its expected reversal or utilization date. The expected reversal or utilization date should be consistent with the expected term used to determine the fair-value-based measure of the award.

Another acceptable alternative is to classify the DTA associated with an equity award as a noncurrent asset. The classification of noncurrent is supported by analogy to the guidance on debt in ASC 470-10-45-14, which indicates that a short-term obligation should be excluded from current liabilities if the obligation is expected to be refinanced by issuance of an equity security. Consequently, since the equity awards will not require the use of current assets, noncurrent classification of the DTA is acceptable.

8-31 Withholding Taxes for Dividends Paid to Shareholders

A tax jurisdiction may impose a “withholding tax” upon an entity, to be paid for the benefit of the recipients when the entity makes a dividend distribution. In certain instances, an entity will receive a future tax benefit for actually withholding the tax from the recipient’s distributions (e.g., a reduction in future income taxes in an amount equivalent to the “withholding tax”).

Question
What income tax consequences result from the “withholding tax”?
Answer

If an entity receives a future tax benefit related to the “withholding tax,” the entity should recognize a DTA for the future tax benefit. The income tax benefit should be recognized as income tax expense from continuing operations. Otherwise, if the entity does not receive a tax benefit, there is no current or deferred tax consequence because the recognition of a withholding tax is not an income tax within the scope of ASC 740. Instead, the withholding tax is a payment on the recipients’ behalf with no tax benefit to the entity making the distribution and should be recorded in equity as part of the dividend distribution.

This conclusion is analogous to the guidance in ASC 740-10-15-4. That guidance indicates that a tax that is assessed on an entity based on dividends distributed is, in effect, a withholding tax for the benefit of recipients of the dividend and should be recorded in equity as part of the dividend distribution in that entity’s separate financial statements if the tax meets both of the following conditions:

1. The tax is payable by the [corporation] if and only if a dividend is distributed to shareholders. The tax does not reduce future income taxes the [corporation] would otherwise pay. [Emphasis added]

2. Shareholders receiving the dividend are entitled to a tax credit at least equal to the tax paid by the entity and that credit is realizable either as a refund or as a reduction of taxes otherwise due, regardless of the tax status of the shareholders.

Therefore, if the tax is recognized as an increase in income tax expense (as opposed to equity as part of the dividend distribution), the future tax benefit likewise should be recognized as a component of income from continuing operations. This conclusion does not apply to dividends paid from a foreign subsidiary to its parent company.
Chapter 9 — Nonemployee Awards

Share-based payment awards issued to nonemployees in exchange for goods or services are within the scope of ASC 505-50. In addition to the issuance of shares, share options, or other equity instruments, the scope of ASC 505-50 applies to liabilities that are either (1) settled by issuing the entity’s equity shares or other equity instruments or (2) indexed, at least in part, to the value of the entity’s equity shares or other equity instruments. The word “indexed” signifies that the value the nonemployee receives upon settlement of the award depends, at least in part, on the value of the entity’s equity. ASC 505-50 does not apply to (1) transactions with individuals that meet the definition of an employee, (2) transactions with an employee stock ownership plan, (3) equity instruments issued in a financing transaction, or (4) equity instruments issued as consideration in a business combination.

While the recognition and measurement guidance under ASC 505-50 differs from the guidance on accounting for employee awards under ASC 718, the SEC staff’s guidance (SAB Topic 14) on nonemployee awards (codified in ASC 718) indicates that it may be appropriate to analogize to the accounting for employee awards when specific guidance on nonemployee awards does not exist. There are three notable respects in which the accounting for nonemployee awards differs from that for employee awards: (1) determination of the measurement date, (2) recognition of the cost of the award, and (3) accounting for the award once performance is complete (i.e., determining whether the award is subject to other applicable GAAP). Because of these differences, it is important for an entity to determine whether the counterparty is an employee or nonemployee when accounting for share-based payment awards. (See Q&A 1-02 for a discussion of the differences (and similarities) between the accounting for share-based payment awards issued to nonemployees and the accounting for awards granted to employees.)

ASC 505-50-20 defines the term “employee” as follows:

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

Leased individuals can also meet the definition of an employee provided that all of the criteria in ASC 505-50-20 are met.

Nonemployee directors do not meet the definition of an employee. Nevertheless, ASC 505-50-20 provides an exception to the definition of an employee for nonemployee directors (acting in their capacity as a director). The exception to account for awards issued to directors as employee awards requires that the nonemployee directors be (1) elected by the issuer’s shareholders or (2) appointed to the board that will be filled by shareholder election when the existing term expires. The exception to the definition of employee does not apply to share-based payment awards granted to nonemployee directors providing other services (e.g., consulting services) to the issuer. Awards granted to nonemployee directors as a result of providing other services to the issuer are accounted for as nonemployee awards.

For individuals that do not meet (1) the definition of an employee (including leased employees) or (2) the exception provided for nonemployee directors, awards issued to them in exchange for goods or services are within the scope of ASC 505-50.
**Recognition**

Like a share-based payment arrangement with an employee, an arrangement with a nonemployee is an exchange between the issuer and the counterparty providing the goods or services. The issuer typically recognizes the effect of that exchange in the balance sheet and income statement as those goods or services are received. The cost may be either (1) recognized as an expense as the goods or services are received or (2) capitalized as part of an asset and later recognized as an expense. For example, if the cost associated with an award is included in the cost of acquiring or producing inventory, the cost arising from the award would be capitalized. The capitalized cost would later be recognized as the cost of goods sold. The classification of the award dictates the corresponding credit in the balance sheet. If the award is classified as equity, the corresponding credit is recorded in equity — typically as paid-in capital. If the award is classified as a liability, the corresponding credit is recorded as a share-based liability.

While ASC 505-50 does not specifically address either the period(s) or the manner (i.e., capitalize versus expense) in which the cost associated with awards issued to nonemployees for goods or services must be recognized, ASC 505-50-25-4 does state that issuers must use the same period(s) and the same manner as they would if they had paid cash for the goods or services.

For nonemployee awards, the measurement date is important because it signifies the date on which the fair-value-based measure of the award, and therefore the cost to be recorded by the issuer, is determined. ASC 505-50 indicates that the measurement date of a nonemployee award is the earlier of (1) the performance commitment date or (2) the date on which the counterparty’s performance is complete (i.e., the date on which the issuer receives the goods or services in exchange for the award). Generally, this is the date when the nonemployee award can no longer be forfeited by the counterparty because the counterparty no longer has an obligation to earn the award. That is, the phrase “counterparty performance is complete” is similar to the end of the “requisite service period” in ASC 718. In contrast, the performance commitment date is the date on which it is probable that the counterparty’s performance will occur because of “sufficiently large disincentives for nonperformance.” The determination of whether a performance commitment contains a sufficiently large disincentive for nonperformance is based on the facts and circumstances of the individual arrangement. In making this determination, an entity should consider both quantitative (e.g., the penalty relative to the total arrangement consideration) and qualitative factors. See Q&A 9-05 for more information about what is considered a sufficiently large disincentive for nonperformance.

ASC 505-50-25-10 indicates that entities must classify an award issued to a nonemployee as either equity or a liability in accordance with the classification criteria in ASC 718-10-25-6 through 25-19 for employee awards. However, for nonemployee awards, once performance is complete, the classification criteria in ASC 718 no longer apply (the criteria would still apply to employee awards even after completion of performance). Accordingly, entities must apply other applicable GAAP to determine the classification of a nonemployee award. In particular, entities must consider whether a nonemployee award should be accounted for as a derivative instrument under ASC 815. ASC 815-10-55-49 states, in part, “equity instruments (including stock options) that are granted to nonemployees as compensation for goods and services in share-based payment transactions are subject to [ASC 815] once performance has occurred.” As a result, an issuer may have classified a nonemployee award as equity during the performance period but may be required to reclassify the award from equity to a derivative liability once performance is complete.

**Initial Measurement**

Nonemployee awards are measured at the fair value of the goods or services received or the fair-value-based measure of the equity instruments issued, whichever is more reliably measurable. If an issuer determines that the fair-value-based measure of the equity instruments granted is more reliably measurable, which is usually the case, the issuer must consider this fact when determining the measurement date of a nonemployee award. That is, if the fair-value-based measure of the equity instruments issued is used to value the award, the issuer must determine whether the measurement date is the performance commitment date or the date on which the counterparty’s performance is complete. In contrast, if the fair value of the goods or services received is used to value the award, the issuer would generally use the date on which the counterparty’s performance is complete as the measurement date.

For employee awards, ASC 718 provides two exceptions to the fair-value-based measurement objective for nonpublic entities. However, those two exceptions do not apply to nonpublic entities that are valuing the awards issued to a nonemployee. As a result, nonpublic entities that cannot reasonably estimate the expected volatility of their share price cannot use calculated value as a surrogate for the fair-value-based measure of a nonemployee award. (See Q&A 9-06 for a discussion of nonpublic entities’ inability to use calculated value in determining the...
value of share-based payment awards issued to nonemployees.) In addition, nonpublic entities cannot elect, as a policy decision, to measure all liability-classified awards issued to a nonemployee at intrinsic value instead of a fair-value-based measure at the end of each reporting period until settlement.

Subsequent Measurement
Once a measurement date has been established, the number of nonemployee awards the counterparty will receive or the terms of the award may change on the basis of the achievement of market conditions, counterparty performance conditions, or a combination of both.

Other Presentation
ASC 505 requires that costs related to awards issued to nonemployees be recorded in net income and that such costs be (1) expensed or capitalized in an issuer’s financial statements as part of an asset to be recognized as an expense later and (2) classified appropriately as either equity or a liability in accordance with the classification criteria in ASC 718 (see the Recognition section above). However, ASC 505 contains little guidance on presentation in the statement of operations. See Q&A 9-13 for a discussion of how an issuer should present costs associated with a nonemployee award in the statement of operations.

As with employee share-based payment awards, the receipt of goods or services from nonemployees in exchange for a share-based payment award is a noncash item. Accordingly, the issuance of such awards is not presented in the statement of cash flows. However, in presenting cash flows under the indirect method, an issuer would present the cost associated with these awards that is recognized in the statement of operations in each reporting period as a reconciling item in arriving at cash flows from operations. In addition, issuers are required to present any excess tax benefits associated with nonemployee awards, as well as any cash paid by the nonemployee (e.g., the exercise price) to the issuer for such awards, as cash inflows from financing activities.

Disclosure
ASC 505-50-50-1 requires entities that issue nonemployee awards to provide similar disclosures to those required in ASC 718-10-50-1 and 50-2 for employee awards. See Q&A 9-14 for a discussion of the disclosures required for nonemployee awards. Also see Chapter 5 for further discussion of the required disclosures for employee awards.

Overview and Scope

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05-1 Entities often sell goods or provide services in exchange for equity instruments issued by the purchaser of the goods or services. Individuals also may provide services in exchange for equity instruments of an entity. These transactions are referred to as share-based payment transactions.

05-2 This Subtopic addresses the accounting and reporting for both the issuer (that is, the purchaser or grantor) and recipient (that is, the goods or service provider or grantee) for a subset of share-based payment transactions. Topic 718 also addresses a subset of these transactions. The applicable accounting and reporting requirements for a specific transaction substantially depend on whether the grantee meets the definition of an employee (see the definition for determining which guidance to apply to a particular transaction). The accounting and reporting required may differ significantly depending on whether that definition of employee is met for the grantee. With certain exceptions, this Subtopic provides guidance when the grantee does not meet that definition of an employee.

05-3 The guidance in this Subtopic addresses the transactions described in this Section in which the grantee receives shares of stock, stock options, or other equity instruments in settlement of the entire transaction or, if the transaction is part cash and part equity instruments, in settlement of the portion of the transaction for which the equity instruments constitute the consideration.

05-4 While certain transactions that involve the contemporaneous exchange of equity instruments for goods or services do not create practice issues, others are more complex in that the exchange spans several periods and the issuance of the equity instruments is contingent on service or delivery of goods that must be completed by the grantee in order to vest in the equity instrument. Additionally, sometimes a fully vested, nonforfeitable equity instrument issued to a grantee contains terms that may vary based on the achievement of a performance condition or certain market conditions. Performance conditions are those conditions that relate to the achievement of a specified performance target, such as attaining a specified level of sales, as contrasted with market conditions, which relate to the achievement of a specified market target such as attaining a specified stock price or amount of intrinsic value.
For example, a fully vested stock option may be issued to a grantee that contains a provision that the exercise price will be reduced if the grantee completes a project by a specified date. In certain cases, the fair value of the equity instruments to be received may be more reliably measurable than the fair value of the goods or services to be given as consideration. The guidance in this Subtopic addresses this situation, including the appropriate date or dates to be used by the grantee to measure revenue under such complex transactions.

In many arrangements, the equity instruments, while nonforfeitable, cannot be exercised by the grantee for a specified period of time. Those arrangements may contain terms providing for earlier exercisability of the equity instrument if the grantee achieves specified performance conditions. For example, a fully vested, nonforfeitable stock option that at issuance is exercisable only after five years may contain a provision that exercisability is accelerated if the grantee makes a specified number of purchases from the grantor. This Subtopic provides guidance on how to measure the cost of fully vested, nonforfeitable equity instruments that are exercisable only after a specified term if the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions; that is, whether the lack of immediate exercisability introduces sufficient doubt about whether, before the grantee performance required to accelerate exercisability, the equity instruments are, in fact, vested. This Subtopic also provides guidance on the accounting for the debit or cost of the transaction, including whether the acceleration of exercisability, upon meeting specified performance conditions, results in an additional cost of the transaction that shall be recognized following what is referred to as modification accounting. Modification accounting is described more fully in paragraphs 718-20-35-3 through 35-4.

While this Subtopic generally does not address the period(s) or manner in which the fair value of the transactions shall be recognized, paragraph 505-50-25-4 does establish guidance by analogizing to cash being exchanged in the transaction instead of the equity instruments.

Specifically, for those transactions that fall within the scope of this Subtopic, the guidance addresses elements of all of the following matters:

a. For all transactions, the date the issuer shall use to measure the fair value of the equity instruments (the measurement date)

b. For all transactions, the period(s) and manner (that is, capitalize versus expense) the issuer shall use to recognize the fair value of the equity instruments

c. For transactions in which the quantity and terms of the equity instruments are all known up front (that is, the quantity and terms are not based on counterparty performance or market conditions), how the equity instruments shall be accounted for before the measurement date for purposes of recognizing, as appropriate, the cost of the transaction

d. For transactions in which the quantity or any of the terms of the equity instruments are not all known up front (that is, the quantity or terms are based on counterparty performance or market conditions), all of the following:
   1. How the equity instruments shall be measured at the measurement date
   2. How the equity instruments shall be accounted for before the measurement date for purposes of recognizing, as appropriate, the cost of the transaction
   3. How the equity instruments shall be accounted for after the measurement date if the resolution of the counterparty performance or market conditions results in changes in the quantity or terms of the equity instruments.

This Subtopic uses the terms compensation and payment in their broadest senses to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee, and refers to recognizing compensation cost rather than compensation expense because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

An objective of accounting for share-based payment transactions, in which an entity exchanges goods or services with nonemployees, is to recognize in the financial statements the most reliably measurable fair values of such transactions. In addition, concurrent disclosure about the financial statement effect of share-based payment transactions, including how such fair values were determined and their effect on cash flows, are also objectives for this accounting.

The guidance in this Subtopic applies to all public and nonpublic entities unless more specific guidance for those entities is provided in other Topics.
Chapter 9 — Nonemployee Awards

A Roadmap to Accounting for Share-Based Payment Awards

ASC 505-50 (continued)

15-2 The guidance in this Subtopic applies to the following transactions, with specific exceptions noted below:

a. 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.

b. Modifications of existing arrangements. (Modifications of existing arrangements do not include changes to the quantity or terms of an equity instrument that occur when any originally unknown quantity or term becomes known pursuant to the terms of the original instruments.)

15-3 The guidance in this Subtopic does not apply to the following transactions:

a. Transactions with individuals meeting the definition of an employee
b. Transactions with employee stock ownership plans
c. Transactions involving equity instruments either issued to a lender or investor that provides financing to the issuer or issued in a business combination.

9-01 Definition of a Common Law Employee

Question
What are the criteria established by IRS Revenue Ruling 87-41, “Employment Status Under Section 530(D) of the Revenue Act of 1978,” that may aid in the assessment of whether an individual is an employee under common law?

Answer
The IRS developed the criteria (20 factors) on the basis of an examination of cases and rulings that determine whether an individual is an employee under common law. The degree of importance of each criterion varies depending on the factual context in which the services of an individual are performed. In addition, because the criteria are designed as guides in assisting in the determination of whether an individual is an employee, scrutiny is required in applying the criteria to assure that the substance of an arrangement is not obscured by an attempt to achieve a particular employment status. The criteria include the following:

- **Instructions** — A worker who is required to comply with another person’s instructions about when, where, and how he or she is to work is ordinarily an employee. In addition, the existence of instructions that involve the integration of a worker’s services into the business operations generally demonstrates that the worker is subject to direction and control.

- **Continuing relationship** — A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. In addition, the worker’s right to terminate the relationship or the employer’s right to discharge the worker indicates an employer-employee relationship.

- **Set hours of work** — The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.

- **Hiring, supervising, and paying assistant** — If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job.

- **Working on the employer’s premises** — If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere.

- **Full time required** — If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working.

- **Payment** — Payment by the hour, week, or month generally points to an employer-employee relationship. In addition, if the person or persons for whom the services are performed ordinarily pay the worker’s business expenses, traveling expenses, or both, the worker ordinarily is an employee.
In addition to the foregoing general criteria, refer to IRS Revenue Ruling 87-41 for additional factors that should be considered when assessing if an individual is an employee under common law. For a further discussion of the definition of an employee, refer to ASC 718-10-20.

Recognition

**ASC 505-50**

25-1 This Section addresses when to first recognize an exchange transaction that involves an equity instrument as one part of the exchange and in which the recipient of the equity instrument is not an employee.

25-2 Transactions in which equity instruments are issued in exchange for the receipt of goods or services may involve a contemporaneous exchange of the equity instruments for goods or services or may involve an exchange that spans several financial reporting periods. Furthermore, by virtue of the terms of the exchange with the counterparty, the quantity and terms of the equity instruments to be issued may be known or only known within a range when the transaction arrangement is established. This Section addresses the recognition approach for any of these transactions if the counterparty to the transaction is other than an employee.

25-3 The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured.

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.

25-5 In the situation in which an entity is the recipient (the goods or service provider or grantee) of the equity instrument, this guidance also does not address when revenue is recognized other than to require that a liability (deferred revenue) or revenue be recognized in the same period(s) and in the same manner as it would if the grantee was to receive cash for the goods or services instead of the equity instruments.

25-6 A 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.

25-7 If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached. A grantor shall recognize the equity instruments when they are issued (in most cases, when the agreement is entered into). Whether the corresponding cost is an immediate expense or a prepaid asset (or whether the debit should be characterized as contra-equity under the requirements of paragraph 505-50-45-1) depends on the specific facts and circumstances. Section 505-50-30 provides guidance on the determination of the measurement date for transactions that are within the scope of this Subtopic.

25-8 An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time if the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions. Any measured cost of the transaction shall be recognized in the same period(s) and in the same manner as if the entity 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.

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.

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. For example, when inventory is sold, the cost is recognized in the income statement as cost of goods sold, and as services are consumed, the cost is usually recognized in determining net income of that period, for example, as expenses incurred for services. In some circumstances, the cost of services (or goods) may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed.
9-02 In-Substance Nonrecourse Notes

**Question**
Are there situations in which a recourse note is substantively a nonrecourse note?

**Answer**
Yes. In considering whether a recourse note is, in substance, a nonrecourse note, entities should consider the guidance in Issue 34 of EITF Issue 00-23. Although EITF Issue 00-23 was nullified, the guidance on determining whether a recourse note is substantively a nonrecourse note remains relevant. A recourse note should be considered nonrecourse if any of the following factors are present:

- The employer has legal recourse to the employee’s other assets but does not intend to seek repayment beyond the shares issued.
- The employer has a history of not demanding repayment of loan amounts in excess of the fair value of the shares.
- The employee does not have sufficient assets or other means (beyond the shares) of justifying the recourse nature of the loan.
- The employer has accepted a recourse note upon exercise and subsequently converts the recourse note to a nonrecourse note.

The SEC observer also stated that all other relevant facts and circumstances should be evaluated and that if the note is ultimately forgiven, the SEC will most likely challenge the appropriateness of the conclusion that the note was a recourse note.

An employee may exercise options by using a nonrecourse note for a portion of the exercise price and a recourse note for the remainder. If the respective notes are not aligned with a corresponding percentage of the underlying shares (i.e., in a non-pro-rata structure), both notes should be accounted for together as nonrecourse. A non-pro-rata structure is one in which the exercise price for each share of stock is represented by both the nonrecourse notes and the recourse notes on the basis of their respective percentages of the total exercise price.

See Q&A 2-01 for a discussion of the impact of recourse and nonrecourse notes on the accounting for share-based payment awards.

9-03 Accounting for Fully Vested, Nonforfeitable Share-Based Payment Awards Issued to Nonemployees

**Question**
If the fair-value-based measure of the share-based payment awards issued is more reliably measurable than the goods or services received, how does an entity (issuer) account for a fully vested, nonforfeitable share-based payment award issued to a nonemployee in exchange for goods or services?

**Answer**
Since the award is not conditioned on the future performance of the nonemployee counterparty (i.e., the award is fully vested and nonforfeitable), the measurement date for the award is the grant date. ASC 505-50-25-7 states, in part:

> If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached. A grantor shall recognize the equity instruments when they are issued (in most cases, when the agreement is entered into).

In addition, under ASC 505-50-25-8, the cost associated with a fully vested, nonforfeitable award issued to a nonemployee must be recognized in the same period(s) and in the same manner (i.e., capitalize versus expense) as if the entity issuing the award (issuer) had paid cash for the goods or services.

See Q&A 9-13 for a discussion of how an entity (issuer) should present the cost associated with a nonemployee award in the statement of operations.
## Initial Measurement

### ASC 505-50

#### General

**30-1** This Section provides measurement guidance for transactions that involve the issuance or receipt of equity instruments in exchange for goods or services with nonemployees. This Section identifies the measurement date for such exchange transactions and addresses issues associated with the measurement of the transactions before and as of the measurement date. Measurement issues associated with these transactions after the measurement date are addressed in Section 505-50-35.

**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.

**30-3** Throughout this Subtopic, the term equity instruments is meant to include both the equity instruments that are provided for in the arrangement with the counterparty and any embedded or freestanding issuer commitments to change the quantity or terms thereof based on counterparty performance conditions or market conditions.

**30-4** Paragraph 505-50-25-3 requires that the accounting for all share-based payment transactions reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances. The minimum value method (a method that reflects the time value of an option but ignores the volatility value) is not an acceptable method for determining the fair value of nonemployee awards by nonpublic entities.

**30-5** The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include stated or unstated rights. Subtopic 505-30 provides pertinent guidance on the repurchase of treasury shares.

**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.

**30-7** Sales incentives in the form of equity instruments shall be measured at the fair value of the sales incentive or the fair value of the equity instruments issued, whichever is more reliably measurable.

### Determining the Fair Value of the Equity Instruments Issued or Received

**30-8** As noted in paragraph 505-50-05-5 for transactions involving the receipt of equity instruments in exchange for providing goods or services, in certain cases, the fair value of the equity instruments to be received may be more reliably measurable than the fair value of the goods or services to be given as consideration.

**30-9** The following guidance addresses measurement issues associated with determining the fair value of the equity instruments issued or received if it has been determined that the fair value of the equity instruments issued or received in a share-based payment transaction within the scope of this Subtopic is more reliably measurable than the fair value of the consideration received or provided in exchange as follows:

- a. Determining the measurement date
- b. Measuring before the measurement date
- c. Measuring at the measurement date
- d. Measuring after the measurement date.

### Determining the Measurement Date

**30-10** The following guidance identifies a measurement date, which determines some of the inputs in the determination of the fair value of equity instruments issued or received in a share-based payment transaction with nonemployees. Guidance is provided separately for the grantor-purchaser and grantee-provider.

#### Grantor-Purchaser

**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.
### ASC 505-50 (continued)

**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.)

**30-13** The counterparty’s performance is complete when the counterparty has delivered or, in the case of sales incentives, purchased the goods or services, despite the fact that at that date the quantity or all the terms of the equity instruments may yet depend on other events (this would occur, for example, if a target stock price requirement has not been met when the counterparty has delivered the goods or services).

**30-14** Situations may arise in which counterparty performance may be required over a period of time (for example, three years) but the equity award granted to the party performing the services is fully vested and nonforfeitable on the date the parties enter into the contract. While this type of arrangement may be rare, because, typically, vesting provisions do exist, the measurement date for an award that is nonforfeitable and that vests immediately could be the date the parties enter into the contract, even (though) services have not yet been performed.

**30-15** As addressed in paragraph 505-50-25-7, if fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached.

**30-16** If an entity grants fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions, the grantor shall measure the fair value of the equity instruments at the date of grant and, under the guidance in paragraph 505-50-25-8, shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash.

**30-17** Examples 1 and 2 (see paragraphs 505-50-55-2 through 55-10) illustrate the identification of situations in which performance commitments may exist before or at the date performance is complete.

#### Grantee-Provider

**30-18** An entity (the grantee or provider) may enter into transactions to provide goods or services in exchange for equity instruments. The grantee 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 either of the following dates referred to as the measurement date:

- a. The date the parties come to a mutual understanding of the terms of the equity-based compensation arrangement and a commitment for performance by the grantee to earn the equity instruments (a performance commitment) is reached
- b. The date at which the grantee’s performance necessary to earn the equity instruments is complete (that is, the vesting date).

**30-19** The term *performance commitment* as it relates to the accounting by a grantee describes the same conditions as for a grantor in paragraph 505-50-30-12. That is, a performance commitment is a commitment under which performance by the grantee to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the grantor and the grantee. Forfeiture of the equity instruments as the sole remedy in the event of the grantee’s nonperformance is not considered a sufficiently large disincentive for purposes of applying the 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. (A granting entity may always be able to sue for nonperformance but it is not always clear whether any significant damages would result.)

#### Measuring Before the Measurement Date

**30-20** Under generally accepted accounting principles (GAAP), it may be appropriate for an issuer to recognize costs related to share-based payment transactions with nonemployees before a measurement date has occurred. The following guidance addresses measurement of the equity instruments in such cases before the measurement date, specifically:

- a. If the quantity and terms of the equity instruments are known up front
- b. If the quantity or any of the terms of the equity instruments are not known up front.

#### If the Quantity and Terms of the Equity Instruments Are Known up Front

**30-21** The quantity and terms of the equity instruments may be known up front. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction during financial reporting periods before the measurement date, for purposes of recognition of costs during those periods the equity instruments shall be measured at their then-current fair values at each of those interim financial reporting dates. Changes in those fair values between those interim reporting dates shall be attributed in accordance with the methods illustrated in Example 5 (see paragraph 505-50-55-28). Example 5, Case A (see paragraph 505-50-55-32) illustrates application of this guidance.
### ASC 505-50 (continued)

**If the Quantity or Any of the Terms of the Equity Instruments Are Not Known up Front**

30-22 When measuring the equity instrument before the measurement date because of a need to recognize the cost of a transaction under GAAP, the quantity or any of the terms of the equity instruments may not be known up front. The following guidance addresses these situations and establishes the measurement requirements if the quantity or terms of the equity instruments are dependent on any of the following:

- a. Market conditions
- b. Counterparty performance conditions
- c. Combination of market conditions and counterparty performance conditions.

30-23 The guidance described in paragraph 505-50-30-21 (that is, the then-current fair value) also applies to the situation in which the quantity and terms of the equity instruments are dependent on only market conditions.

30-24 Paragraph 505-50-30-28 describes how the fair value of such equity instruments shall be calculated.

30-25 The quantity and terms of the equity instruments may be dependent upon counterparty performance conditions. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction in reporting periods before the measurement date, the equity instruments shall be measured at their then-current lowest aggregate fair value at each of those interim reporting dates. Changes in those lowest aggregate fair values between those interim reporting dates shall be attributed in accordance with the methods illustrated in Example 5 (see paragraph 505-50-55-28). Example 5, Cases B and C (see paragraphs 505-50-55-33 through 55-40) illustrate application of this guidance.

30-26 The quantity and terms of the equity instruments may be dependent upon both market conditions and counterparty performance conditions. The guidance in the preceding paragraph (that is, the then-current lowest aggregate fair value) also applies in this situation.

### Measuring at the Measurement Date

30-27 Paragraph 505-50-10-1 establishes the measurement objective of fair value for share-based payment transactions. Sometimes the quantity or any of the terms of an equity instrument may not be known at the measurement date. The following guidance establishes measurement requirements as of the measurement date if the quantity or any of the terms are not known at the measurement date and are dependent on any of the following:

- a. Market conditions
- b. Counterparty performance conditions
- c. Combination of market conditions and counterparty performance conditions.

### Transactions That Involve Only Market Conditions

30-28 The quantity or terms of an equity instrument may be dependent only on market conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of market conditions, then the issuer shall use the fair value of the equity instruments for recognition purposes. That fair value shall be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the issuer’s commitment to change the quantity or terms of the equity instruments based on whether the market condition is met. Example 3, Case A (see paragraph 505-50-55-14) illustrates application of this guidance.

30-29 As it relates to a grantee, if on the measurement date the quantity or any of the terms of the equity instrument are dependent on the achievement of a market condition, then the grantee shall measure revenue based on the fair value of the equity instruments inclusive of the adjustment provisions. That fair value would be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the commitment to change the quantity or terms of the equity instruments based on whether the market condition is met. That is, the existence of a market condition that, if achieved, results in an adjustment to an equity instrument generally affects the value of the instrument. Pricing models have been adapted to value many of those path-dependent equity instruments.

### Transactions That Involve Only Counterparty Performance Conditions

30-30 The quantity or terms of an equity instrument may be dependent only on counterparty performance conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of counterparty performance conditions that, based on the different possible outcomes, result in a range of aggregate fair values for the equity instruments as of that date, then the issuer should utilize the lowest aggregate (that is, the variable terms times the applicable number of equity instruments) amount within that range for recognition purposes. This amount may be zero. Example 4, Case B (see paragraph 505-50-55-22) and Example 5, Cases B and C (see paragraphs 505-50-55-33 through 55-40) illustrate application of this guidance.

### Transactions That Involve Both Market Conditions and Counterparty Performance Conditions

30-31 The quantity or terms of an equity instrument may be dependent on both market conditions and counterparty performance conditions. The guidance in the preceding paragraph (that is, lowest aggregate fair value) also applies in this situation.
9-04  Estimating the Expected Term of an Award in Valuing Options or Similar Instruments Issued to Nonemployees

Under ASC 718, entities must use the expected term of an option or similar instrument, rather than its contractual term, to estimate the fair-value-based measure of a nontransferable share-based payment award granted to an employee.

Question
What expected term should an entity use to estimate the fair-value-based measure of a nontransferable option or similar instrument (e.g., warrant) issued to a nonemployee in exchange for goods or services?

Answer
Footnote 7 of SAB Topic 14.A indicates that in transactions with nonemployees, in the absence of the nontransferability, nonhedgability, and the truncation of the contractual term features often associated with employee share options, the use of an expected term assumption shorter than the contractual term would not be appropriate. Further, the SEC staff has held that when the parties have had no prior business experience, the issuer does not have a basis for determining the intent of the recipient and, therefore, for determining the expected term of the award.

9-05  Performance Commitment — Determination of a Sufficiently Large Disincentive for Nonperformance

As indicated in Q&A 1-02, one notable difference in the accounting for share-based payment awards issued to nonemployees and share-based payment awards granted to employees relates to the awards’ measurement date. Entities should use ASC 505-50-30 to determine the measurement date for awards issued to nonemployees. ASC 505-50-30-11 concludes that the measurement date of a nonemployee award is the earlier of (1) the performance commitment date or (2) the date on which the counterparty’s performance is complete.

ASC 505-50-30-12 elaborates on the term “performance commitment,” stating, in part:

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.)

Question
What is considered a “sufficiently large disincentive for nonperformance” in the determination of whether a performance commitment has been reached in accordance with the provisions of ASC 505-50?

Answer
The determination of whether a performance commitment contains a sufficiently large disincentive for nonperformance is based on the circumstances of the individual arrangement. Entities should consider both quantitative (i.e., the fair-value-based measure of the total arrangement consideration) and qualitative factors. A penalty of 10 percent or more of the fair-value-based measure of the total arrangement consideration is generally viewed as a sufficiently large disincentive for nonperformance. In addition, the penalty for nonperformance needs to be imposed as a direct result of nonperformance by the counterparty of the arrangement. The mere possibility of legal proceedings (the right to sue) does not meet the definition of a sufficiently large disincentive.

Example
On January 1, 20X1, Entity A agreed to issue 150,000 warrants to purchase its stock in exchange for construction services from Entity B. The fair-value-based measure of the warrants on the date of the agreement is $1 million. If B fails to perform the construction services, then B is obligated to pay a cash penalty of $100,000 plus any decline in the fair value of A’s share price below $20 (A’s share price on the date the parties entered into the agreement). Such penalty represents a sufficiently large disincentive for nonperformance. Accordingly, a measurement date is established on the date the parties entered into the agreement (January 1, 20X1) in accordance with ASC 505-50-30-11 and 30-12.
9-06 Nonpublic Entities Using Calculated Value to Determine the Value of Options or Similar Instruments Issued to Nonemployees

Nonpublic entities that cannot reasonably estimate the expected volatility of their own share prices may, under ASC 718, substitute the historical volatility of an appropriate industry sector index for the expected volatility of their own share price in valuing options or similar instruments granted to employees. The resulting measure is referred to as “calculated value” in ASC 718 rather than as a fair-value-based measure.

**Question**
Can a nonpublic entity use calculated value in lieu of a fair-value-based measure to determine the value of an option or similar instrument issued to a nonemployee?

**Answer**
No. Nonpublic entities must use a fair-value-based measure to determine the value of share-based payment awards issued to nonemployees. That is, a nonpublic entity cannot substitute the historical volatility of an appropriate industry sector index for the expected volatility of its own share price in valuing awards issued to nonemployees. ASC 505-50-30-6 states, in part:

> [I]f 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. [Emphasis added]

Therefore, if the fair-value-based measure of the awards issued is more reliably measurable than the fair value of the goods or services received, a nonpublic entity is required to make an estimate of the expected volatility of its own share price. For nonpublic entities that (1) are considering the use of calculated value for options or similar instruments granted to employees and (2) issue options or similar instruments to nonemployees, using a fair-value-based measure for awards issued to nonemployees may call into question the nonpublic entity’s assertion that it cannot reasonably estimate the expected volatility of its own share price in valuing its employee options or similar instruments.

9-07 Accounting for a Share-Based Payment Award Issued to a Nonemployee Before the Award’s Measurement Date

Assume that an entity previously determined the following about its share-based payment awards issued to nonemployees in exchange for goods or services: (1) the fair-value-based measure of the awards is more reliably measurable than the goods or services received and (2) a performance commitment has not been reached; therefore, a measurement date has not been established.

**Question**
How should the entity account for a share-based payment award (e.g., warrant) issued to nonemployees in exchange for goods or services before the measurement date?

**Answer**
An entity recognizes cost for a share-based payment award issued to a nonemployee at the award’s estimated lowest aggregate fair-value-based measure (which could be zero) at the end of each reporting period until the measurement date is established. The cost is recognized as goods are provided or services are rendered; that is, over the same period and in the same manner — as if the entity issuing the awards had paid cash for the goods or services.

ASC 505-50-30-25 states:

> The quantity and terms of the equity instruments may be dependent upon counterparty performance conditions. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction in reporting periods before the measurement date, the equity instruments shall be measured at their then-current lowest aggregate fair value at each of those interim reporting dates. Changes in those lowest aggregate fair values between those interim reporting dates shall be attributed in accordance with the methods illustrated in Example 5 (see paragraph 505-50-55-28). Example 5, Cases B and C (see paragraphs 505-50-55-33 through 55-40 illustrate application of this guidance.

Recognition is based on the assumption that the nonemployee will continue to provide the goods or services in exchange for earning the right to the award. An entity is required to assess the probability that the nonemployee will continue to provide the goods or services in a manner similar to the analysis required for a performance condition included in an award granted to an employee in exchange for employee service.
Further, Example 5 of ASC 505-50-55 illustrates the recognition of the changes in the fair-value-based measure each reporting period. Under ASC 505-50-55, entities are not required to follow the graded vesting attribution model (i.e., the method illustrated in Q&A 4-10) for share-based payment awards issued to nonemployees with a graded vesting schedule. Entities must make a policy decision to use either the straight-line or the graded-vesting attribution model for awards with only a service condition that have a graded vesting schedule. This policy decision should be disclosed and applied consistently.

**Example**

On January 1, 20X1, Entity A enters into an arrangement with an individual who will provide consulting service for the next six months in exchange for 5,000 warrants to purchase A’s common stock. Assume that the fair-value-based measure of the warrants is more reliably measurable than the fair value of the consulting service. The only ramification of the individual’s failure to provide the consulting service is the lost opportunity to earn the warrants, which is not a sufficiently large disincentive for nonperformance. The measurement date will occur on the date on which the individual’s performance is complete (i.e., the end of the six-month consulting period). The fair-value-based measure of the warrants on March 31, 20X1, and June 30, 20X1, are $10 and $12, respectively.

Further assume that the consulting services are provided ratably over the six-month period and that one half of the service has been provided as of March 31, 20X1. On March 31, 20X1, A records consulting expense ($25,000) with a corresponding amount in APIC on the basis of the fair-value-based measure of the warrants ($10), the number of warrants to be issued (5,000), and the percent of services rendered (50% for 3 of 6 months). See the journal entry below.

**Journal Entry: March 31, 20X1**

<table>
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</thead>
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<td>25,000</td>
</tr>
<tr>
<td>APIC</td>
<td>25,000</td>
</tr>
</tbody>
</table>

To record consulting expense on the basis of the fair-value-based measure as of March 31, 20X1 (5,000 warrants × $10 fair-value-based measure × 50% for 3 of 6 months of services rendered).

On June 30, 20X1, the measurement date, A adjusts the consulting expense and paid-in capital on the basis of the fair-value-based measure of the warrants ($12). See the journal entry below.

**Journal Entry: June 30, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consulting expense</td>
<td>35,000</td>
</tr>
<tr>
<td>APIC</td>
<td>35,000</td>
</tr>
</tbody>
</table>

To record consulting expense on the basis of the fair-value-based measure as of June 30, 20X1 [(5,000 warrants × $12 fair-value-based measure × 100% of services rendered) – $25,000 consulting expense previously recognized].

9-08 Measurement of a Liability-Classified Award Issued to a Nonemployee

**Question**

How should an entity initially and subsequently measure liability-classified awards issued to nonemployees?

**Answer**

ASC 505-50 does not specifically address the initial or subsequent measurement of liability-classified awards issued to nonemployees. Under previous accounting guidance, entities typically initially measured liability-classified nonemployee awards at intrinsic value and remeasured those awards at their intrinsic value each reporting period until settlement. That practice was based on an analogy to the initial and subsequent measurement of liability-classified awards granted to employees.

After the issuance of Statement 123(R), which was later codified in ASC 718, entities questioned whether liability-classified nonemployee awards, like liability-classified employee awards, should be initially and subsequently measured at a fair-value-based measure each reporting period until settlement. At the September 2005 Statement 123(R) Resource Group Meeting, the members of the Resource Group indicated that, as a result of the issuance of Statement 123(R), which was later codified in ASC 718, and SAB Topic 14, entities that issue liability-classified awards to nonemployees should initially and subsequently measure those awards at a fair-value-based measure each reporting period until settlement.
Subsequent Measurement

ASC 505-50

35-1 Section 505-50-30 addresses the measurement of equity instruments issued or received if it has been determined that the fair value of the equity instruments issued or received in a share-based payment transaction within the scope of this Subtopic is more reliably measurable than the fair value of the consideration received or provided in exchange, including cases in which the quantity or any of the terms of the equity instruments are not known up front. The measurement guidance in this Section addresses time periods before and as of the measurement date. This Section provides guidance on the measurement of those same equity instruments after the measurement date.

35-2 Example 4, Case A (see paragraph 505-50-55-21) illustrates the accounting required by the grantor if all terms are known up front.

Transactions in Which Quantity or Any Terms Not Known up Front

35-3 The following guidance addresses measurement by the grantor and the grantee, in periods after the measurement date, of equity instruments issued or received in a share-based payment transaction within the scope of this Subtopic in which the quantity or any of the terms were not known up front.

Grantor Accounting

35-4 Grantor accounting guidance is provided for arrangements with:
   a. Only market conditions
   b. Only counterparty performance conditions
   c. Both market conditions and counterparty performance conditions
   d. Acceleration of exercisability conditions.

Only Market Conditions

35-5 Paragraph 505-50-30-28 provides measurement date guidance on the measurement of transactions that involve only market conditions. That guidance describes how the calculation of the fair value of the equity instruments includes a determination of the fair value of the issuer’s commitment to change the quantity or terms of the equity instruments.

35-6 After the issuer measures the then-current fair value of the issuer’s commitment related to the market condition as described in paragraph 505-50-30-28, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting guidance on financial instruments, such as that in Subtopic 815-40.

Only Counterparty Performance Conditions

35-7 Paragraph 505-50-30-30 provides measurement date guidance on the measurement of transactions that involve only counterparty performance conditions. As each quantity and term become known and until all the quantities and terms that stem from the counterparty’s performance become known, the lowest aggregate fair value measured pursuant to the guidance in that paragraph shall be adjusted, to reflect additional cost of the transaction, using the modification accounting methodology described in paragraphs 718-20-35-3 through 35-4. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instruments as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity or term and the then-current fair value of the old equity instruments immediately before the quantity or term becomes known. The then-current fair value is calculated using the assumptions that result in the lowest aggregate fair value if the quantity or any other terms remain unknown.

Both Market Conditions and Counterparty Performance Conditions

35-8 Paragraph 505-50-30-31 provides measurement date guidance on the measurement of transactions that involve both market conditions and counterparty performance conditions.

35-9 Through the date the last performance-related condition is resolved, the issuer shall apply modification accounting for the resolution of both counterparty performance conditions and market conditions. If, at the time the last counterparty performance-related condition is resolved, any market conditions remain, then the issuer shall measure the then-current fair value of the issuer’s commitment to issue additional equity instruments or change the terms of the equity instruments based on whether the market condition is met. This measured amount is an additional cost of the transaction. Example 3, Case B (see paragraph 505-50-55-15) illustrates application of this guidance.

35-10 After the issuer measures the then-current fair value of the issuer’s commitment related to the market condition, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting literature on financial instruments, such as that in Subtopic 815-40.
**ASC 505-50 (continued)**

**Acceleration of Exercisability Conditions**

35-11 Paragraph 505-50-30-16 addresses the situation in which an entity grants fully vested, nonforfeitable equity instruments with terms that provide for potential acceleration of exercisability and establishes that the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash. The following paragraph establishes post-grant-date measurement requirements if the exercisibility is accelerated.

35-12 An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and for which the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions. If, after the arrangement date, the grantee performs as specified and exercisibility is accelerated, the grantor shall record incremental cost measured at the date of the revision of the terms of the equity instruments (that is, the acceleration date) as the difference between the then-current fair value of the revised instruments utilizing the accelerated exercisibility date and the then-current fair value of the old equity instruments immediately before exercisibility is accelerated. If the only change in the terms of the equity instruments is the acceleration of exercisibility, the application of this methodology will only result in a significant additional charge if the expected dividend on the underlying instrument exceeds the sum of the effect of discounting the exercise price and the loss of time value (exclusive of the effect of discounting the exercise price) resulting from the early exercise of the equity instrument.

**Grantee Accounting**

35-13 A grantee may be party to an arrangement in which the terms of the equity instruments are subject to adjustment after the measurement date. The following two paragraphs address transactions in which any of the terms of the equity instruments are subject to adjustment after the measurement date (that is, the terms of the equity instrument are subject to adjustment based on performance above the level committed to in a performance commitment, performance after the instrument is earned, or market conditions) and how the grantee shall account for an increase in fair value as a result of an adjustment (upon resolution of the contingency after the measurement date) as revenue.

35-14 If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of grantee performance conditions (beyond those conditions for which a performance commitment exists), then changes in fair value of the equity instrument that result from an adjustment to the instrument upon the achievement of a performance condition shall be measured as additional revenue from the transaction using a methodology consistent with modification accounting described in paragraphs 718-20-35-3 through 35-4. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instrument as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity and terms and the then-current fair value of the old equity instruments immediately before the adjustment.

35-15 Changes in fair value of the equity instruments after the measurement date unrelated to the achievement of performance conditions shall be accounted for in accordance with any relevant guidance on the accounting and reporting for investments in equity instruments, such as that in Topic 323; 325; 320; and 815.

35-16 Example 4, Case C (see paragraph 505-50-55-25) illustrates grantee accounting if the terms of the equity instrument are dependent on performance.

**9-09 Accounting for the Modification of Share-Based Payment Awards Issued to Nonemployees**

**Question**

How is a modification of a share-based payment award issued to nonemployees accounted for under the provisions of ASC 505-50?

**Answer**

ASC 505-50 addresses the accounting for share-based payment awards issued to nonemployees but does not provide guidance on accounting for the modification of such awards. In addition, while ASC 505-50 discusses the application of modification guidance in the context of nondiscretionary adjustments pursuant to the original terms of an award, it does not address the accounting for discretionary modifications.

Notwithstanding the lack of guidance, generally it is appropriate to analogize to the modification guidance applicable to share-based payment awards granted to employees to determine the appropriate accounting for the modification of share-based payment awards issued to nonemployees. For equity awards, ASC 718-20-35-3 states that incremental compensation cost is measured as the excess, if any, of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification. See Q&A 4-15 for a discussion of the accounting for the modification of a share-based payment award granted to an employee.

ASC 718-30-35-5 states that “no special guidance is necessary in accounting for a modification of a liability award” because liability awards are remeasured at fair value as of each reporting period.
9-10  Changes to Share-Based Payment Awards Issued to Nonemployees as a Result of Market Conditions

The provisions of some share-based payment awards issued to nonemployees may state that the quantity or any of the other terms of the award may be subject to change after the measurement date solely on the basis of achievement of market conditions. ASC 505-50-20 defines market conditions as “[c]onditions that relate to achievement of a specified market target, for example, attaining a specified stock price or specified amount of intrinsic value of a stock option.”

Question

How do entities account for equity-classified share-based awards issued to nonemployees that are subject to change solely on the basis of achievement of market conditions on the measurement date and after the measurement date?

Answer

Accounting on the Measurement Date

In accordance with ASC 505-50-30-11, the measurement date is the earlier of the following:

a. The date at which a commitment for performance by the [nonemployee] is reached (a performance commitment)

b. The date at which the counterparty’s performance is complete.

On the measurement date, an equity award issued to a nonemployee whose quantity or other terms are subject to change after the measurement date solely on the basis of achievement of market conditions is measured at the combined value of:

- The fair-value-based measure of the award (exclusive of the market condition).
- The “fair value of the issuer’s commitment to change the quantity or [any of the other] terms of the [award if] the market condition is met.”


Accounting After the Measurement Date

Under ASC 505-50, the fair-value-based measure of the equity award (exclusive of the market condition) remains unchanged after the measurement date (defined above). Changes in the fair value of the issuer’s commitment to modify the quantity or any of the other terms of the award must be recognized and classified under the relevant accounting literature related to financial instruments. In particular, issuers should consider the guidance in ASC 815-40.

Because of the requirements in ASC 815, once performance has occurred, an issuer may be required to reclassify the award to a derivative liability and remeasure the derivative liability at its fair value amount each reporting period until settlement. See ASC 505-50-35-5 and 35-6.

See Example 3 in Case A of ASC 505-50-55 for an illustration of the accounting for this type of award on and after the measurement date.

9-11  Changes in the Quantity or Terms of a Nonemployee Share-Based Payment Award Because of the Achievement of Counterparty Performance Conditions

Some share-based payment awards issued to nonemployees stipulate that the quantity or other terms of the award may be subject to change after the measurement date solely on the basis of the achievement of counterparty performance conditions. ASC 505-50-20 defines counterparty performance conditions as “[c]onditions that relate to the achievement of a specified performance target, for example, attaining a specified increase in market share for a specified product. A counterparty performance condition might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division.”
**Question**
How are equity-classified share-based payment awards issued to nonemployees that are subject to change solely on the basis of the achievement of counterparty performance conditions accounted for on and after the measurement date?

**Answer**
In accordance with ASC 505-50-30-11, the measurement date is the earlier of the following:

- The date at which a commitment for performance by the [nonemployee] is reached (a performance commitment).
- The date at which the counterparty’s performance is complete.

The accounting for such awards depends on the nature of the award. An entity may issue equity awards to a nonemployee stipulating that the counterparty will receive 0, 500, or 1,000 awards depending on its performance. Thus, on the measurement date, the issuer should measure the equity award at the lowest aggregate fair-value-based measure in the range of possible outcomes. The lowest value in the range of possible outcomes may be zero. The value of each of the possible outcomes is determined by multiplying the fair-value-based measure of the award by the number of awards that would be issued under that possible outcome. See ASC 505-50-30-30 for more information.

**Accounting After the Measurement Date**
After the measurement date (as defined above), the issuer is required to record any incremental cost each time a quantity or term becomes known and must continue recording incremental cost until all of the quantities and terms become known. The amount of incremental cost is measured by using the lowest aggregate fair-value-based measure under the modification accounting guidance in ASC 718-20-35-3 and 35-4. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award. The incremental cost is the excess of the fair-value-based measure of the award on the date the quantity or term becomes known less the fair-value-based measure of the award immediately before the quantity or term becomes known. The fair-value-based measure of the award on the date the quantity or term becomes known is determined by using the assumptions that result in the lowest possible value if the quantity or any of the other terms remain unknown. Once performance has occurred, an issuer may be required under ASC 815 to reclassify the award as a derivative liability and remeasure the derivative liability at fair value each reporting period until settlement. See ASC 505-50-35-7 and ASC 815-40-15-3(c) for more information. Also see Example 4, Case B, and Example 5, Cases B and C, in ASC 505-50-55 for an illustration of the accounting for this type of award on and after the measurement date.

**9-12 Changes in the Quantity or Terms of a Nonemployee Share-Based Payment Award Because of the Achievement of Both Market Conditions and Counterparty Performance Conditions**
Some equity-classified share-based payment awards issued to nonemployees stipulate that the quantity or other terms of the award may be subject to change after the measurement date on the basis of the achievement of both market conditions and counterparty performance conditions.

**Question**
How are equity-classified share-based payment awards issued to nonemployees that are subject to change on the basis of the achievement of both market conditions and counterparty performance conditions accounted for on and after the measurement date?

**Answer**
In accordance with ASC 505-50-30-11, the measurement date is the earlier of the following:

- The date at which a commitment for performance by the [nonemployee] is reached (a performance commitment).
- The date at which the counterparty’s performance is complete.

The accounting for such awards depends on the nature of the award. An entity may issue equity awards to a nonemployee stipulating that the counterparty will receive 0, 500, or 1,000 awards on the basis of its performance. Thus, on the measurement date, the issuer should measure the equity award at the lowest aggregate
A fair-value-based measure in the range of possible outcomes. The lowest value in the range of possible outcomes may be zero. The value of each of the possible outcomes is determined by multiplying the fair-value-based measure of the equity award by the number of awards that would be issued under that possible outcome. See ASC 505-50-30-31 for more information.

**Accounting After the Measurement Date**

After the measurement date (as defined above) and through the date on which the last counterparty performance condition is resolved, the issuer is required to record any incremental cost each time a quantity or term becomes known for the achievement of either a market condition or counterparty performance condition and must continue recording incremental cost until all of the quantities and terms become known. The amount of incremental cost is measured by using the lowest aggregate fair-value-based measure under the modification accounting guidance in ASC 718-20-35-3 and 35-4. See Q&A 4-15 for a discussion of the accounting for a modification of a share-based payment award. The incremental cost is the excess of the fair-value-based measure of the award on the date the quantity or term becomes known less the fair-value-based measure of the award immediately before the quantity or term becomes known. The fair-value-based measure of the award on the date the quantity or term becomes known is determined by using the assumptions that result in the lowest possible value if the quantity or any of the other terms remain unknown.

If a market condition remains at the time the last counterparty performance condition is resolved, the issuer must measure the current fair value of its commitment to change the quantity or any of the other terms of the award that may change if that market condition is met. The fair value of the commitment is recognized as incremental cost of the award. Changes in the fair value of the commitment must be recognized and classified under the accounting literature for financial instruments. Issuers should consider the guidance in ASC 815-40. Once performance has occurred, an issuer may be required under ASC 815 to reclassify the award as a derivative liability and remeasure the derivative liability at fair value each reporting period until settlement. See ASC 505-50-35-8 through 35-10 and ASC 815-40-15-3(c). See Example 3, Case B, in ASC 505-50-55 for an illustration of the accounting for this type of award on and after the measurement date.

**Presentation and Disclosure**

**ASC 505-50**

**Classification of Assets Other Than a Note or a Receivable**

45-1 As discussed in paragraph 505-50-25-7, a grantor may conclude that an asset (other than a note or a receivable) has been received in return for fully vested, nonforfeitable equity instruments that are issued at the date the grantor and grantee enter into an agreement for goods or services (and no specific performance is required by the grantee in order to retain those equity instruments). Such an asset shall not be displayed as contra-equity by the grantor of the equity instruments. The transferability (or lack thereof) of the equity instruments shall not affect the balance sheet display of the asset. This guidance is limited to transactions in which equity instruments are transferred to other than employees in exchange for goods or services.

**Grantor Disclosures**

50-1 An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraphs 718-10-50-1 through 50-2 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements.

**Grantee Disclosures**

50-2 In accordance with paragraphs 845-10-50-1 through 50-2, entities shall disclose, in each period’s financial statements, the amount of gross operating revenue recognized as a result of nonmonetary transactions addressed by the guidance in this Subtopic.

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**9-13 Presentation of the Cost of Share-Based Payment Awards Issued to Nonemployees in the Statement of Operations**

**Question**

Entities often issue share-based payment awards to suppliers, customers, or other service providers (i.e., nonemployees). How should entities present the cost of issuing share-based payment awards to nonemployees in the statement of operations?
**Answer**

The SEC staff has reviewed a number of cases in which registrants issued warrants, shares, options, or convertible instruments to suppliers, customers, partners, or other service providers. The staff has consistently held that when share-based payment awards are issued to customers or potential customers in arrangements in which the awards will not vest or become exercisable without purchases by the recipient, the related cost must be reported as a sales discount — in other words, as a reduction of revenue. In substance, the customer is paying for two things: (1) the product or service and (2) the award. Entities should therefore subtract the fair-value-based measure of the award from the proceeds received to determine how much revenue to recognize. This rationale is consistent with the accounting required under ASC 605-50.

Similarly, when awards are issued to suppliers or potential suppliers and they will not vest or become exercisable unless the recipient provides goods or services to the issuer, the cost of the award should be reported as a cost of the related goods or services.

In some cases, the SEC staff commented when entities presented separate line items in the statement of operations for the apparent purpose of emphasizing that a portion of the sales discounts or expenses did not involve a cash outlay. However, the SEC staff maintains that information that highlights the noncash nature of certain costs is most effectively presented in the statement of cash flows (and may be further highlighted (1) parenthetically in the statement of operations, (2) in the footnotes to the financial statements, or (3) in MD&A). In certain instances, the staff objected to presentations and disclosures that put undue emphasis on revenue, gross margin, or other income statement measures before reductions for the costs of awards issued to customers or suppliers. The SEC staff reiterated its view in SAB Topic 14.F, which states, in part:

*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. [Footnote omitted] 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.

See Q&A 6-01 for discussion of the presentation of compensation cost related to share-based payment awards granted to employees in the statement of operations.

The SEC staff also noted situations in which entities issue share-based payment awards in arrangements that do not appear to require any performance from the counterparty. Some have argued that the lack of such performance requirement indicates that the cost should be recorded as a marketing or even a nonoperating expense instead of a cost of sales or a reduction of revenue. However, the SEC staff has been skeptical of transactions that do not appear to require any performance from the potential customer or supplier for the awards to vest, become exercisable, or both. In the absence of any required future performance, the SEC staff has generally viewed the issuance of such awards as relating to past transactions between the parties and has asked that the cost be classified accordingly. In addition, the SEC staff has held that, to demonstrate that the issuance of an award in these situations is not related to past transactions, there should be evidence that the issuer has or will receive from the counterparty a direct benefit in return for the award that is separable from other business relationships between the issuer and counterparty. Furthermore, the SEC staff has considered whether there is sufficient, objective, and reliable evidence that indicates that the fair value of such benefit is at least as great as the fair-value-based measure of the awards.

In very rare and limited circumstances (e.g., when neither a performance commitment nor past relationship between the parties exists), the SEC staff has accepted presentation of the cost of nonemployee awards as a marketing expense if the presentation appeared reasonable. The SEC staff allowed this when entities made detailed and transparent disclosures of the transaction, including documentation of the lack of any required performance and the fact that no consideration was received for the award.

Whenever significant awards have been issued to or received from business partners, MD&A should include sufficient discussion of the effects of these noncash transactions on the results of operations (i.e., why they are used and what effect their use has on the comparability of the results of operations in the periods presented).

The underpinnings of these SEC staff views are consistent with the guidance on other presentation matters for customer payments and incentives in ASC 605-50-45. Accordingly, these views would also apply to nonemployee awards issued by nonpublic entities.
9-14  Disclosure of Nonemployee Share-Based Payment Awards

Question
What disclosures are required for an entity that issues share-based payment awards to nonemployees?

Answer
ASC 505-50-50-1 states:

An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraphs 718-10-50-1 through 50-2 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements.

Accordingly, entities are required to include separate disclosure for each significant nonemployee share-based payment award to the extent that the differences in the characteristics of the awards are important to an investor’s understanding of the entity’s use of share-based payment awards.
Chapter 10 — Business Combinations

An acquiring entity may issue share-based payment awards (referred to as “replacement awards” in ASC 805) to the acquiree’s employees to replace their existing share-based payment awards. Exchanges of share-based payment awards in a business combination are considered modifications in accordance with ASC 718.

The acquirer often issues replacement awards to ensure that the acquiree’s employees are in a similar economic position immediately before and after the consummation of the business combination. In addition, an acquirer may issue replacement awards that include an additional service requirement for employees to remain with the entity after the acquisition. Therefore, the issuance of share-based payment awards may represent consideration transferred in the business combination (i.e., the award is related to past services that the employee performs for the acquiree before the acquisition date), compensation for future services (i.e., postcombination services) by an employee, or both.

ASC 805 provides guidance on calculating the portion of a replacement share-based payment award that is attributable to (1) precombination service and therefore included in the consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost. The acquiring entity must first analyze the arrangement to determine whether it is obligated to replace the acquiree’s employee awards. ASC 805-30-30-9 states that the acquirer is obligated to replace the acquiree’s share-based payment awards “if the acquiree or its employees have the ability to enforce replacement.” It further indicates that this obligation would be incurred if replacement is required by (1) the terms of the acquisition agreement, (2) the terms of the acquiree’s awards, or (3) applicable laws or regulations. If the acquirer is obligated to replace the awards, all or a portion of the fair-value-based measure of the acquirer’s replacement awards would be included in the measurement of the consideration transferred in the business combination. The portion not included in the measurement of consideration transferred would be included in postcombination compensation cost and recognized over the appropriate requisite service period. Lastly, any excess of the fair-value-based measure of the replacement awards over the fair value of the acquiree awards should be attributed to postcombination services and recognized as postcombination compensation cost. For implementation guidance on this topic, see ASC 805-30-55-6 through 55-14 and ASC 805-30-55-17 through 55-24.

Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Acquiree’s Employees

ASC 805-30

| 30-9 | An acquirer may exchange its share-based payment awards for awards held by employees of the acquiree. This Topic refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer’s replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree’s awards if replacement is required by any of the following:
|  
|   | a. The terms of the acquisition agreement
|   | b. The terms of the acquiree’s awards
|   | c. Applicable laws or regulations.

ASC 718-10-15-6 notes that paragraphs 805-30-30-9 through 30-13 provide guidance on determining whether share-based payment awards issued in a business combination are part of the consideration transferred in exchange for the acquiree, and therefore in the scope of Topic 805, or are for continued service to be recognized in the postcombination period in accordance with [ASC 718].
### ASC 805-30 (continued)

**30-10** In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the postcombination financial statements. That is, none of the fair value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

**30-11** To determine the portion of a replacement award that is part of the consideration transferred for the acquiree, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Topic 718. The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination service.

**30-12** The acquirer shall attribute a portion of a replacement award to postcombination service if it requires postcombination service, regardless of whether employees had rendered all of the service required in exchange for their acquiree awards before the acquisition date. The portion of a nonvested replacement award attributable to postcombination service equals the total fair-value-based measure of the replacement award less the amount attributed to precombination service. Therefore, the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination service.

**30-13** Paragraphs 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-30-55-17) provide additional guidance and illustrations on distinguishing between the portion of a replacement award that is attributable to precombination service, which the acquirer includes in the consideration transferred in the business combination, and the portion that is attributed to postcombination service, which the acquirer recognizes as compensation cost in its postcombination financial statements.

### 10-01 Accounting for Share-Based Payment Awards Exchanged in a Business Combination

An acquiring entity may issue share-based payment awards (referred to as “replacement awards” in ASC 805) to the acquiree’s employees to replace their existing share-based payment awards that are at least, in part, tied to the acquiree’s common stock (e.g., stock options). Exchanges of share-based payment awards in a business combination are considered modifications in accordance with ASC 718.

The acquirer often issues replacement awards to ensure that the acquiree’s employees are in a similar economic position immediately before and after the consummation of the business combination. In addition, an acquirer may issue replacement awards that include an additional service requirement for employees to remain with the entity after the acquisition.

**Question**

How does the acquirer in a business combination account for the exchange of share-based payment awards held by employees of the acquired entity?

**Answer**

The issuance of share-based payment awards may represent consideration transferred in the business combination (i.e., the award relates to past services performed by the employee for the acquiree before the acquisition date), compensation for future services (i.e., postcombination services) by an employee, or both.
The following flowchart illustrates the steps in an entity’s determination of the amount to recognize as consideration transferred in a business combination and as postcombination compensation cost:

Is the acquirer obligated to replace the acquiree’s employee’s awards? (See Q&A 10-02.)

Yes
- Include all or a portion of the fair-value-based measure* of the acquirer’s replacement awards in the consideration transferred. The portion not included in the consideration transferred is included in postcombination compensation cost.
- Calculate the fair-value-based measure of the acquirer’s replacement awards and the acquiree’s awards being replaced as of the acquisition date. (See Q&A 10-04.)
- If the fair-value-based measure of the replacement awards is greater than the fair-value-based measure of the replaced awards, attribute the difference to postcombination compensation cost in accordance with ASC 718. (See Q&A 10-05.)
- Calculate the portion of the fair-value-based measure of the replacement awards that should be attributed to consideration transferred (i.e., precombination service) and the portion of the fair-value-based measure that should be attributed to postcombination compensation cost (i.e., postcombination service). (See Q&A 10-06, Q&A 10-07, Q&A 10-16, and Q&A 10-17.)

No
- If replacement awards are issued, generally account for the entire award as postcombination compensation cost. (See Q&A 10-03.)

* Throughout this diagram, the term "fair-value-based measure" is used to describe the value assigned to share-based payment awards exchanged in a business combination. For further discussion of fair-value-based measures, see Q&A 10-04.

10-02  Determining Whether an Acquirer Is Obligated to Replace the Acquiree’s Employees’ Share-Based Payment Awards

ASC 805 provides guidance on calculating the portion of a replacement share-based payment award that is attributable to (1) precombination service and therefore included in the consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost. The acquiring entity must first analyze the arrangement to determine whether it is “obligated” to replace the acquiree’s employees’ awards. If the acquirer is obligated to replace the awards, then all or a portion of the fair-value-based measure of the acquirer’s replacement awards is included in the measurement of the consideration transferred in the business combination. The portion not included in the measurement of consideration transferred is included in postcombination compensation cost.

**Question**

How does an acquirer determine whether it is obligated to replace the acquiree’s employees’ share-based payment awards?

**Answer**

ASC 805-30-30-9 states that the acquirer is obligated to replace the acquiree’s share-based payment awards “if the acquiree or its employees have the ability to enforce replacement.” It further indicates that this obligation would be incurred if replacement is required by (1) the terms of the acquisition agreement, (2) the terms of the acquiree’s awards, or (3) applicable laws or regulations.

For information about determining the fair value of the awards exchanged in a business combination when the acquirer is obligated to replace the acquiree’s awards, see Q&A 10-04. In addition, see Q&A 10-03 for information about the issuance of replacement awards when the acquirer is not obligated to replace the acquiree’s expired awards.
10-03  Accounting for the Exchange of Share-Based Payment Awards When the Acquirer Is Not Obligated to Replace the Acquiree’s Share-Based Payment Awards

Question
How does the acquirer in a business combination account for the exchange of share-based payment awards when the acquirer is not obligated to replace the acquiree’s awards?

Answer
If an acquiree’s share-based payment awards expire as a result of the business combination and the acquirer issues replacement awards even though it is not obligated to do so, the entire fair-value-based measure of the awards is generally considered compensation cost in the postcombination period and is accounted for as a new award in accordance with ASC 718.

10-04  Determining the Fair Value of Share-Based Payment Awards Exchanged in a Business Combination

If the acquirer is obligated to replace the acquiree’s share-based payment awards, it must determine what portion of the replacement awards is attributable to (1) precombination service and therefore included in the consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost. However, before making this determination, the acquirer must determine the fair-value-based measure of both the acquirer’s replacement awards and the acquiree’s replaced awards as of the acquisition date, in accordance with the requirements of ASC 718.

Question
How is the fair-value-based measure of the acquirer’s replacement share-based payment awards and the acquiree’s replaced awards determined?

Answer
ASC 805-20-30-1 requires, with few exceptions, that assets acquired and liabilities assumed in a business combination be measured at their acquisition-date fair values, as defined in ASC 820. Share-based payment awards are one of the exceptions. ASC 805-20-30-21 indicates that the “acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree’s share-based payment awards with share-based payment awards of the acquirer in accordance with the method in Topic 718.” ASC 805 refers to this resulting measurement method as the “fair-value-based measure” of the awards. Unlike a fair value measure, a fair-value-based measure reflects all substantive characteristics of the award, except for provisions such as vesting conditions (i.e., service or performance conditions).

For information about accounting for the excess of the fair-value-based measure of the acquirer’s replacement awards over that of the acquiree’s replaced awards, see Q&A 10-05. In addition, see Q&A 10-06 for information about determining the portions of the replacement share-based payment award that are attributable to precombination service and postcombination service.

10-05  Accounting for the Excess of the Fair-Value-Based Measure of the Replacement Share-Based Payment Awards Over That of the Replaced Share-Based Payment Awards

Question
How should an acquirer account for the excess of the fair-value-based measure of its replacement share-based payment awards over that of the acquiree’s replaced awards?
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**Answer**

ASC 805-30-30-12 indicates that “the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination service.” Therefore, the excess is recognized as compensation cost in the acquirer’s postcombination financial statements. Such cost would be recognized over the period from the acquisition date through the end of the requisite service period of the replacement awards.

ASC 805-30-55-18 and 55-19 contain the following example:

*Case A: No Required Postcombination Service, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date*

Acquirer issues replacement awards of $110 (fair-value-based measure) at the acquisition date for Target awards of $100 (fair-value-based measure) at the acquisition date. No postcombination services are required for the replacement awards, and Target’s employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to precombination service is the fair-value-based measure of Target’s awards ($100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination service is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to precombination service ($100). Because no postcombination service is required for the replacement awards, Acquirer immediately recognizes $10 as compensation cost in its postcombination financial statements.

**10-06 Determining the Portions of the Replacement Share-Based Payment Award That Are Attributable to Precombination Service and Postcombination Service**

If the acquirer is obligated to replace the acquiree’s share-based payment awards, it must determine what portion of the replacement awards is attributable to (1) precombination service and therefore included in the consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost.

**Question**

How does an entity calculate the portions of the replacement share-based payment award that are attributable to precombination service and postcombination service?

**Answer**

The portion of the replacement share-based payment award that is attributable to precombination service, and therefore included in the consideration transferred, is calculated as follows:

\[
\text{Amount included in consideration transferred} = \frac{\text{Acquisition-date fair-value-based measure of the acquiree’s replaced award}}{\text{Ratio of the precombination service to the greater of (1) the total service period or (2) the original service period of the acquiree’s replaced award}}
\]

The total service period is calculated as follows:

\[
\text{Total service period} = \text{Requisite service period for the acquiree’s replaced award completed before the acquisition date} + \text{Postcombination requisite service period, if any, for the acquirer’s replacement award}
\]

For more information about determining the total service period, see Q&A 10-07.

The portion of the replacement award attributable to postcombination service, and therefore included in postcombination compensation cost, is calculated as follows:

\[
\text{Postcombination compensation cost} = \frac{\text{Acquisition-date fair-value-based measure of the acquirer’s replacement award} - \text{Amount attributable to precombination service}}{\text{After-tax incremental cost}}
\]

---

5 This Q&A uses the term fair-value-based measure; however, ASC 718 also permits the use of calculated value or intrinsic value in specified circumstances. This guidance would also apply in situations in which calculated value or intrinsic value is permitted.
**Example — Allocation of Compensation Expense**

On January 1, 20X1, Entity B grants 100 share-based payment awards to an employee that vest at the end of the third year of service (cliff vesting).

On January 1, 20X2, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employee’s awards with 100 replacement awards that have the same service terms as B’s original awards (i.e., the replacement awards will vest at the end of two additional years). On January 1, 20X2, the fair-value-based measure of both A’s replacement awards and B’s replaced awards is $10 per award.

The total fair-value-based measure of the replacement awards as of the acquisition date is $1,000 (100 awards × $10 fair-value-based measure), of which $333 (one of three years) is attributable to precombination services and $667 (two of three years) is attributable to postcombination services. The $333 is included in the consideration transferred, and the $667 is recognized as compensation cost by A as the services are performed by the employee (i.e., from January 1, 20X2, to December 31, 20X3). Note that the grant-date fair value assigned to the awards issued by B is not relevant as of the acquisition date.

**Examples From ASC 805**

ASC 805-30-55-20 through 55-24 contain the following examples:

**Case B: Postcombination Service Required, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date**

Acquirer exchanges replacement awards that require one year of postcombination service for share-based payment awards of Target for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, Target’s awards had a requisite service period of four years. As of the acquisition date, the Target employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though Target employees had already rendered all of the requisite service, Acquirer attributes a portion of the replacement award to postcombination compensation cost in accordance with paragraphs 805-30-30-12 through 30-13 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year). The portion attributable to precombination services equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (4 years) to the total service period (5 years). Thus, $80 ($100 × 4 ÷ 5 years) is attributed to the precombination service period and therefore included in the consideration transferred in the business combination. The remaining $20 is attributed to the postcombination service period and therefore is recognized as compensation cost in Acquirer’s postcombination financial statements in accordance with Topic 718.

**Case C: Postcombination Service Required, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date**

Acquirer exchanges replacement awards that require one year of postcombination service for share-based payment awards of Target for which employees had not yet rendered all of the required services as of the acquisition date. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, the awards of Target had a requisite service period of four years. As of the acquisition date, the Target employees had rendered two years’ service, and they would have been required to render two additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of Target’s awards is attributable to precombination service.

The replacement awards require only one year of postcombination service. Because employees have already rendered two years of service, the total requisite service period is three years. The portion attributable to precombination services equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (2 years) to the greater of the total service period (3 years) or the original service period of Target’s award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to precombination service and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination service and therefore recognized as compensation cost in Acquirer’s postcombination financial statements. [Emphasis added]

**Case D: No Required Postcombination Service, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date**

Assume the same facts as in Case C, except that Acquirer exchanges replacement awards that require no postcombination service for share-based payment awards of Target for which employees had not yet rendered all of the requisite service as of the acquisition date. The terms of the replaced Target awards did not eliminate any remaining requisite service period upon a change in control. (If the Target awards had included a provision that eliminated any remaining requisite service period upon a change in control, the guidance in Case A would apply.) The fair-value-based measure of both awards is $100. Because employees have already rendered two years of service and the replacement awards do not require any postcombination service, the total service period is two years.
The portion of the fair-value-based measure of the replacement awards attributable to precombination services equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (2 years) to the greater of the total service period (2 years) or the original service period of Target’s award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to precombination service and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination service. Because no postcombination service is required to vest in the replacement award, Acquirer recognizes the entire $50 immediately as compensation cost in the postcombination financial statements. [Emphasis added]

10-07 Determining the Total Service Period of Share-Based Payment Awards Exchanged in a Business Combination

As discussed in Q&A 10-06, an entity calculates the portion of the replacement share-based payment award attributable to precombination service, and therefore included in consideration transferred, by using the ratio of precombination service to the greater of (1) the total service period or (2) the original service period of the acquiree’s replaced award.

Question

How does an entity calculate the total service period for replacement share-based payment awards issued in a business combination?

Answer

The total service period is equal to the requisite service period for the acquiree’s replaced share-based payment award that was completed before the acquisition date plus the postcombination requisite service period, if any, for the acquirer’s replacement award. ASC 805-30-55-9 states, “The requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of Topic 718).”

For acquiree awards that were fully vested before the acquisition date, and that were replaced by new awards that require an additional future service period, the determination of the total service period would not include the period from the vesting date of the acquiree awards to the acquisition date.

Example 1 — Determining the Total Service Period of the Replacement Award When the Replaced Award Is Fully Vested

Assume that an employee has 100 share-based payment awards of Entity B’s common stock that are fully vested on June 30, 20X1. A three-year service period was originally associated with these awards, but they have not been exercised yet. On January 1, 20X2, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employee’s awards. As part of the acquisition, A is obligated to replace B’s fully vested awards with A’s new awards that require an additional three years of service.

The total service period of the replacement awards is six years, which is the sum of the service period of B’s original awards (the replaced awards) plus the service period of A’s new awards (the replacement awards). In other words, the total service period does not include the period from the original vesting date (i.e., June 30, 20X1) to the acquisition date (i.e., January 1, 20X2).

Example 2 — Determining the Total Service Period of the Replacement Award When the Service Period Is the Same as That for the Replaced Award

On January 1, 20X1, Entity B grants 100 share-based payment awards to an employee that vest at the end of the fourth year of service (cliff vesting). On January 1, 20X3, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employee’s awards with 100 replacement awards that have the same service terms as B’s original award (i.e., the replacement awards will vest at the end of two additional years).

The total service period of the replacement awards is four years, which is equal to the service period of B’s original awards. In the calculation of the portion attributable to precombination service, the precombination service period would equal two years (January 1, 20X1, to January 1, 20X3).
10-08 Accelerated Vesting of an Acquiree’s Share-Based Payment Awards Upon a Change in Control

As noted in Q&A 10-06, an acquirer must determine the portion of a replacement share-based payment award that is attributable to (1) precombination service and therefore included in consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost.

Question

How does an acquirer account for the accelerated vesting of an acquiree’s share-based payment awards upon a change in control?

Answer

It depends. The accounting for the accelerated vesting of an award upon a change in control will depend on which party initiated the acceleration as well as on whether the acceleration is a preexisting provision in the terms of the acquiree’s awards.

Acquirer Accelerates Vesting After the Acquisition Date

An acquirer’s decision to immediately vest or reduce the future service period of awards held by employees of the acquiree does not affect the portion of the fair-value-based measure of the replacement awards that is attributable to postcombination service and therefore included in postcombination compensation cost; rather, it affects the timing of the recognition of postcombination compensation cost. For example, if the acquirer decides to immediately vest the replacement awards, the portion of the fair-value-based measure of the awards attributable to postcombination service would be immediately recognized as compensation cost in the acquirer’s postcombination financial statements. The amount of the compensation cost would not be affected.

Acceleration of Vesting Included in the Original Terms of the Award

Conversely, if share-based payment awards of the acquiree become immediately vested on the date of the business combination because of a preexisting provision in the terms of the awards that accelerates the vesting of the awards, the portion of the replacement awards that is attributable to precombination service and therefore included in consideration transferred would be affected. As noted in Q&A 10-06, the portion of the replacement awards attributable to precombination service is the acquisition-date fair-value-based measure of the replaced awards multiplied by the ratio of the precombination service period to the greater of the (1) total service period or (2) original service period of the replaced awards. Since (1) all of the service has been performed in the precombination period, (2) there is no requirement for future service, and (3) the original service period is complete, the entire fair-value-based measure of the replaced awards would be attributable to precombination service and therefore included in consideration transferred.

In addition, since the awards become fully vested contemporaneously with the consummation of the business combination, any remaining unrecognized compensation cost associated with the original grant-date fair value of the awards would be recognized in the acquiree’s precombination financial statements.7

Modifications to the Original Terms of the Award to Add a Change-in-Control Provision in Contemplation of a Business Combination

In some instances, a modification to share-based payment awards is made that adds a change-in-control provision in contemplation of a business combination. The modification may be initiated by the acquiree or requested by the acquirer. Entities should carefully analyze the circumstances surrounding the modification to determine whether it is part of, or separate from, the business combination. Factors that may be considered include, but are not limited to, the business purpose of the modification (e.g., what parties will benefit from the modification to the terms of the award) as well as who initiated the modification (i.e., the acquiree or the acquirer). Also see ASC 805-10-55-18 for further discussion on determining whether a transaction is part of, or separate from, a business combination.

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6 These provisions are commonly referred to as “change-in-control” provisions.

7 Alternatively, if compensation cost is recognized contemporaneously with the business combination, the compensation cost may be presented in neither the acquiree’s precombination financial statements nor the combined entity’s postcombination financial statements (i.e., it is recognized on the “black line”).
Generally, a modification to the original terms of the award to add a change-in-control provision in contemplation of a business combination is made at the request of the acquirer. When a modification of acquiree awards to accelerate their vesting upon a change in control is made at the request of the acquirer, the modification is accounted for in accordance with ASC 718. That is, in addition to the attribution of the compensation cost associated with the original award, the acquiree would record incremental compensation cost on the basis of the excess of the fair-value-based measure of the modified award on the date of modification over the fair-value-based measure of the original award immediately before the modification. The incremental compensation cost would be attributed over the remaining service period of the modified award (excluding the effect of the business combination), which (assuming there were no other modifications to the award) would be the same remaining service period as that of the original award.

Upon the consummation of the business combination, the acceleration of vesting would be considered a transaction that is separate from the business combination. Accordingly, any remaining unrecognized compensation cost associated with the original award and any remaining incremental compensation cost associated with the modified award would not be recognized as compensation cost in the acquiree’s precombination financial statements. In addition, the acceleration of vesting would be accounted for as though the acquirer had decided to accelerate the vesting of the replacement awards immediately after the acquisition. That is, the acquirer’s decision to accelerate the vesting of the awards would affect the timing of the recognition of postcombination compensation cost but not the determination of the portion of the replacement share-based payment award that is attributable to (1) precombination service and therefore included in the consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost.

**Example 1 — Acquirer Accelerates Vesting After the Acquisition Date**

On January 1, 20X1, Entity B issues 100 share-based payment awards to an employee that vest at the end of the third year of service (cliff vesting). On January 1, 20X2, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employee’s awards with 100 replacement awards that have the same service terms as B’s original awards. On January 1, 20X2, the fair-value-based measure of both A’s replacement awards and B’s replaced awards is $10 per award. Entity A then immediately vests all of the outstanding replacement awards on the date of the business combination.

The total fair-value-based measure of the replacement awards as of the acquisition date is $1,000 (100 awards × $10 fair-value-based measure), of which $333 (one of three years) is attributable to precombination service and $667 (two of three years) is attributable to postcombination service. The $333 is included in the consideration transferred, and the $667 is recognized as compensation cost by A in the postcombination financial statements immediately after the business combination.

As indicated above, the acceleration of the vesting of the awards by the acquirer does not affect the portion of the fair-value-based measure of the replacement awards that is attributable to postcombination service and therefore included in postcombination compensation cost (i.e., the $667); rather, it affects the timing of the recognition of postcombination compensation cost (i.e., immediate).

**Example 2 — Acceleration of Vesting Included in the Original Terms of the Award**

Assume the same facts as in Example 1, except that B’s awards included a preexisting provision in the terms of the awards that accelerates the vesting of the awards upon the acquisition of B. Since all of the service has been performed in the precombination period, there is no requirement for future service, and the original service period is complete, the entire $1,000 would be attributable to precombination service and therefore included in consideration transferred.

**10-09 Cash Settlement of an Acquiree’s Share-Based Payment Awards Upon a Change in Control**

In some business combinations, acquirers may, upon a change in control, cash-settle share-based payment awards instead of either accelerating the awards’ vesting provisions or replacing the awards.

**Question**

How does an acquirer account for a cash settlement of an acquiree’s share-based payment awards upon a change in control?
Answer

It depends. As with the acceleration of the vesting provisions of an award upon a change in control (see Q&A 10-08), the accounting for the cash settlement of an award will depend on which party initiated the cash settlement as well as on whether the cash settlement is a preexisting provision in the terms of the acquiree’s awards.

**Acquirer Cash-Settles the Acquiree’s Awards**

If the acquirer cash-settles the acquiree’s awards, the cash payment is generally considered a transaction that is separate from the business combination (see ASC 805-10-55-18). Accordingly, an acquirer’s decision to cash-settle share-based payment awards held by employees of the acquiree does not affect the portion of the fair-value-based measure of the replacement awards that is attributable to postcombination service and therefore included in postcombination compensation cost; rather, it affects the timing of the recognition of postcombination compensation cost. For example, if the acquirer decides to cash-settle the awards, the portion of the fair-value-based measure of the awards attributable to postcombination service would be immediately recognized as compensation cost in the acquirer’s postcombination financial statements. The amount of the compensation cost would not be affected. In accordance with ASC 718-20-35-7, as long as the acquirer cash-settles the awards at their then fair-value-based amount, the amount to repurchase the awards will be charged to equity in the acquirer’s postcombination financial statements.

**Cash Settlement Provision Included in the Original Terms of the Award**

Alternatively, in some circumstances an acquiree’s share-based payment awards can be cash-settled as a result of a change in control because of a preexisting provision in the terms of the awards. ASC 718-10-25-11 states:

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

a. The underlying shares are classified as liabilities.

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

In such a case, assuming all other criteria for equity classification have been met, the awards would be classified as equity until it becomes probable that the change in control will occur (i.e., when it is probable that the awards will be cash-settled). Generally, a change in control is not considered probable until the event has occurred (i.e., when the business combination has been consummated).

Contemporaneously with the closing of the business combination (when it is probable that the awards will be cash-settled), the awards would become a share-based liability. Accordingly, in the acquiree’s precombination financial statements, the awards are accounted for as a share-based liability and therefore would be part of the liabilities assumed by the acquirer in the business combination. As indicated in ASC 718-10-35-15, the change from an equity award to a liability award “shall be accounted for similar to a modification from an equity [award] to [a] liability award.”

**Fully Vested Awards That Are Cash-Settled Upon a Change in Control**

If the awards are fully vested as of the date of acquisition, the acquirer recognizes a share-based liability for the fair-value-based measure of the awards on the date of the acquisition. If the fair-value-based measure of the share-based liability is greater than the original grant-date fair-value-based measure of the equity award, the difference would be recognized as additional compensation cost in the acquiree’s precombination financial statements. Conversely, if the fair-value-based measure of the share-based liability is less than or equal to the original grant-date fair-value-based measure of the equity award, the offsetting amount is recorded to APIC in the acquiree’s precombination financial statements.

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8 Alternatively, if compensation cost is recognized contemporaneously with the business combination, the compensation cost may be presented in neither the acquiree’s precombination financial statements nor the combined entity’s postcombination financial statements (i.e., it is recognized on the “black line”).

9 See footnote 8.
Partial Vested Awards That Are Cash-Settled Upon a Change in Control

If the awards are partially vested as of the date of acquisition, the cash settlement provision immediately vests the award. Accordingly, any unrecognized compensation cost associated with the original equity award is recognized as compensation cost in the acquiree’s precombination financial statements. In addition, the acquirer would recognize a share-based liability for the fair-value-based measure of the awards on the date of the acquisition. Since the award is now fully vested, if the fair-value-based measure is greater than the original grant-date fair-value-based measure of the award, the difference would be recognized as additional compensation cost in the acquiree’s precombination financial statements. Conversely, if the fair-value-based measure is less than the original grant-date fair-value-based measure of the award, the offsetting amount is recorded to APIC in the acquiree’s precombination financial statements.

Example 1 — Fully Vested Awards That Are Cash-Settled Upon a Change in Control

On January 1, 20X1, Entity B issues 1,000 share-based payment awards to its employees, each with a grant-date fair-value-based measure of $5, that vest at the end of the third year of service (cliff vesting). The awards contain a provision that requires cash settlement in the event of a change in control.

On January 1, 20X5, Entity A acquires B in a transaction accounted for as a business combination. On January 1, 20X5, the fair-value-based measure of B’s awards is $6 per award.

Contemporaneously with the closing of the business combination, B (1) reclassifies the amount currently residing in APIC — $5,000 (1,000 awards × $5 grant-date fair value × 100% of services rendered) — as a share-based liability and (2) records the excess $1,000 ($6 acquisition-date fair-value-based measure – $5 grant-date fair-value-based measure) × 1,000 awards × 100% of services rendered) as additional compensation cost in the acquiree’s precombination financial statements to record the share-based liability at its fair-value-based measure, with a corresponding adjustment to the share-based liability.

Example 2 — Partially Vested Awards That Are Cash-Settled Upon a Change in Control

Assume the same facts as in Example 1, except that the awards granted by B vest at the end of the fifth year of service (cliff vesting).

Contemporaneously with the closing of the business combination, B (1) recognizes $1,000 (1,000 awards × $5 grant-date fair-value-based measure × 1 of 5 years of service remaining) for the remaining unrecognized compensation cost associated with the original equity award because the cash settlement provision immediately vests the award; (2) reclassifies the amount now residing in APIC — $5,000 (1,000 awards × $5 grant-date fair-value-based measure × 100% of services rendered) — as a share-based liability; and (3) records the excess $1,000 ($6 acquisition-date fair-value-based measure – $5 grant-date fair-value-based measure) × 1,000 awards × 100% of services rendered) as additional compensation cost in the acquiree’s precombination financial statements to record the share-based liability at its fair-value-based measure, with a corresponding adjustment to the share-based liability.

10-10 Accounting for Changes in Forfeiture Estimates Affecting Share-Based Payment Awards Exchanged in a Business Combination

ASC 805-30-55-11 states that the portion of the fair-value-based measure of the replacement share-based payment award attributable to both precombination and postcombination service must reflect the acquirer’s forfeiture estimate as of the acquisition date. Accordingly, consideration transferred and postcombination compensation cost are recognized only for awards that are expected to vest.

Question

How should the acquirer account for changes in its forfeiture estimate in the postcombination period?

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10 See footnote 8.
11 See footnote 8.
12 See footnote 8.
13 See footnote 8.
Answer
ASC 805-30-55-11 states that changes in the acquirer’s forfeiture estimate in the postcombination period should be reflected in compensation cost for the period in which the change in estimate occurs. However, views differ on how the acquirer should reflect changes in its forfeiture estimate (i.e., an increase or a decrease in the number of awards expected to vest) in postcombination compensation cost.

The following are two acceptable views on circumstances involving an increase in the forfeiture estimate (in the event of a decrease in forfeiture estimate, only View B would apply) and the related tax implications of each view regarding this estimate:

- **View A** — An increase in an acquirer’s forfeiture estimate (i.e., a decrease in the number of awards expected to vest) should result in the reversal of compensation cost associated with the acquisition-date fair-value-based measure that was attributed to postcombination service as of the acquisition date. Under this view, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to precombination service must be recognized in APIC to the extent that the acquirer has sufficient prior excess tax benefits (i.e., APIC pool). To the extent that the acquirer does not have sufficient prior excess tax benefits, the reversal of the DTA is recorded in the current-period income tax provision. The reversal of the DTA related to postcombination service must be recognized in the current-period income tax provision.

- **View B** — An increase in the acquirer’s forfeiture estimate (i.e., a decrease in the number of awards expected to vest) should result in the reversal of compensation cost for the acquisition-date fair-value-based measure of the awards not expected to vest, regardless of whether that measure was attributed to precombination or postcombination service as of the acquisition date. This reversal of compensation cost may exceed the amounts previously recognized as compensation cost in the acquirer’s postcombination financial statements. In addition, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to both the precombination and postcombination service must be recognized in the current-period income tax provision.

An acquirer may elect either view as an accounting policy. However, in accordance with ASC 235-10-50-1, an entity’s accounting policy must be applied consistently and must be disclosed if it is material to the financial statements.

The examples below illustrate the accounting for an increase in the acquirer’s forfeiture estimate under View A and View B.

**Example 1 — View A**
On January 1, 20X1, Entity B grants employees 100 nonqualified (tax-deductible) share options that vest at the end of the fifth year of service (cliff vesting). On December 31, 20X4, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employees’ awards with 100 replacement awards that have the same service terms as B’s original award (i.e., the replacement awards will vest at the end of one additional year of service). The fair-value-based measure of each award on the acquisition date is $10. Accordingly, the fair-value-based measure of both A’s awards (the replacement awards) and B’s awards (the replaced awards) is $1,000 as of the acquisition date. Further assume that A attributes $800 of the acquisition-date fair-value-based measure of the replacement awards to precombination service and the remaining $200 to postcombination service. The $200 attributed to the postcombination service is recognized as postcombination compensation cost over the replacement award’s remaining one-year service period. On the acquisition date, A estimates that 25 percent of the replacement awards granted will be forfeited. Assume that A’s applicable tax rate is 40 percent and that A has sufficient prior excess tax benefits (i.e., APIC pool).

**Journal Entries: December 31, 20X4, Acquisition Date**

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To record the portion of the acquisition-date fair-value-based measure of the replacement award of $600 ($800 acquisition-date fair-value-based measure allocated to precombination service x 75% awards expected to vest) that is attributable to precombination service and therefore included in consideration transferred and the corresponding income tax effects.
Chapter 10 — Business Combinations
A Roadmap to Accounting for Share-Based Payment Awards

Journal Entries: Quarter Ended March 31, 20X5

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To record the portion of the acquisition-date fair-value-based measure of the replacement award of $37.50 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 75% awards expected to vest × 25% services rendered) attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the first quarter of service.

Journal Entries: Quarter Ended June 30, 20X5

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To record the portion of the acquisition-date fair-value-based measure of the replacement award of $37.50 [($200 acquisition-date fair-value-based measure allocated to postcombination service × 75% awards expected to vest × 50% services rendered) – $37.50 compensation cost previously recognized] attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the second quarter of service.

During the third quarter, A goes through a restructuring and many of B’s former employees terminate their employment before their replacement awards vest. Accordingly, A changes its forfeiture estimate for the replacement awards from 25 percent to 80 percent.

Journal Entries: Quarter Ended September 30, 20X5

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To record the adjustment for the increase in forfeiture estimate in the third quarter of $45 [($200 acquisition-date fair-value-based measure allocated to postcombination service × 20% revised awards expected to vest × 75% services rendered) – $75 compensation cost previously recognized] and the corresponding income tax effects.

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To record the reversal of $176 [($800 acquisition-date fair-value-based measure allocated to precombination service × 20% revised awards expected to vest × 40% tax rate) – $240 DTA previously recognized] for the DTA related to the acquisition-date fair-value-based measure attributed to precombination service. If A does not have sufficient prior excess tax benefits, the reversal of the DTA would be recorded in the current-period income tax provision.

There were no additional changes to the forfeiture estimate in the fourth quarter; therefore, 20 of the 100 originally issued awards vested.
Journal Entries: Quarter Ended December 31, 20X5

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To record the portion of the acquisition-date fair-value-based measure of the replacement award of $10 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 20% awards expected to vest × 100% services rendered) – $30 compensation cost previously recognized attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the fourth quarter of service.

Example 2 — View B

Assume the same facts as in Example 1, View A. Under this view, there is no difference in the accounting as of the acquisition date and for the first two quarters of service in the postcombination period (i.e., the journal entries are the same). However, A’s accounting in the third quarter for the change in forfeiture estimate will differ from the accounting under View A, as illustrated in Example 1, View A.

Because A’s forfeiture estimate has increased to 80 percent in the third quarter, only $200 of the $1,000 acquisition-date fair-value-based measure of the replacement awards should be allocated between the precombination and postcombination service periods. Accordingly, A recognizes an adjustment in postcombination compensation cost for the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement awards that was originally included in consideration transferred but that is associated with replacement awards of $440 that are no longer expected to vest ($800 acquisition-date fair-value-based measure allocated to consideration transferred × 20% revised awards expected to vest) – $600 amount previously recognized as consideration transferred] and (2) the amount of the acquisition-date fair-value-based measure of the replacement awards that was originally included in postcombination compensation cost but that is associated with replacement awards of $45 that are no longer expected to vest ($200 acquisition-date fair-value-based measure allocated to postcombination service × 20% revised awards expected to vest × 75% services rendered) – $75 compensation cost previously recognized.

With respect to the income tax adjustments, the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in consideration transferred would be recorded in the income tax provision along with the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in postcombination compensation cost.

Journal Entries: Quarter Ended September 30, 20X5

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>485</td>
<td></td>
</tr>
<tr>
<td>Compensation cost</td>
<td></td>
<td>485</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>194</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>194</td>
</tr>
</tbody>
</table>

To record the adjustment of $485 ($440 + $45) for the increase in forfeiture estimate in the third quarter and the corresponding income tax effects.

As in Example 1, there were no additional changes to the forfeiture estimate in the fourth quarter; therefore, 20 of the 100 originally issued awards vested.
Journal Entries: Quarter Ended December 31, 20X5

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
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<tr>
<td>APIC</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Income tax provision</td>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>

To record the portion of the acquisition-date fair-value-based measure of the replacement award of $10 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 20% awards expected to vest × 100% services rendered) – $30 compensation cost previously recognized] attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the fourth quarter of service.

10-11 Accounting for a Change in Probability of Meeting a Performance Condition of Share-Based Payment Awards Exchanged in a Business Combination

ASC 805-30-55-11 states that the portion of the fair-value-based measure of the replacement share-based payment award attributable to both precombination and postcombination service “shall reflect the acquirer’s estimate of the number of replacement awards for which the requisite service is expected to be rendered.” Accordingly, consideration transferred and postcombination compensation cost are recognized only for awards expected to vest. In addition, ASC 805-30-55-12 states that “the effects of other events, such as . . . the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with Topic 718 in determining compensation cost for the period in which an event occurs.”

Question

How should an acquirer account for a change in the probability that a performance condition will be achieved in the postcombination period?

Answer

ASC 805-30-55-12 states that the effects of the ultimate outcome of awards with performance conditions that occur after the acquisition date should be accounted for in accordance with ASC 718 in the period that the event occurs. However, views differ on how an acquirer should reflect a change in the expected outcome of a performance condition (e.g., achievement of a performance condition that was deemed probable as of the acquisition date and is subsequently considered improbable) in postcombination compensation cost.

The following represent two acceptable views on circumstances in which the achievement of a performance condition is deemed probable as of the acquisition date and is subsequently considered improbable. If achievement of a performance condition is deemed improbable as of the acquisition date and subsequently becomes probable, only View B would apply.

- **View A** — A change in the expected outcome of a performance condition from probable to improbable should result in the reversal of compensation cost associated with the acquisition-date fair-value-based measure that was attributed to postcombination service as of the acquisition date. Under this view, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to precombination service must be recognized in APIC to the extent that the acquirer has sufficient prior excess tax benefits (i.e., APIC pool). To the extent that the acquirer does not have sufficient prior excess tax benefits, the reversal of the DTA is recorded in the current-period income tax provision. The reversal of the DTA related to postcombination service must be recognized in the current-period income tax provision.

- **View B** — A change in the expected outcome of a performance condition from probable to improbable should result in the reversal of compensation cost for the acquisition-date fair-value-based measure of all awards not expected to vest, regardless of whether that acquisition-date fair-value-based measure was attributed to precombination or postcombination service as of the acquisition date. This reversal of compensation cost may exceed the amounts previously recognized as compensation cost in the acquirer’s postcombination financial statements. In addition, the reversal of the corresponding DTA related to the acquisition-date fair-value-based measure attributed to both the precombination and postcombination service must be recognized in the current-period income tax provision.
An acquirer may elect either view as an accounting policy. However, in accordance with ASC 235-10-50-1, an entity’s accounting policy must be applied consistently and must be disclosed if it is material to the financial statements.

See below for examples that illustrate the accounting for a change in the expected outcome of a performance condition from probable to improbable under Views A and View B.

**Example 1 — View A**

On January 1, 20X1, Entity B grants employees 100 nonqualified (tax-deductible) share options that vest only if B’s cumulative net income over the succeeding five years is greater than $5 million. On the grant date, it is deemed probable that the performance condition will be achieved. Accordingly, B begins to recognize compensation cost on a straight-line basis over the five-year service period.

On December 31, 20X4, Entity A acquires B in a transaction accounted for as a business combination and is obligated to replace the employees’ awards with 100 replacement awards that have the same terms as B’s original award (i.e., the replacement awards will vest at the end of one additional year of service if the performance condition is achieved). The fair-value-based measure of each award on the acquisition date is $10. Accordingly, the fair-value-based measure of both A’s awards (the replacement awards) and B’s awards (the replaced awards) is $1,000 as of the acquisition date.

Further assume that A attributes $800 of the acquisition-date fair-value-based measure of the replacement awards to precombination service and the remaining $200 to postcombination service. The $200 attributed to the postcombination service is recognized as postcombination compensation cost over the replacement award’s remaining one-year service period. On the acquisition date, it is still probable that the performance condition will be achieved. Assume that A’s applicable tax rate is 40 percent and that A has sufficient prior excess tax benefits (i.e., APIC pool).

**Journal Entries: December 31, 20X4, Acquisition Date**

<table>
<thead>
<tr>
<th>Goodwill</th>
<th>800</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>800</td>
</tr>
<tr>
<td>DTA</td>
<td>320</td>
</tr>
<tr>
<td>Goodwill</td>
<td>320</td>
</tr>
</tbody>
</table>

To record the portion of the acquisition-date fair-value-based measure of the replacement award attributable to precombination service and therefore included in consideration transferred and the corresponding income tax effects.

**Journal Entries: Quarter Ended March 31, 20X5**

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>50</th>
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</thead>
<tbody>
<tr>
<td>APIC</td>
<td>50</td>
</tr>
<tr>
<td>DTA</td>
<td>20</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>20</td>
</tr>
</tbody>
</table>

To record the portion of the acquisition-date fair-value-based measure of the replacement award of $50 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 25% services rendered) attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the first quarter of service.
Journal Entries: Quarter Ended June 30, 20X5

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>20</td>
<td></td>
</tr>
</tbody>
</table>

To record the portion of the acquisition-date fair-value-based measure of the replacement award of $50 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 50% services rendered) – $50 compensation cost previously recognized attributable to postcombination service and therefore included in postcombination compensation cost and the corresponding income tax effects for the second quarter of service.

During the third quarter, A loses one of its largest customers and no longer believes that achievement of the performance condition is probable.

Journal Entries: Quarter Ended September 30, 20X5

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>100</td>
<td></td>
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<tr>
<td>Compensation cost</td>
<td></td>
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<tr>
<td>Income tax provision</td>
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<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>40</td>
</tr>
</tbody>
</table>

To record an adjustment for the change in the expected outcome of the performance condition from probable to improbable in the third quarter of $100 ($200 acquisition-date fair-value-based measure allocated to postcombination service × 50% services rendered) and the postcombination compensation cost and the corresponding income tax effects.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td></td>
<td>320</td>
</tr>
<tr>
<td>DTA</td>
<td>320</td>
<td></td>
</tr>
</tbody>
</table>

To record the reversal of $320 ($800 acquisition-date fair-value-based measure allocated to precombination service × 40% tax rate) to the DTA related to the acquisition-date fair-value-based measure attributed to precombination service. If A does not have sufficient prior excess tax benefits, the reversal of the DTA would be recorded in the current-period income tax provision.

Entity A did not ultimately achieve the performance condition. Therefore, none of the awards vested and no additional entries were necessary.

Example 2 — View B

Assume all the same facts as in Example 1. Under this view, there is no difference in the accounting as of the acquisition date and for the first two quarters of service in the postcombination period (i.e., the journal entries are the same). However, A’s accounting in the third quarter for the change in the expected outcome of the performance condition from probable to improbable will differ from the accounting under View A, as illustrated in Example 1.

Because A has now determined that achievement of the performance condition is no longer probable, A recognizes an adjustment in postcombination compensation cost for the sum of (1) the amount of acquisition-date fair-value-based measure of the replacement awards that was originally included in consideration transferred but that is associated with replacement awards of $800 that are no longer expected to vest and (2) the amount of acquisition-date fair-value-based measure of the replacement awards that was originally included in postcombination compensation cost but that is associated with replacement awards $100 that are no longer expected to vest ($200 acquisition-date fair-value-based measure allocated to postcombination service × 50% services rendered).
With respect to the income tax adjustments, the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in consideration transferred would be recorded in the income tax provision along with the offsetting entry for the reversal of the DTA associated with the amount that was previously recorded in postcombination compensation cost.

**Journal Entries: Quarter Ended September 30, 20X5**

```
APIC  900
  Compensation cost
Income tax provision  360
  DTA  360
  To record an adjustment for the change in the expected outcome of the performance condition from probable to improbable in the third quarter of $900 ($800 acquisition-date fair-value-based measure allocated to precombination service + ($200 acquisition-date fair-value-based measure allocated to postcombination service × 50% services rendered) and the corresponding income tax effects.
```

As in Example 1, A did not ultimately achieve the performance condition. Therefore, none of the awards vested and no additional entries were necessary.

### 10-12 Replacement Awards With Graded Vesting Exchanged in a Business Combination

Graded vesting awards are awards that are split into multiple tranches in which each tranche legally vests as service is provided. For example, an entity may grant an employee 100 share-based payment awards, in which 25 of the awards legally vest for each of four years of service provided.

ASC 718-10-35-8 states, in part:

> An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:
> a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards,
> b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. [Emphasis added]

An acquiree may have made an accounting policy election regarding the recognition of the compensation cost for an award with a graded vesting schedule (i.e., as a single award or as in-substance multiple awards) that is different from the election made by the acquirer.\(^\text{14}\)

**Question**

How does an acquirer account for share-based payment awards with a graded vesting schedule exchanged in a business combination?

**Answer**

Regardless of how the acquiree elected to account for its replaced share-based-payment awards with a graded vesting schedule, the acquirer uses its existing accounting policy election for similar awards with a graded vesting schedule to recognize compensation cost for the replacement awards. ASC 805-30-55-12 states:

> If the replacement award has a graded vesting schedule, the acquirer shall recognize the related compensation cost in accordance with its policy election for other awards with graded vesting in accordance with paragraph 718-10-35-8. [Emphasis added]

The guidance above is significant in the determination of the portion of the fair-value-based measure of the replacement award that is attributable to (1) precombination service and therefore included in consideration transferred and (2) postcombination service and therefore included in postcombination compensation cost. If the

\(^{14}\) Note that regardless of an entity’s policy decision regarding the recognition of compensation cost, it may elect to value the awards as (1) a single award or (2) in-substance multiple awards. That is, even though certain valuation techniques may directly or indirectly treat each portion of the award as individual awards, the entity is able to make a policy decision to recognize compensation cost as (1) a single award or (2) in-substance multiple awards.
Chapter 10 — Business Combinations
A Roadmap to Accounting for Share-Based Payment Awards

acquirer’s accounting policy election is to treat an award with a graded vesting schedule as a single award, then
the determination of the total service period and the original service period will be based on a single award (e.g., a
single award with four years of required service). Conversely, if the acquirer’s accounting policy election is to treat
an award with a graded vesting schedule as in-substance multiple awards, then the determination of the total
service period and the original service period will be based on each tranche of the award as though the award is
in-substance multiple awards (e.g., four separate awards with required service of one, two, three, and four years,
respectively). See the examples below for a further illustration.

Note that if the policy elections of the acquiree and the acquirer differ, on a combined basis (i.e., in the acquiree’s
financial statements and the acquirer’s postcombination financial statements) compensation cost (1) may not be
recorded in either the acquiree’s precombination financial statements or the acquirer’s postcombination financial
statements or (2) may be recorded in both the acquiree’s precombination financial statements and the acquirer’s
postcombination financial statements. See Example 2 below for an illustration.

Example 1 — Replacement Awards With Graded Vesting

On January 1, 20X1, Entity B grants 1,000 employee share-based payment awards. The awards vest in 25 percent
increments each year over the next four years (i.e., a graded vesting schedule). On December 31, 20X3, Entity A
acquired B in a transaction accounted for as a business combination and is obligated by the acquisition agreement
to replace B’s awards with the same terms and conditions. (See Q&A 10-02 for a discussion on determining when
an acquirer is obligated to exchange an acquiree’s awards.) Both A and B have chosen, as their policy election, to
recognize compensation cost on a straight-line basis over the requisite service period for the entire award (i.e., as
though the award is a single award). For simplicity, the effects of forfeitures and income taxes have been ignored.

The fair-value-based measure of both awards (i.e., the replaced awards and the replacement awards) is $10 per
award as of the acquisition date. The portion of the fair-value-based amount of the replacement award attributable
to (1) precombination service and therefore included in consideration transferred is $7,500 ($10 fair-value-based
measure of the replacement award × 1,000 awards × 75% for three of four years of services rendered) and (2)
postcombination service and therefore included in postcombination compensation cost is $2,500 ($10 fair-value-
based measure of the replacement award × 1,000 awards × 25% for one of four years of services rendered).

Example 2 — Replacement Awards With Graded Vesting When the Model Elected by the
Acquirer to Recognize Compensation Cost Is Different From the Model Elected by the Acquiree

Assume the same facts as in Example 1, except that the acquirer has chosen, as its policy election, to recognize
compensation cost over the requisite service period for each separately vesting portion of the award (i.e., as
though the award is in-substance multiple awards). The acquirer has also made a policy election to value such
share-based payment awards as a single award. The following table summarizes the attribution of the fair-value-
based amount of the replacement awards ($10,000 = 1,000 awards × $10 fair-value-based measure of the
replacement award) over each of the first three years of service. For simplicity, the effects of forfeitures and income
taxes have been ignored.

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Cumulative Amount After Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1</td>
<td>2,500</td>
<td>2,500</td>
<td>—</td>
<td>$ 2,500</td>
</tr>
<tr>
<td>Tranche 2</td>
<td>2,500</td>
<td>1,250</td>
<td>1,250</td>
<td>2,500</td>
</tr>
<tr>
<td>Tranche 3</td>
<td>2,500</td>
<td>833</td>
<td>833</td>
<td>2,500</td>
</tr>
<tr>
<td>Tranche 4</td>
<td>2,500</td>
<td>625</td>
<td>625</td>
<td>2,500</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
<td>625</td>
<td>625</td>
<td>$ 9,375</td>
</tr>
</tbody>
</table>

The portion of the fair-value-based amount of the replacement award attributable to (1) precombination service
and therefore included in consideration transferred is $9,375 and (2) postcombination service and therefore
included in postcombination compensation cost is $625.
10-13 Stay Bonus Arrangements

Sometimes in a business combination, as part of the negotiations of the acquisition agreement, the acquiree or acquirer may provide key employees of the acquiree a bonus (in cash, equity instruments, or both) if they continue employment until, or for a certain amount of time after, the acquisition date. These arrangements are often referred to as "stay bonuses."

Question

How should a stay bonus arrangement be accounted for in a business combination?

Answer

It depends. The compensation arrangement must be analyzed so that entities can determine whether it constitutes compensation for (1) precombination service and is therefore included in the consideration transferred or (2) postcombination service and is therefore included in postcombination compensation cost. If the arrangement is negotiated as part of the business combination, and if it requires postcombination service, the arrangement generally would meet the criteria for a transaction that is separate from the business combination. Accordingly, all of the related compensation cost would be considered compensation for postcombination services and therefore be included in postcombination compensation cost.

Example 1 — Stay Bonuses Awarded by the Acquiree in Conjunction With a Business Combination

Entity A is in negotiation with Entity B to acquire its subsidiary, Entity C. Entity C, in contemplation of the business combination, offers a cash bonus to its key management employees in exchange for their continued employment through the negotiations and up through the consummation of the acquisition by A. Upon consummation of the acquisition, it is expected that C’s key management employees will be terminated.

Since the bonus is negotiated by C to entice its key management employees to continue their employment until the consummation of the acquisition, and no postcombination service is required, the compensation cost generally would be recognized in the precombination financial statements of C (i.e., as compensation for precombination service) and included in the consideration transferred.

Example 2 — Stay Bonuses Offered by the Acquirer in Conjunction With a Business Combination

Assume the same facts as in Example 1, except that Entity A offered a cash bonus to the key management employees of Entity C in exchange for their continued employment for two years after the consummation of the acquisition.

In this case, since the bonus is awarded to C’s employees as a condition of their continued employment after the consummation of the acquisition, and their employment is for the benefit of the combined entity, the arrangement would meet the criteria for a transaction that is separate from the business combination. Accordingly, all of the related compensation cost would be considered compensation for postcombination services and therefore included in postcombination compensation cost.

10-14 Last-Man-Standing Awards Issued in a Business Combination

In a business combination, sometimes the acquirer will issue share-based payment awards to a group of key employees of the acquiree. Such awards are usually placed in a trust and require (1) the employee’s service in a future period, (2) forfeiture of the award if employment is terminated before the end of the requisite service period, and (3) the redistribution of any forfeited awards to the remaining employees within the group. These arrangements are often referred to as “last-man-standing” awards.

Question

How should last-man-standing awards be accounted for in a business combination?

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15 If the bonus is provided in equity instruments, an entity should consider whether the arrangement is a share-based payment arrangement within the scope of ASC 718.
**Answer**

It depends. Although such awards have terms and conditions that vary, they are typically considered compensation for postcombination services. The forfeiture and subsequent redistribution of the awards are accounted for (1) as the forfeiture of the original award and (2) the grant of a new award. That is, the acquirer would reverse any compensation cost previously recognized for the forfeited award (on the basis of the original grant-date fair-value-based measure) and then recognize compensation cost for the new award (on the basis of the fair-value-based measure on the date the award is redistributed) over the remaining requisite service period.

**Example**

On January 1, 20X1, Entity A acquires Entity B and, as part of the acquisition agreement, grants each of 10 key management employees of the acquiree 100 new share-based payment awards that vest at the end of the fifth year of service (cliff vesting). The grant-date fair-value-based measure of each award as of the acquisition date is $10. The provisions of the award state that if employment is terminated before the end of five years (i.e., the vesting date), the employee's awards are forfeited and redistributed among the remaining employees within the group.

The total grant-date fair-value-based measure of the awards as of the acquisition date is $10,000 (10 employees × 100 awards × $10 grant-date fair value), which A recognizes in the postcombination financial statements as compensation cost over the five-year service period ($2,000 per year). On December 31, 20X3, two employees within the group terminate their employment and forfeit their awards. The awards are then redistributed to the remaining eight members within the group. The fair-value-based measure of each redistributed award (i.e., the new awards) is $12 on the date the awards were redistributed.

On December 31, 20X3, A would reverse $1,200 (2 employees × 100 awards × $10 grant-date fair value × 60% for three of five years of services rendered) of previously recognized compensation cost corresponding to the forfeited awards. Entity A would continue to recognize $1,600 in annual compensation cost over the remaining two years of service for the original awards provided to the remaining employees (8 employees × 100 awards × $10 grant-date fair value ÷ 5 years). In addition, A would recognize $1,200 in additional annual compensation cost over the remaining two years of service for the redistributed awards (200 awards × $12 grant-date fair value ÷ 2 years of remaining service).

**10-15 Golden Parachute Arrangements**

An entity’s key management employees may have as part of their employment agreement (or as a separate agreement) a compensation arrangement that provides them with a bonus (in cash, equity instruments, or both) if they are terminated upon the acquisition of the entity. These arrangements are often referred to as “golden parachutes.”

**Question**

How should a golden parachute arrangement be accounted for in a business combination?

**Answer**

It depends. The arrangement must be analyzed so that entities can determine whether it constitutes compensation for (1) precombination service and is therefore included in the consideration transferred or (2) postcombination service and is therefore included in postcombination compensation cost. If the arrangements were negotiated by the acquiree before the consummation of the business combination, and if no postcombination service is required, the arrangements would generally be considered compensation for precombination services and would therefore be included in the consideration transferred. That is, the acquiree would establish a bonus payable (with the offsetting amount recorded as compensation cost) in the acquiree’s closing balance sheet. Accordingly, the bonus payable would be part of the liabilities assumed by the acquirer in the business combination.

See also ASC 805-10-55-18 for guidance on determining whether a transaction is part of a business combination.

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16 See footnote 15.

17 Alternatively, if compensation cost is recognized contemporaneously with the business combination, the compensation cost may be presented in neither the acquiree’s precombination financial statements nor the combined entity’s postcombination financial statements (i.e., it is recognized on the “black line”).
**Income Tax Accounting for Replacement Awards**

**ASC 805-740**

**Replacement Awards Classified as Equity**

25-10 Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in the Business Combinations Topic. For a replacement award classified as equity that ordinarily would result in postcombination tax deductions under current tax law, an acquirer shall recognize a deferred tax asset for the deductible temporary difference that relates to the portion of the fair-value-based measure attributed to precombination employee service and therefore included in consideration transferred in the business combination.

25-11 For a replacement award classified as equity that ordinarily would not result in tax deductions under current tax law, an acquirer shall recognize no deferred tax asset for the portion of the fair-value-based measure attributed to precombination service and thus included in consideration transferred in the business combination. A future event, such as an employee’s disqualifying disposition of shares under a tax law, may give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

**Tax Deductions for Replacement Awards**

45-5 Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in this Topic. After the acquisition date, the deduction reported on a tax return for a replacement award classified as equity may exceed the fair-value-based measure of the award. In that situation, the acquirer shall recognize any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for that award related to pre- and postcombination service (the excess tax benefit) as additional paid-in capital. That accounting treatment is consistent with the accounting required by paragraphs 718-740-45-2 through 45-3 for an excess tax benefit for a share-based payment award classified as equity that is granted outside of a business combination.

45-6 The accounting if the amount deductible on the acquirer’s tax return is less than the fair-value-based measure of the award also is the same as that prescribed by paragraph 718-740-45-4 for other awards. The write-off of a deferred tax asset related to that deficiency, net of any related valuation allowance, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in earnings.

**10-16 Tax Benefits of Tax-Deductible Share-Based Payment Awards Exchanged in a Business Combination**

**Question**

Under ASC 805-740, what is the appropriate income tax accounting for tax-deductible share-based payment awards that are exchanged in a business combination?

**Answer**

**Income Tax Accounting as of the Acquisition Date**

For share-based payment awards that (1) are exchanged in a business combination and (2) ordinarily result in a tax deduction under current tax law (e.g., nonqualified share options), an acquirer should record a DTA as of the acquisition date for the tax benefit of the fair-value-based measure of the award included in the consideration transferred. For guidance on calculating the amount of the fair-value-based measure to include in the consideration transferred, see Q&A 10-04.

**Income Tax Accounting After the Acquisition Date**

For the portion of the fair-value-based measure of the acquirer’s replacement award that is attributed to postcombination service and therefore included in postcombination compensation cost, a DTA is recorded over the remaining service period (i.e., as the postcombination compensation cost is recorded) for the tax benefit of the postcombination compensation cost.

In accordance with ASC 718, the DTA for awards classified as equity is not subsequently adjusted to reflect changes in the entity’s share price. In contrast, for awards classified as a liability, the DTA is remeasured, along with the compensation cost, in every reporting period until settlement.

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18 This Q&A uses the term fair-value-based measure; however, ASC 718 also permits the use of calculated value or intrinsic value in specified circumstances. This guidance would also apply in situations in which calculated value or intrinsic value is permitted.
Income Tax Accounting Upon Exercise of the Share-Based Payment Awards

ASC 805-740-45-5 and 45-6 state that any difference between (1) the tax benefit received from exercising the share-based payment awards and (2) the previously recorded DTA balance related to the fair-value-based measure attributed to both precombination service (included in consideration transferred) and postcombination service (included in postcombination compensation cost) should be recognized in accordance with ASC 718-740-45-2 and 45-3. That is, any excess of the tax benefit of the tax deduction over the DTA (i.e., excess tax benefits) should be recorded as an increase (credit) to paid-in capital. In contrast, any shortfalls of the tax benefit of the tax deduction in comparison to the DTA (i.e., tax benefit deficiencies) are recorded as a decrease (debit) to paid-in capital but only to the extent that previous excess tax benefits exist (often referred to as the "APIC pool"). In the absence of an APIC pool, tax benefit deficiencies must be recorded as an expense in the income statement in the period of the tax deduction.

The following examples, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from tax-deductible share-based payment awards that are exchanged in a business combination after the effective date of Statement 141(R).

Example 1

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (e.g., nonqualified share options).
- Company A’s applicable tax rate is 40 percent.
- Company A has an APIC pool.

Company A issues replacement awards of $110 (fair-value-based measure) on the acquisition date in exchange for Company B’s awards of $100 (fair-value-based measure) on the acquisition date. The exercise price of the replacement awards issued by A is $15. No postcombination services are required for the replacement awards, and B’s employees had rendered all of the required service for the acquiree awards as of the acquisition date.

The amount attributable to precombination service is the fair-value-based measure of B’s awards ($100) on the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination service is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to precombination service ($100). Because no postcombination service is required for the replacement awards, A immediately recognizes $10 as compensation cost in its postcombination financial statements. See the following journal entries.

**Journal Entry: June 30, 20X1**

| Goodwill | 100 |
| Compensation cost | 10 |
| APIC | 110 |

To record the portions of the fair-value-based measure of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).

| DTA | 44 |
| Goodwill | 40 |
| Income tax provision | 4 |

To record the associated income tax effects of the fair-value-based measure of the portions of the replacement award that are attributable to precombination service (i.e., consideration transferred) and postcombination service (i.e., postcombination compensation cost).
On September 30, 20X1, all replacement awards issued by A are exercised when the market price of A’s shares is $150. Given the exercise of the replacement awards, A will realize a tax deduction of $135 ($150 market price of A’s shares less the $15 exercise price). The tax benefit of the tax deduction is $54 ($135 × 40% tax rate). Therefore, an excess tax benefit of $10 (tax benefit of the tax deduction of $54 less the previously recorded DTA of $44) is recorded to APIC. See the following journal entry.

**Journal Entry: September 30, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
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<tbody>
<tr>
<td>Taxes payable</td>
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<td></td>
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<tr>
<td>DTA</td>
<td>44</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

To record the income tax effects of the award upon exercise.

**Example 2**

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are awards that would typically result in a tax deduction (i.e., nonqualified options).
- Company A’s applicable tax rate is 40 percent.

Company A exchanges replacement awards that require one year of postcombination service for share-based payment awards of Company B for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 on the acquisition date. The exercise price of the replacement awards is $15. When originally granted, B’s awards had a requisite service period of four years. As of the acquisition date, B’s employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though B’s employees had already rendered the requisite service for the original awards, A attributes a portion of the replacement award to postcombination compensation cost in accordance with ASC 805-30-30-12 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year).

The portion attributable to precombination service equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, $80 ($100 × 4) ÷ 5 years) is attributed to the precombination service period and therefore is included in the consideration transferred in the business combination. The remaining $20 is attributed to the postcombination service period and therefore is recognized as compensation cost in A’s postcombination financial statements, in accordance with ASC 718. See the following journal entries.

**Journal Entries: June 30, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
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</tr>
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<td>APIC</td>
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<tr>
<td>DTA</td>
<td>32</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>32</td>
<td></td>
</tr>
</tbody>
</table>

To record the portion of the fair-value-based measure of the replacement award attributable to precombination service (i.e., consideration transferred) and the associated income tax effects.
Chapter 10 — Business Combinations
A Roadmap to Accounting for Share-Based Payment Awards

Journal Entries: December 31, 20X1

<table>
<thead>
<tr>
<th>Account</th>
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<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
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<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Income tax provision</td>
<td></td>
<td>4</td>
</tr>
</tbody>
</table>

To record the compensation cost and the associated income tax effects for the six-month period from the date of the acquisition until December 31, 20X1.

On June 30, 20X2, all replacement awards issued by A vest and are exercised when the market price of A’s shares is $150. Given the exercise of the replacement awards, A will realize a tax deduction of $135 ([$150 market price of A’s shares less the $15 exercise price]). The tax benefit of the tax deduction is $54 ($135 × 40% tax rate). Therefore, an excess tax benefit of $14 (tax benefit of the tax deduction of $54 less the previously recorded DTA of $40 ($32 + $4 + $4)) is recorded to APIC. See the following journal entries.

Journal Entries: June 30, 20X2

<table>
<thead>
<tr>
<th>Account</th>
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<td></td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Income tax provision</td>
<td></td>
<td>4</td>
</tr>
</tbody>
</table>

To record the compensation cost and the associated income tax effects for the six-month period ended June 30, 20X2.

Journal Entries: June 30, 20X2

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
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<td></td>
</tr>
<tr>
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<td></td>
<td>40</td>
</tr>
<tr>
<td>APIC</td>
<td></td>
<td>14</td>
</tr>
</tbody>
</table>

To record the income tax effects of the award upon exercise.

10-17 Tax Benefits Received From the Disqualifying Disposition of Incentive Stock Options Exchanged in a Business Combination

Under ASC 805-740, an acquirer should not record a DTA as of the acquisition date for the tax benefits of the fair-value-based measure19 of the acquirer’s replacement share-based payment award included in the consideration transferred that ordinarily does not result in a tax deduction (e.g., ISOs). However, an acquirer may receive a tax deduction from these awards as a result of events that occur after the acquisition date (e.g., a disqualifying disposition). While ASC 805-740-25-11 states that the “tax effects of such an event shall be recognized only when it occurs,” it does not address how such effects are recognized in the financial statements.

Question

For share-based payment awards exchanged in a business combination that do not ordinarily result in a tax deduction, what is the appropriate income tax accounting for the tax benefits received from an employee’s disqualifying disposition?

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19 This Q&A uses the term fair-value-based measure; however, ASC 718 also permits the use of calculated value or intrinsic value in specified circumstances. This guidance would also apply in situations in which calculated value or intrinsic value is permitted.
Answer

The following are two currently acceptable approaches to accounting for these benefits:

**Approach 1** — The tax benefit of any tax deduction up to the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement share-based payment award included in the consideration transferred and (2) the postcombination compensation cost recognized for the replacement share-based payment award, should be included in the income tax provision (i.e., the sum of (1) and (2) should equal the fair-value-based measure of the replacement share-based payment award as of the acquisition date). Any tax benefit of the tax deduction that is greater than this sum would be recognized as APIC. This view is consistent with ASC 718-740-35-3, which states that only the “excess tax benefit” should be recognized as an adjustment to APIC. In addition, the results of this approach are similar to the results when an entity accounts for the excess tax benefits received from share-based payment awards that ordinarily result in a tax deduction (i.e., nonqualified awards), as described in Q&A 10-16.

**Approach 2** — The tax benefit of any tax deduction up to the postcombination compensation cost recognized for the replacement share-based payment award should be included in the income tax provision. Any tax benefit of the tax deduction greater than this amount would be recognized as APIC.

The examples below, adapted from ASC 805-30-55, illustrate the income tax accounting for tax benefits received from ISOs that are exchanged in a business combination after the effective date of Statement 141(R).

**Example 1 — Approach 1**

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the following:

- Company A has a calendar year-end and therefore adopted Statement 141(R) on January 1, 20X1.
- The acquisition date of the business combination is June 30, 20X1.
- Company A was obligated to issue the replacement awards under the terms of the acquisition agreement.
- The replacement awards in this example are ISOs that do not normally result in a tax deduction.
- Company A’s applicable tax rate is 40 percent.

Company A exchanges replacement awards that require one year of postcombination service for share-based payment awards of B for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 on the acquisition date. The exercise price of the replacement awards is $15. When originally granted, B’s awards had a requisite service period of four years. As of the acquisition date, B’s employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though B’s employees had already rendered all the requisite service for the original awards, A attributes a portion of the replacement award to postcombination compensation cost in accordance with ASC 805-30-30-12 because the replacement awards require one year of postcombination service. The total service period is five years — the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year).

The portion attributable to precombination service equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (four years) to the total service period (five years). Thus, $80 ([100 × 4] ÷ 5 years) is attributed to the precombination service period and therefore is included in the consideration transferred in the business combination. The remaining $20 is attributed to the postcombination service period and therefore is recognized as compensation cost in A’s postcombination financial statements, in accordance with ASC 718. See the following journal entries:

**Journal Entry: June 30, 20X1**

| Goodwill | 80 |
| APIC | 80 |

To record the portion of the fair-value-based measure of the replacement awards attributable to precombination service (i.e., consideration transferred). No DTA is recorded since the ISOs exchanged normally do not result in a tax deduction.
Journal Entry: December 31, 20X1

Compensation cost 10
APIC 10

To record the compensation cost for the six-month period from the acquisition date until December 31, 20X1. No DTA is recorded since the ISOs exchanged normally do not result in a tax deduction.

On June 30, 20X2, all replacement awards issued by A are exercised and the underlying shares are sold before the minimum holding period required by the IRS, thus resulting in a disqualifying disposition. On June 30, 20X2, the market price of A’s shares is $150. Given the disqualifying disposition of the replacement awards, A will realize a tax deduction of $135 ($150 market price of Company A’s shares less the $15 exercise price). The tax benefit of the tax deduction is $54 ($135 × 40% tax rate). See the following journal entries:

Journal Entry: June 30, 20X2

Compensation cost 10
APIC 10

To record the compensation cost for the six-month period ended June 30, 20X2.

Journal Entry: June 30, 20X2

Taxes payable 54
Income tax provision 40
APIC 14

To record the income tax effects of the award upon disqualifying disposition.

The amount included in the income tax provision is computed as the tax effect of the sum of (1) the amount of the acquisition-date fair-value-based measure of the replacement share-based payment awards included in the consideration transferred ($80) and (2) the postcombination compensation cost recognized for the replacement share-based payment awards ($20), or [($80 + $20) × 40% tax rate] = $40. The amount recognized in APIC is computed as the tax benefit of the tax deduction greater than this sum or [($135 – $100) × 40% tax rate] = $14.

Example 2 — Approach 2

The par value of the common stock issued and cash received for the option’s exercise price are not considered in this example.

Assume the same facts and circumstances as in Example 1, Approach 1. Under Approach 2, the June 30 and December 31, 20X1, journal entries will be the same as those under Approach 1.

As in Example 1, Approach 1, on June 30, 20X2, all replacement awards issued by A are exercised and the underlying shares are sold before the minimum holding period required by the IRS, thus resulting in a disqualifying disposition. On June 30, 20X2, the market price of A’s shares is $150. Given the disqualifying disposition of the replacement awards, A will realize a tax deduction of $135 ($150 market price of A’s shares less the $15 exercise price). The tax benefit of the tax deduction is $54 ($135 × 40% tax rate). See the following journal entries:

Journal Entry: December 31, 20X2

Compensation cost 10
APIC 10

To record the compensation cost for the six-month period ended December 31, 20X2.
Journal Entry: June 30, 20X2

Taxes payable 54
  Income tax provision 8
  APIC 46

To record the income tax effects of the award upon disqualifying disposition.

The amount included in the income tax provision is computed as the tax effect of the postcombination compensation cost recognized for the replacement share-based payment award ($20), or ($20 x 40% tax rate) = $8. The amount recognized in APIC is computed as the tax benefit of the tax deduction greater than the tax effect of the postcombination compensation cost, or [($135 – $20) x 40% tax rate] = $46.
Chapter 11 — Implementation Guidance

This chapter, which primarily consists of excerpts from ASC 718, provides guidance (including illustrative examples) on implementing the provisions of the FASB’s guidance on share-based payment awards. Topics covered in this chapter include (1) classification of an award as equity or a liability, (2) ESPPs, (3) equity-based payments to nonemployees, and (4) awards issued/exchanged in a business combination.

Guidance Applicable to Both Equity and Liability Awards

<table>
<thead>
<tr>
<th>ASC 718-10</th>
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<table>
<thead>
<tr>
<th>Implementation Guidance — General</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-1 This Subtopic and Subtopics 718-20 and 718-30 are interrelated and the required guidance may be located in either this Subtopic or one of the other Subtopics. In general, material that relates to both equity and liability instruments is included in this Subtopic, while material more specifically related to either equity or liability instruments is included in their respective Subtopics.</td>
</tr>
<tr>
<td>55-2 Implementation guidance is provided on the following matters:</td>
</tr>
<tr>
<td>a. Fair value measurement objectives and application</td>
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<tr>
<td>b. Fair-value-based instruments in a share-based transaction</td>
</tr>
<tr>
<td>c. Valuation techniques</td>
</tr>
<tr>
<td>d. Selecting assumptions for use in an option pricing model</td>
</tr>
<tr>
<td>1. Consistent use of valuation techniques and methods for selecting assumptions</td>
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<tr>
<td>2. Selecting or estimating the risk-free rate for the expected term</td>
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<tr>
<td>3. Selecting or estimating the expected term</td>
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<tr>
<td>4. Selecting or estimating the expected volatility</td>
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<tr>
<td>5. Selecting or estimating expected dividends</td>
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<tr>
<td>6. Dividend protected awards</td>
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<tr>
<td>7. Selecting or considering credit risk</td>
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<tr>
<td>8. Contingency features that affect the option pricing model</td>
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<td>9. Consider dilution.</td>
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<tr>
<td>e. Calculated value for certain nonpublic entities</td>
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<tr>
<td>f. Market, performance, and service conditions</td>
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<tr>
<td>1. Market, performance, and service conditions that affect vesting and exercisability</td>
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<tr>
<td>2. Market, performance, and service conditions that affect factors other than vesting and exercisability</td>
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<tr>
<td>3. Estimating the requisite service period</td>
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<tr>
<td>4. Explicit, implicit, and derived requisite service periods.</td>
</tr>
<tr>
<td>g. Determination of grant date</td>
</tr>
<tr>
<td>h. Service inception date and grant date</td>
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<tr>
<td>i. Equity restructuring</td>
</tr>
<tr>
<td>j. Classification of certain awards with repurchase features</td>
</tr>
<tr>
<td>k. Employee of a physician practice.</td>
</tr>
</tbody>
</table>
ASC 718-10 (continued)

55-3 In this Section fair value also applies to nonpublic entities that use the calculated value method pursuant to paragraph 718-10-30-20.

Fair Value Measurement Objectives and Application

55-4 The measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value 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. That estimate is based on the share price and other pertinent factors (including those enumerated in paragraphs 718-10-55-21 through 55-22, if applicable) at the grant date and is not remeasured in subsequent periods under the fair-value-based method.

55-5 A restriction that continues in effect after the entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For instance, 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. For share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees’ expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option’s expected term).

55-6 In contrast, a restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in the fair value of the instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

55-7 Note that performance and service conditions are vesting conditions for purposes of this Topic. Market conditions are not vesting conditions for purposes of this Topic but market conditions may affect exercisability of an award. Market conditions are included in the estimate of the grant-date fair value of awards (see paragraphs 718-10-55-64 through 55-66).

55-8 Reload features and contingent features that require an employee to transfer equity shares earned, or realized gains from the sale of equity instruments earned, to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature, shall not be reflected in the grant-date fair value of an equity award. Those features are accounted for if and when a reload grant or contingent event occurs. A clawback feature can take various forms but often functions as a noncompete mechanism. For example, an employee that terminates the employment relationship and begins to work for a competitor is required to transfer to the issuing entity (former employer) equity shares granted and earned in a share-based payment transaction.

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.

Fair-Value-Based Instruments in a Share-Based Transaction

55-10 The definition of fair value refers explicitly only to assets and liabilities, but the concept of value in a current exchange embodied in it applies equally to the equity instruments subject to this Topic. Observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, shall be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees. Determining whether an equity or liability instrument is similar is a matter of judgment, based on an analysis of the terms of the instrument and other relevant facts and circumstances. For example, awards to employees of a public entity of shares of its common stock, subject only to a service or performance condition for vesting (nonvested shares), shall be measured based on the market price of otherwise identical (that is, identical except for the vesting condition) common stock at the grant date.

55-11 If observable market prices of identical or similar equity or liability instruments of the entity are not available, the fair value of equity and liability instruments awarded to employees shall be estimated by using a valuation technique that meets all of the following criteria:

a. It is applied in a manner consistent with the fair value measurement objective and the other requirements of this Topic.

b. It is based on established principles of financial economic theory and generally applied in that field (see paragraph 718-10-55-16). Established principles of financial economic theory represent fundamental propositions that form the basis of modern corporate finance (for example, the time value of money and risk-neutral valuation).

c. It reflects all substantive characteristics of the instrument (except for those explicitly excluded by this Topic, such as vesting conditions and reload features).

That is, the fair values of equity and liability instruments granted in a share-based payment transaction shall be estimated by applying a valuation technique that would be used in determining an amount at which instruments with the same characteristics (except for those explicitly excluded by this Topic) would be exchanged.
ASC 718-10 (continued)

55-12 An estimate of the amount at which instruments similar to employee share options and other instruments granted to employees would be exchanged would factor in expectations of the probability that the requisite service would be rendered and the instruments would vest (that is, that the performance or service conditions would be satisfied). However, as noted in paragraph 718-10-55-4, the measurement objective in this Topic is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. Therefore, the estimated fair value of the instruments at grant date does not take into account the effect on fair value of vesting conditions and other restrictions that apply only during the requisite service period. Under the fair-value-based method required by this Topic, the effect of vesting conditions and other restrictions that apply only during the requisite service period is reflected by recognizing compensation cost only for instruments for which the requisite service is rendered.

Valuation Techniques

55-13 In applying a valuation technique, the assumptions used shall be consistent with the fair value measurement objective. That is, assumptions shall reflect information that is (or would be) available to form the basis for an amount at which the instruments being valued would be exchanged. In estimating fair value, the assumptions used shall not represent the biases of a particular party. Some of those assumptions will be based on or determined from external data. Other assumptions, such as the employees’ expected exercise behavior, may be derived from the entity’s own historical experience with share-based payment arrangements.

55-14 The fair value of any equity or liability instrument depends on its substantive characteristics. Paragraphs 718-10-55-21 through 55-22 list the minimum set of substantive characteristics of instruments with option (or option-like) features that shall be considered in estimating those instruments’ fair value. However, a share-based payment award could contain other characteristics, such as a market condition, that should be included in a fair value estimate. Judgment is required to identify an award’s substantive characteristics and, as described in paragraphs 718-10-55-15 through 55-20, to select a valuation technique that incorporates those characteristics.

55-15 Valuation techniques used for employee share options and similar instruments estimate the fair value of those instruments at a single point in time (for example, at the grant date). The assumptions used in a fair value measurement are based on expectations at the time the measurement is made, and those expectations reflect the information that is available at the time of measurement. The fair value of those instruments will change over time as factors used in estimating their fair value subsequently change, for instance, as share prices fluctuate, risk-free interest rates change, or dividend streams are modified. Changes in the fair value of those instruments are a normal economic process to which any valuable resource is subject and do not indicate that the expectations on which previous fair value measurements were based 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.

55-16 A lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton formula) are among the valuation techniques that meet the criteria required by this Topic for estimating the fair values of employee share options and similar instruments. A Monte Carlo simulation technique is another type of valuation technique that satisfies the requirements in paragraph 718-10-55-11. Other valuation techniques not mentioned in this Topic also may satisfy the requirements in that paragraph. Those valuation techniques or models, sometimes referred to as option-pricing models, are based on established principles of financial economic theory. Those techniques are used by valuation professionals, dealers of derivative instruments, and others to estimate the fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities. Those techniques are used to establish trade prices for derivative instruments and to establish values in adjudications. As discussed in paragraphs 718-10-55-21 through 55-50, both lattice models and closed-form models can be adjusted to account for the substantive characteristics of share options and similar instruments granted to employees.

55-17 This Topic does not specify a preference for a particular valuation technique or model in estimating the fair values of employee share options and similar instruments. Rather, this Topic requires the use of a valuation technique or model that meets the measurement objective in paragraph 718-10-30-6 and the requirements in paragraph 718-10-55-11. The selection of an appropriate valuation technique or model will depend on the substantive characteristics of the instrument being valued. Because an entity may grant different types of instruments, each with its own unique set of substantive characteristics, an entity may use a different valuation technique for each different type of instrument. The appropriate valuation technique or model selected to estimate the fair value of an instrument with a market condition must take into account the effect of that market condition. The designs of some techniques and models better reflect the substantive characteristics of a particular employee share option or similar instrument. Paragraphs 718-10-55-18 through 55-20 discuss certain factors that an entity should consider in selecting a valuation technique or model for its employee share options or similar instruments.
Selecting Assumptions for Use in an Option Pricing Model

55-18 The Black-Scholes-Merton formula assumes that option exercises occur at the end of an option’s contractual term, and that expected volatility, expected dividends, and risk-free interest rates are constant over the option’s term. If used to estimate the fair value of instruments in the scope of this Topic, the Black-Scholes-Merton formula must be adjusted to take account of certain characteristics of employee share options and similar instruments that are not consistent with the model’s assumptions (for example, the ability to exercise before the end of the option’s contractual term). Because of the nature of the formula, those adjustments take the form of weighted-average assumptions about those characteristics. In contrast, a lattice model can be designed to accommodate dynamic assumptions of expected volatility and dividends over the option’s contractual term, and estimates of expected option exercise patterns during the option’s contractual term, including the effect of blackout periods. Therefore, the design of a lattice model more fully reflects the substantive characteristics of a particular employee share option or similar instrument. Nevertheless, both a lattice model and the Black-Scholes-Merton formula, as well as other valuation techniques that meet the requirements in paragraph 718-10-55-11, can provide a fair value estimate that is consistent with the measurement objective and fair-value-based method of this Topic.

55-19 Regardless of the valuation technique or model selected, an entity shall develop reasonable and supportable estimates for each assumption used in the model, including the employee share option or similar instrument’s expected term, taking into account both the contractual term of the option and the effects of employees’ expected exercise and post-vesting employment termination behavior. The term supportable is used in its general sense: capable of being maintained, confirmed, or made good; defensible. An application is supportable if it is based on reasonable arguments that consider the substantive characteristics of the instruments being valued and other relevant facts and circumstances.

55-20 An entity shall change the valuation technique it uses to estimate fair value if it concludes that a different technique is likely to result in a better estimate of fair value (see paragraph 718-10-55-27). For example, an entity that uses a closed-form model might conclude, when information becomes available, that a lattice model or another valuation technique would provide a fair value estimate that better achieves the fair value measurement objective and, therefore, change the valuation technique it uses.

ASC 718-10 (continued)

55-21 If an observable market price is not available for a share option or similar instrument with the same or similar terms and conditions, an entity shall estimate the fair value of that instrument using a valuation technique or model that meets the requirements in paragraph 718-10-55-11 and takes into account, at a minimum, all of the following:

a. The exercise price of the option.

b. The expected term of the option, taking into account both the contractual term of the option and the effects of employees’ expected exercise and post-vesting employment termination behavior. In a closed-form model, the expected term is an assumption used in (or input to) the model, while in a lattice model, the expected term is an output of the model (see paragraphs 718-10-55-29 through 55-34, which provide further explanation of the expected term in the context of a lattice model).

c. The current price of the underlying share.

d. The expected volatility of the price of the underlying share for the expected term of the option.

e. The expected dividends on the underlying share for the expected term of the option (except as provided in paragraphs 718-10-55-44 through 55-45).

f. The risk-free interest rate(s) for the expected term of the option.

55-22 The term expected in (d); (e); and (f) in the preceding paragraph [718-10-55-21] relates to expectations at the measurement date about the future evolution of the factor that is used as an assumption in a valuation model. The term is not necessarily used in the same sense as in the term expected future cash flows that appears elsewhere in the Codification. The phrase expected term of the option in (d); (e); and (f) in the preceding paragraph applies to both closed-form models and lattice models (as well as all other valuation techniques). However, if an entity uses a lattice model (or other similar valuation technique, for instance, a Monte Carlo simulation technique) that has been modified to take into account an option’s contractual term and employees’ expected exercise and post-vesting employment termination behavior, then (d); (e); and (f) in the preceding paragraph apply to the contractual term of the option.

55-23 There is likely to be a range of reasonable estimates for expected volatility, dividends, and term of the option. If no amount within the range is more or less likely than any other amount, an average of the amounts in the range (the expected value) shall be used. In a lattice model, the assumptions used are to be determined for a particular node (or multiple nodes during a particular time period) of the lattice and not over multiple periods, unless such application is supportable.
Historical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience shall be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past. The appropriate weight to place on historical experience is a matter of judgment, based on relevant facts and circumstances. For example, an entity with two distinctly different lines of business of approximately equal size may dispose of the one that was significantly less volatile and generated more cash than the other. In that situation, the entity might place relatively little weight on volatility, dividends, and perhaps employees’ exercise and post-vesting employment termination behavior from the predisposition (or disposition) period in developing reasonable expectations about the future. In contrast, an entity that has not undergone such a restructuring might place heavier weight on historical experience. That entity might conclude, based on its analysis of information available at the time of measurement, that its historical experience provides a reasonable estimate of expected volatility, dividends, and employees’ exercise and post-vesting employment termination behavior. This guidance is not intended to suggest either that historical volatility is the only indicator of expected volatility or that an entity must identify a specific event in order to place less weight on historical experience. Expected volatility is an expectation of volatility over the expected term of an employee share option or similar instrument; that expectation shall consider all relevant factors in paragraph 718-10-55-37, including possible mean reversion. Paragraphs 718-10-55-35 through 55-41 provide further guidance on estimating expected volatility.

In certain circumstances, historical information may not be available. For example, an entity whose common stock has only recently become publicly traded may have little, if any, historical information on the volatility of its own shares. That entity might base expectations about future volatility on the average volatilities of similar entities for an appropriate period following their going public. A nonpublic entity will need to exercise judgment in selecting a method to estimate expected volatility and might do so by basing its expected volatility on the average volatilities of otherwise similar public entities. For purposes of identifying otherwise similar entities, an entity would likely consider characteristics such as industry, stage of life cycle, size, and financial leverage. Because of the effects of diversification that are present in an industry sector index, the volatility of an index should not be substituted for the average of volatilities of otherwise similar entities in a fair value measurement.

This guidance is organized as follows:

- Selecting consistent assumptions
- Selecting or estimating the risk-free rate for the expected term
- Selecting or estimating the expected term
- Selecting or estimating the expected volatility
- Selecting or estimating expected dividends
- Dividend protected awards
- Selecting or considering credit risk
- Contingency features that affect the option pricing model
- Consider dilution.

Consistent Use of Valuation Techniques and Methods for Selecting Assumptions

Assumptions used to estimate the fair value of equity and liability instruments granted to employees shall be determined in a consistent manner from period to period. For example, an entity might use the closing share price or the share price at another specified time as the current share price on the grant date in estimating fair value, but whichever method is selected, it shall be used consistently. The valuation technique an entity selects to estimate fair value for a particular type of instrument also shall be used consistently and shall not be changed unless a different valuation technique is expected to produce a better estimate of fair value. A change in either the valuation technique or the method of determining appropriate assumptions used in a valuation technique is a change in accounting estimate for purposes of applying Topic 250, and shall be applied prospectively to new awards.

Selecting or Estimating the Risk-Free Rate for the Expected Term

Option-pricing models call for the risk-free interest rate as an assumption to take into account, among other things, the time value of money. A U.S. entity issuing an option on its own shares must use as the risk-free interest rates the implied yields currently available from the U.S. Treasury zero-coupon yield curve over the contractual term of the option if the entity is using a lattice model incorporating the option’s contractual term. If the entity is using a closed-form model, the risk-free interest rate is the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term used as the assumption in the model. For entities based in jurisdictions outside the United States, the risk-free interest rate is the implied yield currently available on zero-coupon government issues denominated in the currency of the market in which the share (or underlying share), which is the basis for the instrument awarded, primarily trades. It may be necessary to use an appropriate substitute if no such government issues exist or if circumstances indicate that the implied yield on zero-coupon government issues is not representative of a risk-free interest rate.
The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement). The expected term is an assumption in a closed-form model. However, if an entity uses a lattice model that has been modified to take into account an option’s contractual term and employees’ expected exercise and post-vesting employment termination behavior, the expected term is estimated based on the resulting output of the lattice. For example, an entity’s experience might indicate that option holders tend to exercise their options when the share price reaches 200 percent of the exercise price. If so, that entity might use a lattice model that assumes exercise of the option at each node along each share price path in a lattice at which the early exercise expectation is met, provided that the option is vested and exercisable at that point. Moreover, such a model would assume exercise at the end of the contractual term on price paths along which the exercise expectation is not met but the options are in-the-money at the end of the contractual term. The terms at-the-money, in-the-money, and out-of-the-money are used to describe share options whose exercise price is equal to, less than, or greater than the market price of the underlying share, respectively.

The valuation approach described recognizes that employees’ exercise behavior is correlated with the price of the underlying share. Employees’ expected post-vesting employment termination behavior also would be factored in. Expected term, which is a required disclosure (see paragraph 718-10-50-2), then could be estimated based on the output of the resulting lattice. An example of an acceptable method for purposes of financial statement disclosures of estimating the expected term based on the results of a lattice model is to use the lattice model’s estimated fair value of a share option as an input to a closed-form model, and then to solve the closed-form model for the expected term. Other methods also are available to estimate expected term.

Other factors that may affect expectations about employees’ exercise and post-vesting employment termination behavior include the following:

a. The vesting period of the award. An option’s expected term must at least include the vesting period. Under some share option arrangements, an option holder may exercise an option prior to vesting (usually to obtain a specific tax treatment); however, such arrangements generally require that any shares received upon exercise be returned to the entity (with or without a return of the exercise price to the holder) if the vesting conditions are not satisfied. Such an exercise is not substantive for accounting purposes.

b. Employees’ historical exercise and post-vesting employment termination behavior for similar grants.

c. Expected volatility of the price of the underlying share. An entity also might consider whether the evolution of the share price affects an employee’s exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time).

d. Blackout periods and other coexisting arrangements such as agreements that allow for exercise to automatically occur during blackout periods if certain conditions are satisfied.

e. Employees’ ages, lengths of service, and home jurisdictions (that is, domestic or foreign).

If sufficient information about employees’ expected exercise and post-vesting employment termination behavior is available, a method like the one described in paragraph 718-10-55-30 might be used because that method reflects more information about the instrument being valued (see paragraph 718-10-55-18). However, 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.

Option value increases at a decreasing rate as the term lengthens (for most, if not all, options). For example, a two-year option is worth less than twice as much as a one-year option, other things equal. Accordingly, estimating the fair value of an option based on a single expected term that effectively averages the differing exercise and postvesting employment termination behaviors of identifiable groups of employees will potentially misstate the value of the entire award.
Factors to consider in estimating expected volatility include the following:

- Volatility of the share price, including changes in that volatility and possible mean reversion of that volatility. Mean reversion refers to the tendency of a financial variable, such as volatility, to revert to some long-run average level. Statistical models have been developed that take into account the mean-reverting tendency of volatility. In computing historical volatility, for example, an entity might disregard an identifiable period of time 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 expected or contractual term. If an entity’s share price was extremely volatile for an identifiable period of time, due to a general market decline, that entity might place less weight on its volatility during that period of time because of possible mean reversion. Volatility over the most recent period is generally commensurate with either of the following:
  1. The contractual term of the option if a lattice model is being used to estimate fair value
  2. The expected term of the option if a closed-form model is being used. An entity might evaluate changes in volatility and mean reversion over that period by dividing the contractual or expected term into regular intervals and evaluating evolution of volatility through those intervals.

- The implied volatility of the share price determined from the market prices of traded options or other traded financial instruments such as outstanding convertible debt, if any.

- For a public entity, the length of time its shares have been publicly traded. If that period is shorter than the expected or contractual term of the option, the term structure of volatility for the longest period for which trading activity is available shall be more relevant. A newly public entity also might consider the expected volatility of similar entities. In evaluating similarity, an entity would likely consider factors such as industry, stage of life cycle, size, and financial leverage. A nonpublic entity might base its expected volatility on the expected volatilities of entities that are similar except for having publicly traded securities.

- Appropriate and regular intervals for price observations. If an entity considers historical volatility in estimating expected volatility, it shall use intervals that are appropriate based on the facts and circumstances and that provide the basis for a reasonable fair value estimate. For example, a publicly traded entity would likely use daily price observations, while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.

- Corporate and capital structure. An entity’s corporate structure may affect expected volatility (see paragraph 718-10-55-24). An entity’s capital structure also may affect expected volatility; for example, highly leveraged entities tend to have higher volatilities.

Although use of unadjusted historical volatility may be appropriate for some entities (or even for most entities in some time periods), a marketplace participant would not use historical volatility without considering the extent to which the future is likely to differ from the past.

A closed-form model, such as the Black-Scholes-Merton formula, cannot incorporate a range of expected volatilities over the option’s expected term (see paragraph 718-10-55-18). Lattice models can incorporate a term structure of expected volatility; that is, a range of expected volatilities can be incorporated into the lattice over an option’s contractual term. Determining how to incorporate a range of expected volatilities into a lattice model to provide a reasonable fair value estimate is a matter of judgment and shall be based on a careful consideration of the factors listed in paragraph 718-10-55-37 as well as other relevant factors that are consistent with the fair value measurement objective of this Topic.
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<th>Page</th>
<th>Content</th>
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<tbody>
<tr>
<td>55-40</td>
<td>An entity shall establish a process for estimating expected volatility and apply that process consistently from period to period (see paragraph 718-10-55-27). That process:</td>
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<td></td>
<td>a. Shall comprehend an identification of information available to the entity and applicable factors such as those described in paragraph 718-10-55-37</td>
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<td>b. Shall include a procedure for evaluating and weighting that information.</td>
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<tr>
<td>55-41</td>
<td>The process developed by an entity shall be determined by the information available to it and its assessment of how that information would be used to estimate fair value. For example, consistent with paragraph 718-10-55-24, an entity’s starting point in estimating expected volatility might be its historical volatility. That entity also shall consider the extent to which currently available information indicates that future volatility will differ from the historical volatility. An example of such information is implied volatility (from traded options or other instruments).</td>
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<tr>
<td>55-42</td>
<td>Option-pricing models generally call for expected dividend yield as an assumption. However, the models may be modified to use an expected dividend amount rather than a yield. An entity may use either its expected yield or its expected payments. Additionally, an entity’s historical pattern of dividend increases (or decreases) shall be considered. For example, if an entity has historically increased dividends by approximately 3 percent per year, its estimated share option value shall not be based on a fixed dividend amount throughout the share option’s expected term. As with other assumptions in an option-pricing model, an entity shall use the expected dividends that would likely be reflected in an amount at which the option would be exchanged (see paragraph 718-10-55-13).</td>
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<tr>
<td>55-43</td>
<td>As with other aspects of estimating fair value, the objective is to determine the assumption about expected dividends that would likely be used by marketplace participants in determining an exchange price for the option.</td>
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### Dividend Protected Awards

55-44 Expected dividends are taken into account in using an option-pricing model to estimate the fair value of a share option because dividends paid on the underlying shares reduce the fair value of those shares and option holders generally are not entitled to receive those dividends. However, an award of share options may be structured to protect option holders from that effect by providing them with some form of dividend rights. Such dividend protection may take a variety of forms and shall be appropriately reflected in estimating the fair value of a share option. For example, if a dividend paid on the underlying shares is applied to reduce the exercise price of the option, the effect of the dividend protection is appropriately reflected by using an expected dividend assumption of zero. |

55-45 In certain situations, employees may receive the dividends paid on the underlying equity shares while the option is outstanding. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost. The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity’s estimates of forfeitures (see paragraph 718-10-35-3). |

### Selecting or Estimating Expected Dividends

55-46 An entity may need to consider the effect of its credit risk on the estimated fair value of liability awards that contain cash settlement features because potential cash payoffs from the awards are not independent of the entity’s risk of default. Any credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with increases in the price of the underlying share is expected to be de minimis because increases in an entity’s share price generally are positively associated with its ability to liquidate its liabilities. However, a credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with decreases in the price of the entity’s shares may be necessary because decreases in an entity’s share price generally are negatively associated with an entity’s ability to liquidate its liabilities. |

### Contingency Features That Affect the Option Pricing Model

55-47 Contingent features that might cause an employee to return to the entity either equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements, such as a clawback feature (see paragraph 718-10-55-8), shall not be reflected in estimating the grant-date fair value of an equity instrument. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs. For instance, a share-based payment arrangement may stipulate the return of vested equity shares to the issuing entity for no consideration if the employee terminates the employment relationship to work for a competitor. The effect of that provision on the grant-date fair value of the equity shares shall not be considered. If the issuing entity subsequently receives those shares (or their equivalent value in cash or other assets) as a result of that provision, a credit shall be recognized in the income statement upon the receipt of the shares. That credit is limited to the lesser of the recognized compensation cost associated with the share-based payment arrangement that contains the contingent feature and the fair value of the consideration received. The event is recognized in the income statement because the resulting transaction takes place with an employee (or former employee) as a result of the current (or prior) employment relationship rather than as a result of the employee’s role as an equity owner. Example 10 (see paragraph 718-20-55-84) provides an illustration of the accounting for an award that contains a clawback feature.
ASC 718-10 (continued)

Consider Dilution

55-48 Traded options ordinarily are written by parties other than the entity that issues the underlying shares, and when exercised result in an exchange of already outstanding shares between those parties. In contrast, exercise of employee share options results in the issuance of new shares by the entity that wrote the option (the employer), which increases the number of shares outstanding. That dilution might reduce the fair value of the underlying shares, which in turn might reduce the benefit realized from option exercise.

55-49 If the market for an entity’s shares is reasonably efficient, the effect of potential dilution from the exercise of employee share options will be reflected in the market price of the underlying shares, and no adjustment for potential dilution usually is needed in estimating the fair value of the employee share options. For a public entity, an exception might be a large grant of options that the market is not expecting, and also does not believe will result in commensurate benefit to the entity. For a nonpublic entity, on the other hand, potential dilution may not be fully reflected in the share price if sufficient information about the frequency and size of the entity’s grants of equity share options is not available for third parties who may exchange the entity's shares to anticipate the dilutive effect.

55-50 An entity shall consider whether the potential dilutive effect of an award of share options needs to be reflected in estimating the fair value of its options at the grant date. For public entities, the expectation is that situations in which such a separate adjustment is needed will be rare.

Calculated Value for Certain Nonpublic Entities

55-51 Nonpublic entities may have sufficient information available on which to base a reasonable and supportable estimate of the expected volatility of their share prices. For example, a nonpublic entity that has an internal market for its shares, has private transactions in its shares, or issues new equity or convertible debt instruments may be able to consider the historical volatility, or implied volatility, of its share price in estimating expected volatility. Alternatively, a nonpublic entity that can identify similar public entities for which share or option price information is available may be able to consider the historical, expected, or implied volatility of those entities’ share prices in estimating expected volatility. Similarly, this information may be used to estimate the fair value of its options or to benchmark various aspects of its performance (see paragraph 718-10-55-25).

55-52 This Topic requires all entities to use the fair-value-based method to account for share-based payment arrangements that are classified as equity instruments. However, if it is not practicable for a nonpublic entity to estimate the expected volatility of its share price, paragraph 718-10-30-20 requires it to use the calculated value method. Alternatively, it may not be possible for a nonpublic entity to reasonably estimate the fair value of its equity share options and similar instruments at the date they are granted because the complexity of the award’s terms prevents it from doing so. In that case, paragraphs 718-10-30-21 through 30-22 require that the nonpublic entity account for its equity instruments at their intrinsic value, revalued at each reporting date through the date of exercise or other settlement.

55-53 Relatively few small nonpublic entities offer share options to their employees, and those that do often are emerging entities that intend to make a future initial public offering. Many of those nonpublic entities that plan an initial public offering likely will be able to reasonably estimate the fair value of their equity share options and similar instruments using the guidance on selecting an appropriate expected volatility assumption provided in paragraphs 718-10-55-35 through 55-41.

55-54 Estimating the expected volatility of a nonpublic entity’s shares may be difficult and that the resulting estimated fair value may be more subjective than the estimated fair value of a public entity’s options. However, many nonpublic entities could consider internal and industry factors likely to affect volatility, and the average volatility of comparable entities, to develop an estimate of expected volatility. Using an expected volatility estimate determined in that manner often would result in a reasonable estimate of fair value.

55-55 For purposes of this Topic, it is not practicable for a nonpublic entity to estimate the expected volatility of its share price if it is unable to obtain sufficient historical information about past volatility, or other information such as that noted in paragraph 718-10-55-1, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award without undue cost and effort. In that situation, this Topic requires a nonpublic entity to estimate a value for its equity share options and similar instruments by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price as an assumption in its valuation model. All other inputs to a nonpublic entity’s valuation model shall be determined in accordance with the guidance in paragraphs 718-10-55-4 through 55-47.

55-56 There are many different indexes available to consider in selecting an appropriate industry sector index. For example, Dow Jones Indexes maintain a global series of stock market indexes with industry sector splits available for many countries, including the United States. The historical values of those indexes are easily obtainable from its website. An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and that also reflects, if possible, the size of the entity. If a nonpublic entity operates in a variety of different industry sectors, then it might select a number of different industry sector indexes and weight them according to the nature of its operations; alternatively, it might select an index for the industry sector that is most representative of its operations. If a nonpublic entity operates in an industry sector in which no public entities operate, then it shall select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000 because those indexes are sufficiently diversified as to be not representative of the industry sector, or sectors, in which the nonpublic entity operates.
**AST 718-10 (continued)**

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<tr>
<td><strong>55-57</strong></td>
<td>A nonpublic entity shall use the selected index consistently, unless the nature of the entity’s operations changes such that another industry sector index is more appropriate, in applying the calculated value method in both the following circumstances:</td>
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<tr>
<td></td>
<td>a. For all of its equity share options or similar instruments</td>
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<td>b. In each accounting period.</td>
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<td><strong>55-58</strong></td>
<td>The calculation of the historical volatility of an appropriate industry sector index shall be made using the daily historical closing values of the index selected for the period of time prior to the grant date (or service inception date) of the equity share option or similar instrument that is equal in length to the expected term of the equity share option or similar instrument. If daily values are not readily available, then an entity shall use the most frequent observations available of the historical closing values of the selected index. If historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity shall use the closing values for the longest period of time available. The method used shall be consistently applied (see paragraph 718-10-55-27). Example 9 (see paragraph 718-20-55-77) provides an illustration of accounting for an equity share option award granted by a nonpublic entity that uses the calculated value method.</td>
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**Market, Performance, and Service Conditions**

**55-59** This guidance is organized as follows:

- **a.** Market, performance, and service conditions that affect vesting and exercisability
- **b.** Market, performance, and service conditions that affect factors other than vesting and exercisability
- **c.** Estimating the requisite service period
- **d.** Explicit, implicit, and derived requisite service periods.

**Market, Performance, and Service Conditions That Affect Vesting and Exercisability**

**55-60** An employee’s share-based payment award becomes vested at the date that the employee’s right to receive or retain equity shares, other equity instruments, or assets under the award is no longer contingent on satisfaction of either a performance condition or a service condition. This Topic distinguishes among market conditions, performance conditions, and service conditions that affect the vesting or exercisability of an award (see paragraphs 718-10-30-12 and 718-10-30-14). Exercisability is used for market conditions in the same context as vesting is used for performance and service conditions. Other conditions affecting vesting, exercisability, exercise price, and other pertinent factors in measuring fair value that do not meet the definitions of a market condition, performance condition, or service condition are discussed in paragraph 718-10-55-65.

**55-61** Analysis of the market, performance, or service conditions (or any combination thereof) that are explicit or implicit in the terms of an award is required to determine the requisite service period over which compensation cost is recognized and whether recognized compensation cost may be reversed if an award fails to vest or become exercisable (see paragraph 718-10-30-27). If exercisability or the ability to retain the award (for example, an award of equity shares may contain a market condition that affects the employee’s ability to retain those shares) is based solely on one or more market conditions compensation cost for that award is recognized if the employee renders the requisite service, even if the market condition is not satisfied. An award containing one or more market conditions may have an explicit, implicit, or derived service period. Paragraphs 718-10-55-69 through 55-79 provide guidance on explicit, implicit, and derived service periods. If exercisability (or the ability to retain the award) is based solely on one or more market conditions, compensation cost for that award is reversed if the employee does not render the requisite service, unless the market condition is satisfied prior to the end of the requisite service period, in which case any unrecognized compensation cost would be recognized at the time the market condition is satisfied. If vesting is based solely on one or more performance or service conditions, any previously recognized compensation cost is reversed if the award does not vest (that is, the requisite service is not rendered). Examples 1 through 4 (see paragraphs 718-20-55-4 through 55-50) provide illustrations of awards in which vesting is based solely on performance or service conditions.

**55-62** Vesting or exercisability may be conditional on satisfying one or more types of conditions (for example, vesting and exercisability occur upon satisfying both a market and a performance or service condition). Vesting also may be conditional on satisfying one of two or more types of conditions (for example, vesting and exercisability occur upon satisfying either a market condition or a performance or service condition). Regardless of the nature and number of conditions that must be satisfied, the existence of a market condition requires recognition of compensation cost if the requisite service is rendered, even if the market condition is never satisfied.

**55-63** Even if only one of two or more conditions must be satisfied and a market condition is present in the terms of the award, then compensation cost is recognized if the requisite service is rendered, regardless of whether the market, performance, or service condition is satisfied (see Example 5 [paragraph 718-10-55-100] provide an example of such an award).
## ASC 718-10 (continued)

**Market, Performance, and Service Conditions That Affect Factors Other Than Vesting and Exercisability**

**55-64** Market, performance, and service conditions may affect an award’s exercise price, contractual term, quantity, conversion ratio, or other pertinent factors that are relevant in measuring an award’s fair value. For instance, an award’s quantity may double, or an award’s contractual term may be extended, if a company-wide revenue target is achieved. Market conditions that affect an award’s fair value (including exercisability) are included in the estimate of grant-date fair value (see paragraph 718-10-30-15). Performance or service conditions that only affect vesting are excluded from the estimate of grant-date fair value, but all other performance or service conditions that affect an award’s fair value are included in the estimate of grant-date fair value (see that same paragraph). Examples 3, 4, and 6 (see paragraphs 718-20-55-41, 718-20-55-47, and 718-20-55-61) provide further guidance on how performance conditions are considered in the estimate of grant-date fair value.

**55-65** An award may be indexed to a factor in addition to the entity’s share price. If that factor is not a market, performance, or service condition, that award shall be classified as a liability for purposes of this Topic (see paragraphs 718-10-25-13 through 25-14A). An example would be an award of options whose exercise price is indexed to the market price of a commodity, such as gold. Another example would be a share award that will vest based on the appreciation in the price of a commodity, such as gold; that award is indexed to both the value of that commodity and the issuing entity’s shares. If an award is so indexed, the relevant factors shall be included in the fair value estimate of the award. Such an award would be classified as a liability even if the entity granting the share-based payment instrument is a producer of the commodity whose price changes are part or all of the conditions that affect an award’s vesting conditions or fair value.

**55-66** The following flowchart provides guidance on determining how to account for an award based on the existence of market, performance, or service conditions (or any combination thereof).

### Accounting for Awards with Market, Performance, or Service Conditions

1. Based on the terms of the share-based payment instrument, is the instrument a liability under the provisions of this Subtopic?  
   - Yes: The award is classified and accounted for as a liability.
   - No:
     1a. Does the award contain a market condition (paragraph 718-10-55-60)?
        - Yes: The award is classified and accounted for as equity with reversal of recognized compensation cost if the award fails to vest (that is, the requisite service is not rendered) (paragraph 718-10-55-61).
        - No: Vesting conditions are based solely on the satisfaction of performance or service conditions (or any combination thereof). The award is classified and accounted for as equity with reversal of recognized compensation cost if the award fails to vest (that is, the requisite service is not rendered) (paragraph 718-10-55-61).

2. Is exercisability of the award based solely on the satisfaction of one or more market conditions (paragraph 718-10-55-61)?
   - Yes: Regardless of the nature and number of conditions that must be satisfied, the existence of a market condition requires recognition of compensation cost if the requisite service is rendered, even if the market condition is never satisfied. Even if only one of two or more conditions must be satisfied and a market condition is present in the terms of an award, then compensation cost is recognized if the requisite service is rendered, regardless of whether the market, performance, or service condition is satisfied (paragraphs 718-10-55-62 through 55-63).
   - No: Compensation cost is recognized if the requisite service is rendered, regardless of whether the market condition is satisfied (paragraph 718-10-55-61).

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1. The award shall be classified and accounted for as equity. Market conditions are included in the grant-date fair value estimate of the award.
2. Performance and service conditions that affect vesting are not included in estimating the grant-date fair value of the award. Performance and service conditions that affect the exercise price, contractual term, conversion ratio, or other pertinent factors affecting the fair value of an award are included in estimating the grant-date fair value of the award.
### ASC 718-10 (continued)

#### Estimating the Requisite Service Period

**55-67** Paragraph 718-10-35-2 requires that compensation cost be recognized over the requisite service period. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. The requisite service period shall be estimated based on an analysis of the terms of the award and other relevant facts and circumstances, including co-existing employment agreements and an entity’s past practices; that estimate shall ignore nonsubstantive vesting conditions. For example, the grant of a deep out-of-the-money share option award without an explicit service condition will have a derived service period. Likewise, if an award with an explicit service condition that was at-the-money when granted is subsequently modified to accelerate vesting at a time when the award is deep out-of-the-money, that modification is not substantive because the explicit service condition is replaced by a derived service condition. If a market, performance, or service condition requires future service for vesting (or exercisability), an entity cannot define a prior period as the requisite service period. The requisite service period for awards with market, performance, or service conditions (or any combination thereof) shall be consistent with assumptions used in estimating the grant-date fair value of those awards.

**55-68** An employee’s share-based payment award becomes vested at the date that the employee’s right to receive or retain equity shares, other equity instruments, or cash under the award is no longer contingent on satisfaction of either a performance condition or a service condition. Any unrecognized compensation cost shall be recognized when an award becomes vested. If an award includes no market, performance, or service conditions, then the entire amount of compensation cost shall be recognized when the award is granted (which also is the date of issuance in this case). Example 1 (see paragraph 718-10-55-86) provides an illustration of estimating the requisite service period.

#### Explicit, Implicit, and Derived Requisite Service Periods

**55-69** A requisite service period may be explicit, implicit, or derived. An explicit service period is one that is stated in the terms of the share-based payment award. For example, an award that vests after three years of continuous employee service has an explicit service period of three years, which also would be the requisite service period.

**55-70** An implicit service period is one that may be inferred from an analysis of an award’s terms. For example, if an award of share options vests only upon the completion of a new product design and the design is expected to be completed 18 months from the grant date, the implicit service period is 18 months, which also would be the requisite service period.

**55-71** A derived service period is based on a market condition in a share-based payment award that affects exercisability, exercise price, or the employee’s ability to retain the award. A derived service period is inferred from the application of certain valuation techniques used to estimate fair value. For example, the derived service period for an award of share options that an employee can exercise only if the share price doubles at any time during a five-year period can be inferred from certain valuation techniques that are used to estimate fair value. This example, and others noted in this Section, implicitly assume that the rights conveyed by the instrument to the holder are dependent on the holder’s being an employee of the entity. That is, if the employment relationship is terminated, the award lapses or is forfeited shortly thereafter. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of market condition satisfaction (as inferred from the valuation technique). For example, if the derived service period is three years, the requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition is satisfied at an earlier date, in which case any unrecognized compensation cost would be recognized immediately upon its satisfaction. If the requisite service is not rendered, all previously recognized compensation cost would be reversed. If the requisite service is rendered, the recognized compensation is not reversed even if the market condition is never satisfied. An entity that uses a closed-form model to estimate the grant-date fair value of an award with a market condition may need to use another valuation technique to estimate the derived service period.

**55-72** An award with a combination of market, performance, or service conditions may contain multiple explicit, implicit, or derived service periods. For such an award, the estimate of the requisite service period shall be based on an analysis of all of the following:

- All vesting and exercisability conditions
- All explicit, implicit, and derived service periods
- The probability that performance or service conditions will be satisfied.
ASC 718-10 (continued)

55-73 Thus, if vesting (or exercisability) of an award is based on satisfying both a market condition and a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the longest of the explicit, implicit, or derived service periods. If vesting (or exercisability) of an award is based on satisfying either a market condition or a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the shortest of the explicit, implicit, or derived service periods.

55-74 For example, a share option might specify that vesting occurs after three years of continuous employee service or when the employee completes a specified project. The employer estimates that it is probable that the project will be completed within 18 months. The employer also believes it is probable that the service condition will be satisfied. Thus, that award contains an explicit service period of 3 years related to the service condition and an implicit service period of 18 months related to the performance condition. Because it is considered probable that both the performance condition and the service condition will be achieved, the requisite service period over which compensation cost is recognized is 18 months, which is the shorter of the explicit and implicit service periods.

55-75 As illustrated in the preceding paragraph, if an award vests upon the earlier of the satisfaction of a service condition (for example, four years of service) or the satisfaction of one or more performance conditions, it will be necessary to estimate when, if at all, the performance conditions are probable of achievement. For example, if initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, the requisite service period is four years. If one year into the four-year requisite service period a performance condition becomes probable of achievement by the end of the second year, the requisite service period would be revised to two years for attribution of compensation cost (at that point in time, there would be only one year of the two-year requisite service period remaining).

55-76 If an award vests upon the satisfaction of both a service condition and the satisfaction of one or more performance conditions, the entity also must initially determine which outcomes are probable of achievement. For example, an award contains a four-year service condition and two performance conditions, all of which need to be satisfied. If initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, then no compensation cost would be recognized unless the two performance conditions and the service condition subsequently become probable of achievement. If both performance conditions become probable of achievement one year after the grant date and the entity estimates that both performance conditions will be achieved by the end of the second year, the requisite service period would be four years as that is the longest period of both the explicit service period and the implicit service periods. Because the requisite service is now expected to be rendered, compensation cost will be recognized in the period of the change in estimate (see paragraph 718-10-35-3) as the cumulative effect on current and prior periods of the change in the estimated number of awards for which the requisite service is expected to be rendered. Therefore, compensation cost for the first year will be recognized immediately at the time of the change in estimate for the awards for which the requisite service is expected to be rendered. The remaining unrecognized compensation cost for those awards would be recognized prospectively over the remaining requisite service period.

55-77 As indicated in paragraph 718-10-55-75, the initial estimate of the requisite service period based on an explicit or implicit service period shall be adjusted for changes in the expected and actual outcomes of the related service or performance conditions that affect vesting of the award. Such adjustments will occur as the entity revises its estimates of whether or when different conditions or combinations of conditions are probable of being satisfied. Compensation cost ultimately recognized is equal to the grant-date fair value of the award based on the actual outcome of the performance or service conditions (see paragraph 718-10-30-15). If an award contains a market condition and a performance or service condition and the initial estimate of the requisite service period is based on the market condition’s derived service period, then the requisite service period shall not be revised unless either of the following criteria is met:

   a. The market condition is satisfied before the end of the derived service period
   b. Satisfying the market condition is no longer the basis for determining the requisite service period.

55-78 How a change to the initial estimate of the requisite service period is accounted for depends on whether that change would affect the grant-date fair value of the award (including the quantity of instruments) that is to be recognized as compensation. For example, if the quantity of instruments for which the requisite service is expected to be rendered changes because a vesting condition becomes probable of satisfaction or if the grant-date fair value of an instrument changes because another performance or service condition becomes probable of satisfaction (for example, a performance or service condition that affects exercise price becomes probable of satisfaction), the cumulative effect on current and prior periods of those changes in estimates shall be recognized in the period of the change. In contrast, if compensation cost is already being attributed over an initially estimated requisite service period and that initially estimated period changes solely because another market, performance, or service condition becomes the basis for the requisite service period, any unrecognized compensation cost at that date of change shall be recognized prospectively over the revised requisite service period, if any (that is, no cumulative-effect adjustment is recognized).

55-79 To summarize, changes in actual or estimated outcomes that affect either the grant-date fair value of the instrument awarded or the quantity of instruments for which the requisite service is expected to be rendered (or both) are accounted for using a cumulative effect adjustment, and changes in estimated requisite service periods for awards for which compensation cost is already being attributed are accounted for prospectively only over the revised requisite service period, if any.
Determination of Grant Date

55-80 This guidance expands on the guidance provided in paragraph 718-10-25-5.

55-81 The definition of grant date requires that an employer and employee have a mutual understanding of the key terms and conditions of the share-based compensation arrangement. Those terms may be established through any of the following:

   a. A formal, written agreement
   b. An informal, oral arrangement
   c. An entity’s past practice.

55-82 A mutual understanding of the key terms and conditions means that there is sufficient basis for both the employer and the employee to understand the nature of the relationship established by the award, including both the compensatory relationship and the equity relationship subsequent to the date of grant. The grant date for an award will be the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares. In order to assess that financial exposure, the employer and employee must agree to the terms; that is, there must be a mutual understanding. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory). Additionally, to have a grant date for an award to an employee, the recipient of that award must meet the definition of an employee.

55-83 The determination of the grant date shall be based on the relevant facts and circumstances. For instance, a look-back share option may be granted with an exercise price equal to the lower of the current share price or the share price one year hence. The ultimate exercise price is not known at the date of grant, but it cannot be greater than the current share price. In this case, the relationship between the exercise price and the current share price provides a sufficient basis to understand both the compensatory and equity relationship established by the award; the recipient begins to benefit from subsequent changes in the price of the employer’s equity shares. However, if the award’s terms call for the exercise price to be set equal to the share price one year hence, the recipient does not begin to benefit from, or be adversely affected by, changes in the price of the employer’s equity shares until then. Therefore, grant date would not occur until one year hence. Awards of share options whose exercise price is determined solely by reference to a future share price would generally not provide a sufficient basis to understand the nature of the compensatory and equity relationships established by the award until the exercise price is known.

Classification of Certain Awards with Repurchase Features

55-84 The following paragraph further explains the guidance in paragraphs 718-10-25-9 through 25-12.

55-85 An entity may, for example, grant shares under a share-based compensation arrangement that the employee can put (sell) to the employer (the entity) shortly after the vesting date for cash equal to the fair value of the shares on the date of repurchase. That award of puttable shares would be classified as a liability because the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the share is issued (see paragraph 718-10-25-9(a)). Alternatively, an entity might grant its own shares under a share-based compensation arrangement that may be put to the employer only after the employee has held them for a reasonable period of time after vesting but at a fixed redemption amount. Those puttable shares also would be classified as liabilities under the requirements of this Topic because the repurchase price is based on a fixed amount rather than variations in the fair value of the employer’s shares. The employee cannot bear the risks and rewards normally associated with equity share ownership for a reasonable period of time because of that redemption feature. However, if a share with a repurchase feature gives the employee the right to sell shares back to the entity for a fixed amount over the fair value of the shares at the date of repurchase, paragraph 718-20-35-7 requires that the fixed amount over the fair value be recognized as additional compensation cost over the requisite service period (with a corresponding liability being accrued).

Identifying an Employee of a Physician Practice Management Entity

55-85A A physician practice management entity shall determine whether an employee of the physician practice is considered an employee of the physician practice management entity for purposes of determining the method of accounting for that person’s share-based compensation as follows:

   a. An employee of a physician practice that is consolidated by the physician practice management entity shall be considered an employee of the physician practice management entity and its subsidiaries.
   b. An employee of a physician practice that is not consolidated by the physician practice management entity shall not be considered an employee of the physician practice management entity and its subsidiaries.

Illustrations — Example 1: Estimating the Requisite Service Period

55-86 This Example illustrates the guidance in paragraphs 718-10-30-25 through 30-26.

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 (continued)

55-88[1] 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 performance or service condition for vesting, that is, the award is effectively vested, and thus, the award’s entire fair value should be recognized as compensation cost on the grant date. All of the terms of a share-based payment award and other relevant facts and circumstances must be analyzed when determining the requisite service period.

Example 2: Definition of Employee

55-89 This Example illustrates the evaluation as to whether an individual meets conditions to be considered an employee under the definition of that term used in this Topic.

55-90 This Topic defines employee as an individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service (IRS) Revenue Ruling 87-41. An example of whether that condition exists follows. Entity A issues options to members of its Advisory Board, which is separate and distinct from Entity A’s board of directors. Members of the Advisory Board are knowledgeable about Entity A’s industry and advise Entity A on matters such as policy development, strategic planning, and product development. The Advisory Board members are appointed for two-year terms and meet four times a year for one day, receiving a fixed number of options for services rendered at each meeting. Based on an evaluation of the relationship between Entity A and the Advisory Board members, Entity A concludes that the Advisory Board members do not meet the common law definition of employee. Accordingly, the awards to the Advisory Board members are accounted for as awards to nonemployees under the provisions of this Topic.

55-91 Nonemployee directors acting in their role as members of an entity’s board of directors shall be treated as employees if those directors were elected by the entity’s shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to them for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees in accordance with Section 505-50-25. Additionally, consolidated groups may have multiple boards of directors; this guidance applies only to either of the following:
   a. The nonemployee directors acting in their role as members of a parent entity’s board of directors
   b. Nonemployee members of a consolidated subsidiary’s board of directors to the extent that those members are elected by shareholders that are not controlled directly or indirectly by the parent or another member of the consolidated group.

Example 3: Share-Based Payment Award with a Performance Condition and Multiple Service Periods

55-92 The following Cases illustrate share-based payment awards with a performance condition (see paragraphs 718-10-25-20 through 25-21; 718-10-30-27; and 718-10-35-4) and multiple service dates:
   a. Performance targets are set at the inception of the arrangement (Case A).
   b. Performance targets are established at some time in the future (Case B).
   c. Performance targets established up front but vesting is tied to the vesting of a preceding award (Case C).

55-93 Cases A, B, and C share the following assumptions:
   a. On January 1, 20X5, Entity T enters into an arrangement with its chief executive officer relating to 40,000 share options on its stock with an exercise price of $30 per option.
   b. The arrangement is structured such that 10,000 share options will vest or be forfeited in each of the next 4 years (20X5 through 20X8) depending on whether annual performance targets relating to Entity T’s revenues and net income are achieved.

Case A: Performance Targets Are Set at the Inception of the Arrangement

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.

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[1] On June 19, 2014, the FASB issued ASU 2014-12, which added ASC 718-10-30-28. The guidance in ASU 2014-12 is effective for all entities (i.e., public business entities and all other entities) for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. Entities may apply the amendments in ASU 2014-12 either (1) prospectively to all awards granted or modified after the effective date or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter.
**ASC 718-10 (continued)**

**Case B: Performance Targets Are Established at Some Time in the Future**

55-95  
If the arrangement had instead provided that the annual performance targets would be established during January of each year, the grant date (and, therefore, the measurement date) for each tranche would be that date in January of each year (20X5 through 20X8) because a mutual understanding of the key terms and conditions would not be reached until then. In that case, each tranche of 10,000 share options has its own service inception date, grant-date fair value, and 1-year requisite service period. The fair value measurement of compensation cost for each tranche would be affected because not all of the key terms and conditions of each award are known until the compensation committee sets the performance targets and, therefore, the grant dates are those dates.

**Case C: Performance Targets Established up Front but Vesting Is Tied to the Vesting of a Preceding Award**

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.

**Example 4: Share-Based Payment Award with a Service Condition and Multiple Service Periods**

55-97  
The following Cases illustrate the guidance in paragraph 718-10-30-12 to determine the service period for awards with multiple service periods:

a. Exercise price established at subsequent dates (Case A)

b. Exercise price established at inception (Case B).

**Case A: Exercise Price Established at Subsequent Dates**

55-98  
The chief executive officer of Entity T enters into a five-year employment contract on January 1, 20X5. The contract stipulates that the chief executive officer will be given 10,000 fully vested share options at the end of each year (50,000 share options in total). The exercise price of each tranche will be equal to the market price at the date of issuance (December 31 of each year in the five-year contractual term). In this Case, there are five separate grant dates. The grant date for each tranche is December 31 of each year because that is the date when there is a mutual understanding of the key terms and conditions of the agreement—that is, the exercise price is known and the chief executive officer begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares (see paragraphs 718-10-55-80 through 55-83 for additional guidance on determining the grant date). Because the awards' terms do not include a substantive future requisite service condition that exists at the grant date (the options are fully vested when they are issued), and the exercise price (and, therefore, the grant date) is determined at the end of each period, the service inception date precedes the grant date. The requisite service provided in exchange for the first award (pertaining to 20X5) is independent of the requisite service provided in exchange for each consecutive award. The terms of the share-based compensation arrangement provide evidence that each tranche compensates the chief executive officer for one year of service, and each tranche shall be accounted for as a separate award with its own service inception date, grant date, and one-year service period; therefore, the provisions of paragraph 718-10-35-8 would not be applicable to this award because of its structure.

**Case B: Exercise Price Established at Inception**

55-99  
The following Cases illustrate the guidance in paragraph 718-10-35-5 in circumstances in which an award includes both a market condition and a service condition:

a. When only one condition must be met (Case A)

b. When both conditions must be met (Case B).

55-100  
Cases A and B share the following assumptions.
### ASC 718-10 (continued)

**55-102** On January 1, 20X5, Entity T grants an executive 200,000 share options on its stock with an exercise price of $30 per option. The award specifies that vesting (or exercisability) will occur upon the earlier of the following for Case A or both are met for Case B:

a. The share price reaching and maintaining at least $70 per share for 30 consecutive trading days  

b. The completion of eight years of service.

**55-103** The award contains an explicit service period of eight years related to the service condition and a derived service period related to the market condition.

#### Case A: When Only One Condition Must Be Met

**55-104** An entity shall make its best estimate of the derived service period related to the market condition (see paragraph 718-10-55-71). The derived service period may be estimated using any reasonable methodology, including Monte Carlo simulation techniques. For this Case, the derived service period is assumed to be six years. As described in paragraphs 718-10-55-72 through 55-73, if an award’s vesting (or exercisability) is conditional upon the achievement of either a market condition or performance or service conditions, the requisite service period is generally the shortest of the explicit, implicit, and derived service periods. In this Case, the requisite service period over which compensation cost would be attributed is six years (shorter of eight and six years). (An entity may grant a fully vested deep out-of-the-money share option that would lapse shortly after termination of service, which is the equivalent of an award with both a market condition and a service condition. The explicit service period associated with the explicit service condition is zero; however, because the option is deep-out-of-the-money at the grant date, there would be a derived service period.)

**55-105** Continuing with this Case, if the market condition is actually satisfied in February 20X9 (based on market prices for the prior 30 consecutive trading days), Entity T would immediately recognize any unrecognized compensation cost because no further service is required to earn the award. If the market condition is not satisfied as of that date but the executive renders the six years of requisite service, compensation cost shall not be reversed under any circumstances.

#### Case B: When Both the Market and Service Condition Must Be Met

**55-106** The initial estimate of the requisite service period for an award requiring satisfaction of both market and performance or service conditions is generally the longest of the explicit, implicit, and derived service periods (see paragraphs 718-10-55-72 through 55-73). For example, if the award described in Case A required both the completion of 8 years of service and the share price reaching and maintaining at least $70 per share for 30 consecutive trading days, compensation cost would be recognized over the 8-year explicit service period. If the employee were to terminate service prior to the eight-year requisite service period, compensation cost would be reversed even if the market condition had been satisfied by that time.

#### Example 6: Service Inception Date and Grant Date

**55-107** The following Example illustrates the guidance in paragraph 718-10-35-6.

**55-108** This Topic distinguishes between service inception date and grant date. The service inception date is the date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date precedes the grant date if all of the following criteria are met:

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

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

c. Either of the following conditions applies:

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

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

**55-109** In certain circumstances the service inception date may begin after the grant date (see paragraphs 718-10-55-93 through 55-94 for an example illustrating that circumstance).

**55-110** For example, Entity T offers a position to an individual on April 1, 20X5, that has been approved by the chief executive officer and board of directors. In addition to salary and other benefits, Entity T offers to grant 10,000 shares of Entity T stock that vest up on the completion of 5 years of service (the market price of Entity T’s stock is $25 on April 1, 20X5). The share award will begin vesting on the date the offer is accepted. The individual accepts the offer on April 2, 20X5, but is unable to begin providing services to Entity T until June 2, 20X5 (that is, substantive employment begins on June 2, 20X5). The individual also does not receive a salary or participate in other employee benefits until June 2, 20X5. On June 2, 20X5, the market price of Entity T stock is $40. In this Example, the service inception date is June 2, 20X5, the first date that the individual begins providing substantive employee services to Entity T. The grant date is the same date because that is when the individual would meet the definition of an employee. The grant-date fair value of the share award is $400,000 (10,000 x $40).
A Roadmap to Accounting for Share-Based Payment Awards

ASC 718-10 (continued)

55-111 If necessary board approval of the award described in the preceding paragraph was obtained on August 5, 20X5, two months after substantive employment begins (June 2, 20X5), both the service inception date and the grant date would be August 5, 20X5, as that is the date when all necessary authorizations were obtained. If the market price of Entity T’s stock was $38 per share on August 5, 20X5, the grant-date fair value of the share award would be $380,000 (10,000 × $38). Additionally, Entity T would not recognize compensation cost for the shares for the period between June 2, 20X5, and August 4, 20X5, neither during that period nor cumulatively on August 5, 20X5, when both the service inception date and the grant date occur. 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. Future service in this context represents the service to be rendered beginning as of the service inception date.

55-112 If the service inception date precedes the grant date, recognition of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting dates that occur before the grant date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on the fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting dates) (see paragraph 718-10-35-6).

55-113 If an award’s terms do not include a substantive future requisite service condition that exists at the grant date, the service inception date may precede the grant date. For example, on January 1, 20X5, an employee is informed that an award of 100 fully vested options will be made on January 1, 20X6, with an exercise price equal to the share price on January 1, 20X6. All approvals for that award have been obtained as of January 1, 20X5. That individual is still an employee on January 1, 20X6, and receives the 100 fully vested options on that date. There is no substantive future service period associated with the options after January 1, 20X6. Therefore, the requisite service period is from the January 1, 20X5, service inception date through the January 1, 20X6, grant date, as that is the period during which the employee is required to perform service in exchange for the award. The relationship between the exercise price and the current share price that provides a sufficient basis to understand the equity relationship established by the award is known on January 1, 20X6. Compensation cost would be recognized during 20X5 in accordance with the preceding paragraph.

55-114 If an award contains either a market or a performance condition, which if not satisfied during the service period preceding the grant date and following the date the award is given results in a forfeiture of the award, then the service inception date may precede the grant date. For example, an authorized award is given on January 1, 20X5, with a two-year cliff vesting service requirement commencing on that date. The exercise price will be set on January 1, 20X6. The award will be forfeited if Entity T does not sell 1,000 units of product X in 20X5. In this Example, the employee earns the right to retain the award if the performance condition is met and the employee renders service in 20X5 and 20X6. The requisite service period is two years beginning on January 1, 20X5. The service inception date (January 1, 20X5) precedes the grant date (January 1, 20X6). Compensation cost would be recognized during 20X5 in accordance with paragraph 718-10-55-112.

55-115 In contrast, consider an award that is given on January 1, 20X5, with only a three-year cliff vesting explicit service condition, which commences on that date. The exercise price will be set on January 1, 20X6. In this Example, the service inception date cannot precede the grant date because there is a substantive future requisite service condition that exists at the grant date (two years of service). Therefore, there would be no attribution of compensation cost for the period between January 1, 20X5, and December 31, 20X5, neither during that period nor cumulatively on January 1, 20X6, when both the service inception date and the grant date occur. 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. The requisite service period would be two years, commencing on January 1, 20X6.

Example 7: Tandem Awards

55-116 A tandem award is an award with two or more components in which exercise of one part cancels the other(s). In contrast, a combination award is an award with two or more separate components, all of which can be exercised. The following Cases illustrates one aspect of the guidance in paragraph 718-10-25-15:

a. Share option or cash settled stock appreciation rights (Case A)

b. Phantom shares or share options (Case B).

Case A: Share Option or Cash Settled Stock Appreciation Rights

55-117 This Case illustrates the accounting for a tandem award in which employees have a choice of either share options or cash-settled stock appreciation rights. 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 (continued)

**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.

**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), 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.

### Case B: Phantom Shares or Share Options

**55-120** This Case illustrates a tandem award in which the components have different values after the grant date, depending on movements in the price of the entity’s stock. The employee’s choice of which component to exercise will depend on the relative values of the components when the award is exercised.

**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.

**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.

**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.

<table>
<thead>
<tr>
<th>Units</th>
<th>Exercise of Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>$ 45,000 ($45 × 1,000)</td>
</tr>
<tr>
<td>Purchase price</td>
<td></td>
</tr>
<tr>
<td>Net cash value</td>
<td>$ 45,000</td>
</tr>
</tbody>
</table>

**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.

**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.

**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.

**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.

**55-128** Compensation cost is measured based on the combined value of the two parts.
Awards Classified as Equity

ASC 718-20

Implementation Guidance — General

55-1  This Section may contain summaries or references to specific tax code or other regulations that existed at the time that the standard was issued. The Financial Accounting Standards Board (FASB) does not monitor such code or regulations and assumes no responsibility for the current accuracy of the summaries or references. Users must evaluate such code or regulations to determine consistency of the current code or regulation with that presented.

Equity Restructuring

55-2  In accordance with paragraph 718-20-35-6, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification, except as follows. If an award is modified to add an antidilution provision (that is, a provision designed to equalize an award’s value before and after an equity restructuring) and that modification is not made in contemplation of an equity restructuring, a comparison of the fair value of the modified award and the fair value of the original award immediately before the modification is not required. Example 13 (see paragraph 718-20-55-103) provides additional guidance on accounting for modifications of awards in the context of equity restructurings.

Illustrations — General

55-3  The following Examples are included in this Subtopic because they assume equity classification. However, these Examples would also apply to awards classified as liabilities except that the amounts in the Examples would likely change due to the requirement under Subtopic 718-30 to remeasure share-based liability awards at fair value each reporting period until settlement.
Example 1: Accounting for Share Options with Service Conditions

55-4 The following Cases illustrate the guidance in paragraphs 718-10-35-2 through 35-7 and 718-740-25-2 through 25-3, except for the vesting provisions:

a. Share options with cliff vesting (Case A)
b. Share options with graded vesting (Case B).

55-5 Cases A and B share all of the following assumptions.

55-6 Entity T, a public entity, grants at-the-money employee share options with a contractual term of 10 years. All share options vest at the end of three years (cliff vesting), which is an explicit service (and requisite service) period of three years. The share options do not qualify as incentive stock options for U.S. tax purposes. The enacted tax rate is 35 percent.

55-7 The following table shows assumptions and information about the share options granted on January 1, 20X5 applicable to both Cases.

<table>
<thead>
<tr>
<th>Share options granted</th>
<th>900,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees granted options</td>
<td>3,000</td>
</tr>
<tr>
<td>Expected forfeitures per year</td>
<td>3.0%</td>
</tr>
<tr>
<td>Share price at the grant date</td>
<td>$30</td>
</tr>
<tr>
<td>Exercise price</td>
<td>$30</td>
</tr>
<tr>
<td>Contractual term of options</td>
<td>10 years</td>
</tr>
<tr>
<td>Risk-free interest rate over contractual term</td>
<td>1.5 to 4.3%</td>
</tr>
<tr>
<td>Expected volatility over contractual term</td>
<td>40 to 60%</td>
</tr>
<tr>
<td>Expected dividend yield over contractual term</td>
<td>1.0%</td>
</tr>
<tr>
<td>Suboptimal exercise factor</td>
<td>2</td>
</tr>
</tbody>
</table>

55-8 A suboptimal exercise factor of two means that exercise is generally expected to occur when the share price reaches two times the share option’s exercise price. Option-pricing theory generally holds that the optimal (or profit-maximizing) time to exercise an option is at the end of the option’s term; therefore, if an option is exercised before the end of its term, that exercise is referred to as suboptimal. Suboptimal exercise also is referred to as early exercise. Suboptimal or early exercise affects the expected term of an option. Early exercise can be incorporated into option-pricing models through various means. In this Case, Entity T has sufficient information to reasonably estimate early exercise and has incorporated it as a function of Entity T’s future stock price changes (or the option’s intrinsic value). In this Case, the factor of 2 indicates that early exercise would be expected to occur, on average, if the stock price reaches $60 per share ($30 × 2). Rather than use its weighted average suboptimal exercise factor, Entity T also may use multiple factors based a distribution of early exercise data in relation to its stock price.

55-9 This Case assumes that each employee receives an equal grant of 300 options. Using as inputs the last 7 items from the table in paragraph 718-20-55-7, Entity T’s lattice-based valuation model produces a fair value of $14.69 per option. A lattice model uses a suboptimal exercise factor to calculate the expected term (that is, the expected term is an output) rather than the expected term being a separate input. If an entity uses a Black-Scholes-Merton option-pricing formula, the expected term would be used as an input instead of a suboptimal exercise factor.

Case A: Share Options with Cliff Vesting

55-10 Total compensation cost recognized over the requisite service period (which is the vesting period in this Case) shall be the grant-date fair value of all share options that actually vest (that is, all options for which the requisite service is rendered). Paragraph 718-10-35-3 requires an entity to estimate at the grant date the number of share options for which the requisite service is expected to be rendered (which, in this Case, is the number of share options for which vesting is deemed probable). If that estimate changes, it shall be accounted for as a change in estimate and its cumulative effect (from applying the change retrospectively) recognized in the period of change. Entity T estimates at the grant date the number of share options expected to vest and subsequently adjusts compensation cost for changes in the estimated rate of forfeitures and differences between expectations and actual experience. This Case assumes that none of the compensation cost is capitalized as part of the cost of an asset.
The estimate of the number of forfeitures considers historical employee turnover rates and expectations about the future. Entity T has experienced historical turnover rates of approximately 3 percent per year for employees at the grantees’ level, and it expects that rate to continue over the requisite service period of the awards. Therefore, at the grant date Entity T estimates the total compensation cost to be recognized over the requisite service period based on an expected forfeiture rate of 3 percent per year. Actual forfeitures are 5 percent in 20X5, but no adjustments to cumulative compensation cost are recognized in 20X5 because Entity T still expects actual forfeitures to average 3 percent per year over the 3-year vesting period. As of December 31, 20X6, management decides that the forfeiture rate will likely increase through 20X7 and changes its estimated forfeiture rate for the entire award to 6 percent per year. Adjustments to cumulative compensation cost to reflect the higher forfeiture rate are made at the end of 20X6. At the end of 20X7 when the award becomes vested, actual forfeitures have averaged 6 percent per year, and no further adjustment is necessary.

The first set of calculations illustrates the accounting for the award of share options on January 1, 20X5, assuming that the share options granted vest at the end of three years. (Case B illustrates the accounting for an award assuming graded vesting in which a specified portion of the share options granted vest at the end of each year.) The number of share options expected to vest is estimated at the grant date to be 821,406 (900,000×.973). 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 3-year vesting period is $4,022,151 ($12,066,454÷3). In this Case, Entity T has concluded that it will have sufficient future taxable income to realize the deferred tax benefits from its share-based payment transactions. The journal entries to recognize compensation cost and related deferred tax benefit at the enacted tax rate of 35 percent are as follows for 20X5.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$4,022,151</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$4,022,151</td>
</tr>
<tr>
<td>To recognize compensation cost.</td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$1,407,753</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>$1,407,753</td>
</tr>
<tr>
<td>To recognize the deferred tax asset for the temporary difference related to compensation cost ($4,022,151×.35=$1,407,753).</td>
<td></td>
</tr>
</tbody>
</table>

The net after-tax effect on income of recognizing compensation cost for 20X5 is $2,614,398 ($4,022,151−$1,407,753).

Absent a change in estimated forfeitures, the same journal entries would be made to recognize compensation cost and related tax effects for 20X6 and 20X7, resulting in a net after-tax cost for each year of $2,614,398. However, at the end of 20X6, management changes its estimated employee forfeiture rate from 3 percent to 6 percent per year. The revised number of share options expected to vest is 747,526 (900,000×.943). 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 related journal entries and the computations follow.

At December 31, 20X6, to adjust for new forfeiture rate.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revised total compensation cost</td>
<td>$10,981,157</td>
</tr>
<tr>
<td>Revised cumulative cost as of December 31, 20X6 ($10,981,157×2/3)</td>
<td>$7,320,771</td>
</tr>
<tr>
<td>Cost already recognized in 20X5 and 20X6 ($4,022,151×2)</td>
<td>$8,044,302</td>
</tr>
<tr>
<td>Adjustment to cost at December 31, 20X6</td>
<td>$(723,531)</td>
</tr>
</tbody>
</table>

The related journal entries are as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>$723,531</td>
</tr>
<tr>
<td>Compensation cost</td>
<td>$723,531</td>
</tr>
<tr>
<td>To adjust previously recognized compensation cost and equity to reflect a higher estimated forfeiture rate.</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>$253,236</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$253,236</td>
</tr>
<tr>
<td>To adjust the deferred tax accounts to reflect the tax effect of increasing the estimated forfeiture rate ($723,531×.35=$253,236).</td>
<td></td>
</tr>
</tbody>
</table>
ASC 718-20 (continued)

55-16 Journal entries for 20X7 are as follows.

- Compensation cost $3,660,386
- Additional paid-in capital $3,660,386

To recognize compensation cost ($10,981,157 ÷ 3 = $3,660,386).

- Deferred tax asset $1,281,135
- Deferred tax benefit $1,281,135

To recognize the deferred tax asset for additional compensation cost ($3,660,386 x .35 = $1,281,135).

55-17 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.

Share Option — Cliff Vesting

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>$12,066,454 (821,406 x $14.69)</td>
<td>$4,022,151 ($12,066,454 ÷ 3)</td>
<td>$4,022,151</td>
</tr>
<tr>
<td>20X6</td>
<td>$10,981,157 (747,526 x $14.69)</td>
<td>$3,298,620 ([($10,981,157 ÷ 2) – $4,022,151]</td>
<td>$7,320,771</td>
</tr>
<tr>
<td>20X7</td>
<td>$10,981,157 (747,526 x $14.69)</td>
<td>$3,660,386 ($10,981,157 ÷ 3)</td>
<td>$10,981,157</td>
</tr>
</tbody>
</table>

55-18 All 747,526 vested share options are exercised on the last day of 20Y2. Entity T has already recognized its income tax expense for the year without regard to the effects of the exercise of the employee share options. In other words, current tax expense and current taxes payable were recognized based on income and deductions before consideration of additional deductions from exercise of the employee share options. Upon exercise, the amount credited to common stock (or other appropriate equity accounts) is the sum of the cash proceeds received and the amounts previously credited to additional paid-in capital in the periods the services were received (20X5 through 20X7). In this case, Entity T has no-par common stock and at exercise, the share price is assumed to be $60.

55-19 At exercise the journal entries are as follows.

- Cash (747,526 x $30) $22,425,780
- Additional paid-in capital $10,981,157
- Common stock $33,406,937

To recognize the issuance of common stock upon exercise of share options and to reclassify previously recorded paid-in capital.

55-20 In this Case, the difference between the market price of the shares and the exercise price on the date of exercise is deductible for tax purposes pursuant to U.S. tax law in effect in 2004 (the share options do not qualify as incentive stock options). Realized benefits of tax return deductions in excess of compensation cost recognized are accounted for as a credit to additional paid-in capital. (See Subtopic 718-740 for additional guidance on tax issues.) As indicated in paragraph 718-740-25-10, a share option exercise may result in a tax deduction before the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable. With the share price of $60 at exercise, the deductible amount is $22,425,780 (747,526 x ($60 – $30)). Entity T has sufficient taxable income to fully realize that deduction, and the tax benefit realized is $7,849,023 ($22,425,780 x .35).

55-21 At exercise the journal entries are as follows.

- Deferred tax expense $3,843,405

To write off the deferred tax asset related to deductible share options at exercise ($10,981,157 x .35 = $3,843,405).

- Current taxes payable $7,849,023

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon exercise of share options.
The credit to additional paid-in capital is the tax benefit of the excess of the deductible amount over the recognized compensation cost \( \left[ \$22,425,780 - \$10,981,157 \right] \times 0.35 = \$4,005,618 \).

If instead the share options expired unexercised, previously recognized compensation cost would not be reversed. There would be no deduction on the tax return and, therefore, the entire deferred tax asset of $3,843,405 would be charged to income tax expense or additional paid-in capital, to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with FASB Statement No. 123R, Share-Based Payment, or FASB Statement No. 123, Accounting for Stock-Based Compensation (see paragraphs 718-740-35-5 through 35-7). If employees terminated with out-of-the-money vested share options, the deferred tax asset related to those share options would be written off when those options expire. A write-off of a deferred tax asset related to a deficiency of deductible compensation cost in relation to recognized compensation cost for financial reporting purposes shall not be reflected in the statement of cash flows because the unit of account for cash flow purposes is an individual award (or portion thereof) as opposed to a portfolio of awards.

Topic 230 requires that the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized be classified in the statement of cash flows as a cash inflow from financing activities and a cash outflow from operating activities. Under either the direct or indirect method of reporting cash flows, Entity T would disclose the following activity in its statement of cash flows for the year ended December 31, 20Y2.

Cash outflow from operating activities:

- Excess tax benefits from share-based payment arrangements \( \$4,005,618 \)

Cash inflow from financing activities:

- Excess tax benefits from share-based payment arrangements \( \$4,005,618 \)

Case B: Share Options with Graded Vesting

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

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

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

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

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

Entity T awards 900,000 share options on January 1, 20X5, that vest according to a graded schedule of 25 percent for the first year of service, 25 percent for the second year, and the remaining 50 percent for the third year. Each employee is granted 300 share options. The following table shows the calculation as of January 1, 20X5, of the number of employees and the related number of share options expected to vest. Using the expected 3 percent annual forfeiture rate, 90 employees are expected to terminate during 20X5 without having vested in any portion of the award, leaving 2,910 employees to vest in 25 percent of the award. During 20X6, 87 employees are expected to terminate, leaving 2,823 to vest in the second 25 percent of the award. During 20X7, 85 employees are expected to terminate, leaving 2,738 employees to vest in the last 50 percent of the award. That results in a total of 840,675 share options expected to vest from the award of 900,000 share options with graded vesting.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Employees</th>
<th>Number of Vested Share Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>(3,000 - 90 \times 0.03) = 2,910</td>
<td>(2,910 \times 75 \times 0.25 = 218,250)</td>
</tr>
<tr>
<td>20X6</td>
<td>(2,910 - 87 \times 0.03) = 2,823</td>
<td>(2,823 \times 75 \times 0.25 = 211,725)</td>
</tr>
<tr>
<td>20X7</td>
<td>(2,823 - 85 \times 0.03) = 2,738</td>
<td>(2,738 \times 150 \times 0.50 = 410,700)</td>
</tr>
</tbody>
</table>

Total vested options 840,675
The value of the share options that vest over the three-year period is estimated by separating the total award into three groups (or tranches) according to the year in which they vest (because the expected life for each tranche differs). The following table shows the estimated compensation cost for the share options expected to vest. The estimates of expected volatility, expected dividends, and risk-free interest rates are incorporated into the lattice, and the graded vesting conditions affect only the earliest date at which suboptimal exercise can occur (see paragraph 718-20-55-8 for information on suboptimal exercise). Thus, the fair value of each of the 3 groups of options is based on the same lattice inputs for expected volatility, expected dividend yield, and risk-free interest rates used to determine the value of $14.69 for the cliff-vesting share options (see paragraphs 718-20-55-7 through 55-9). The different vesting terms affect the ability of the suboptimal exercise to occur sooner (and affect other factors as well, such as volatility), and therefore there is a different expected term for each tranche.

<table>
<thead>
<tr>
<th>Year</th>
<th>Vested Options</th>
<th>Value per Option</th>
<th>Compensation Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>218,250</td>
<td>$ 13.44</td>
<td>$ 2,933,280</td>
</tr>
<tr>
<td>20X6</td>
<td>211,725</td>
<td>14.17</td>
<td>3,000,143</td>
</tr>
<tr>
<td>20X7</td>
<td>410,700</td>
<td>14.69</td>
<td>6,033,183</td>
</tr>
<tr>
<td></td>
<td>840,675</td>
<td></td>
<td>$ 11,966,606</td>
</tr>
</tbody>
</table>

Compensation cost is recognized over the periods of requisite service during which each tranche of share options is earned. Thus, the $2,933,280 cost attributable to the 218,250 share options that vest in 20X5 is recognized in 20X5. The $3,000,143 cost attributable to the 211,725 share options that vest at the end of 20X6 is recognized over the 2-year vesting period (20X5 and 20X6). The $6,033,183 cost attributable to the 410,700 share options that vest at the end of 20X7 is recognized over the 3-year vesting period (20X5, 20X6, and 20X7).

The following table shows how the $11,966,606 expected amount of compensation cost determined at the grant date is attributed to the years 20X5, 20X6, and 20X7.

<table>
<thead>
<tr>
<th>Pretax Cost to Be Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
</tr>
<tr>
<td>Share options vesting in 20X5</td>
</tr>
<tr>
<td>Share options vesting in 20X6</td>
</tr>
<tr>
<td>Share options vesting in 20X7</td>
</tr>
<tr>
<td>Cost for the year</td>
</tr>
<tr>
<td>Cumulative cost</td>
</tr>
</tbody>
</table>

Entity T could use the same computation of estimated cost, as in the preceding table, but could elect to recognize compensation cost on a straight-line basis for all graded vesting awards. In that case, total compensation cost to be attributed on a straight-line basis over each year in the 3-year vesting period is approximately $3,988,868 ($11,966,606 ÷ 3). Entity T also could use a single weighted-average expected life to value the entire award and arrive at a different amount of total compensation cost. Total compensation cost could then be attributed on a straight-line basis over the three-year vesting period. However, this Topic requires that compensation cost recognized at any date must be at least equal to the amount attributable to options that are vested at that date. For example, if 50 percent of this same option award vested in the first year of the 3-year vesting period, 436,500 options [2,910 × 150 (300 × 50%)] would be vested at the end of 20X5. Compensation cost amounting to $5,866,560 ($6,444,412 × $13.44) attributable to the vested awards would be recognized in the first year.

Compensation cost is adjusted for awards with graded vesting to reflect differences between estimated and actual forfeitures as illustrated for the cliff-vesting options, regardless of which method is used to estimate value and attribute cost.

Accounting for the tax effects of awards with graded vesting follows the same pattern illustrated in paragraphs 718-20-55-20 through 55-23. However, unless Entity T identifies and tracks the specific tranche from which share options are exercised, it would not know the recognized compensation cost that corresponds to exercised share options for purposes of calculating the tax effects resulting from that exercise. If an entity does not know the specific tranche from which share options are exercised, it should assume that options are exercised on a first-vested, first-exercised basis (which works in the same manner as the first-in, first-out [FIFO] basis for inventory costing).
Example 2: Share Option Award Under Which the Number of Options to Be Earned Varies

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

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

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.

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.

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.

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 20X6, Entity T estimates that 913 employees (1,000 × .973) will remain in service until the vesting date. At the end of 20X6, the number of employees estimated to remain in service is adjusted for the higher forfeiture rate, and the number of employees estimated to remain in service is 831 (1,000 × .943). The compensation cost of the award is initially estimated based on the number of options expected to vest, which in turn is based on the expected level of performance and the fair value of each option. That amount would be adjusted as needed for changes in the estimated and actual forfeiture rates and for differences between estimated and actual market share growth. The amount of compensation cost recognized (or attributed) when achievement of a performance condition is probable depends on the relative satisfaction of the performance condition based on performance to date. Entity T determines that recognizing compensation cost ratably over the three-year vesting period is appropriate with one-third of the value of the award recognized each year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>$1,341,197 ($14.69 × 100 × 913)</td>
<td>$447,066 ($1,341,197 ÷ 3)</td>
<td>$447,066</td>
</tr>
<tr>
<td>20X6</td>
<td>$1,220,739 ($14.69 × 100 × 831)</td>
<td>$366,760 (($1,220,739 × 2/3) − $447,066)</td>
<td>$813,826</td>
</tr>
<tr>
<td>20X7</td>
<td>$2,441,478 ($14.69 × 200 × 831)</td>
<td>$1,627,652 ($2,441,478 − $813,826)</td>
<td>$2,441,478</td>
</tr>
</tbody>
</table>
Example 4: Share Option Award with Other Performance Conditions

55-47 This Example illustrates the guidance in paragraphs 718-10-30-15.

55-48 While performance conditions usually affect vesting conditions, they may affect exercise price, contractual term, quantity, or other factors that affect an award’s fair value before, at the time of, or after vesting. This Topic requires that all performance conditions be accounted for similarly. A potential grant-date fair value is estimated for each of the possible outcomes that are reasonably determinable at the grant date and associated with the performance condition(s) of the award (as demonstrated in Example 3 [see paragraph 718-20-55-41]). Compensation cost ultimately recognized is equal to the grant-date fair value of the award that coincides with the actual outcome of the performance condition(s).

55-49 To illustrate the notion described in the preceding paragraph and attribution of compensation cost if performance conditions have different service periods, assume Entity T grants 10,000 at-the-money share options on its common stock to an employee. The options have a 10-year contractual term. The share options vest upon successful completion of phase-two clinical trials to satisfy regulatory testing requirements related to a developmental drug therapy. Phase-two clinical trials are scheduled to be completed (and regulatory approval of that phase obtained) in approximately 18 months; hence, the implicit service period is approximately 18 months. Further, the share options will become fully transferable upon regulatory approval of the drug therapy (which is scheduled to occur in approximately four years). The implicit service period for that performance condition is approximately 30 months (beginning once phase-two clinical trials are successfully completed). Based on the nature of the performance conditions, the award has multiple requisite service periods (one pertaining to each performance condition) 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.

Example 3: Share Option Award Under Which the Exercise Price Varies

55-41 This Example illustrates the guidance in paragraph 718-10-30-15.

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).

55-43 Entity T estimates at the grant date the expected level of market share growth, the exercise price of the options, and the expected term of the options. Other assumptions, including the risk-free interest rate and the service period over which the cost is attributed, are consistent with those estimates. Entity T estimates at the grant date that its market share growth will be at least 10 percentage points over the 2-year performance period, which means that the expected exercise price of the share options is $15, resulting in a fair value of $19.99 per option. Option value is determined using the same assumptions noted in paragraph 718-20-55-7 except the exercise price is $15 and the award is not exercisable at $15 per option for 2 years.

55-44 Total compensation cost to be recognized if the performance condition is satisfied would be $199,900 (10,000 × $19.99). Paragraph 718-10-30-15 requires that the fair value of both awards with service conditions and awards with performance conditions be estimated as of the date of grant. Paragraph 718-10-35-3 also requires recognition of cost for the number of instruments for which the requisite service is provided. For this performance award, Entity T also selects the expected assumptions at the grant date if the performance goal is not met. If market share growth is not at least 10 percentage points over the 2-year period, Entity T estimates a fair value of $13.08 per option. Option value is determined using the same assumptions noted in paragraph 718-20-55-7 except the award is immediately vested.

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.

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.

Chapter 11 — Implementation Guidance
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ASC 718-20 (continued)

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).

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

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

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.

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.

Example 4: Share Option Award with Other Performance Conditions

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

While performance conditions usually affect vesting conditions, they may affect exercise price, contractual term, quantity, or other factors that affect an award’s fair value before, at the time of, or after vesting. This Topic requires that all performance conditions be accounted for similarly. A potential grant-date fair value is estimated for each of the possible outcomes that are reasonably determinable at the grant date and associated with the performance condition(s) of the award (as demonstrated in Example 3 [see paragraph 718-20-55-41]). Compensation cost ultimately recognized is equal to the grant-date fair value of the award that coincides with the actual outcome of the performance condition(s).

To illustrate the notion described in the preceding paragraph and attribution of compensation cost if performance conditions have different service periods, assume Entity T grants 10,000 at-the-money share options on its common stock to an employee. The options have a 10-year contractual term. The share options vest upon successful completion of phase-two clinical trials to satisfy regulatory testing requirements related to a developmental drug therapy. Phase-two clinical trials are scheduled to be completed (and regulatory approval of that phase obtained) in approximately 18 months; hence, the implicit service period is approximately 18 months. Further, the share options will become fully transferable upon regulatory approval of the drug therapy (which is scheduled to occur in approximately four years). The implicit service period for that performance condition is approximately 30 months (beginning once phase-two clinical trials are successfully completed). Based on the nature of the performance conditions, the award has multiple requisite service periods (one pertaining to each performance condition) that affect the pattern in which compensation cost is attributed. Paragraphs 718-10-55-67 through 55-79 and 718-10-55-86 through 55-88 provide guidance on estimating the requisite service period of an award. The determination of whether compensation cost should be recognized depends on Entity C’s assessment of whether the performance conditions are probable of achievement. Entity C expects that all performance conditions will be achieved. That assessment is based on the relevant facts and circumstances, including Entity C’s historical success rate of bringing developmental drug therapies to market.
ASC 718-20 (continued)

55-50 At the grant date, Entity C estimates that the potential fair value of each share option under the 2 possible outcomes is $10 (Outcome 1, in which the share options vest and do not become transferable) and $16 (Outcome 2, in which the share options vest and do become transferable). The difference in estimated fair values of each outcome is due to the change in estimate of the expected term of the share option. Outcome 1 uses an expected term in estimating fair value that is less than the expected term used for Outcome 2, which is equal to the award’s 10-year contractual term. If a share option is transferable, its expected term is equal to its contractual term (see paragraph 718-10-55-29). If Outcome 1 is considered probable of occurring, Entity C would recognize $100,000 (10,000 x $10) of compensation cost ratably over the 18-month requisite service period related to the successful completion of phase-two clinical trials. If Outcome 2 is considered probable of occurring, then Entity C would recognize an additional $60,000 (10,000 x ($16 – $10)) of compensation cost ratably over the 30-month requisite service period (which begins after phase-two clinical trials are successfully completed) related to regulatory approval of the drug therapy. Because Entity C believes that Outcome 2 is probable, it recognizes compensation cost in the pattern described. However, if circumstances change and it is determined at the end of Year 3 that the regulatory approval of the developmental drug therapy is likely to be obtained in six years rather than four, the requisite service period for Outcome 2 is revised, and the remaining unrecognized compensation cost would be recognized prospectively through Year 6. On the other hand, if it becomes probable that Outcome 2 will not occur, compensation cost recognized for Outcome 2, if any, would be reversed.

Example 5: Share Option with a Market Condition—Indexed Exercise Price

55-51 This Example illustrates the guidance in paragraph 718-10-30-15.

55-52 Entity T grants share options whose exercise price varies with an index of the share prices of a group of entities in the same industry, that is, a market condition. Assume that on January 1, 20X5, Entity T grants 100 share options on its common stock with an initial exercise price of $30 to each of 1,000 employees. The share options have a maximum term of 10 years. The exercise price of the share options increases or decreases on December 31 of each year by the same percentage that the index has increased or decreased during the year. For example, if the peer group index increases by 10 percent in 20X5, the exercise price of the share options during 20X6 increases to $33 ($30 x 1.10). On January 1, 20X5, the peer group index is assumed to be 400. The dividend yield on the index is assumed to be 1.25 percent.

55-53 Each indexed share option may be analyzed as a share option to exchange 0.0750 (30 ÷ 400) shares of the peer group index for a share of Entity T stock—that is, to exchange one noncash asset for another noncash asset. A share option to purchase stock for cash also can be thought of as a share option to exchange one asset (cash in the amount of the exercise price) for another (the share of stock). The intrinsic value of a cash share option equals the difference between the price of the stock upon exercise and the amount—the price—of the cash exchanged for the stock. The intrinsic value of a share option to exchange 0.0750 shares of the peer group index for a share of Entity T stock also equals the difference between the prices of the two assets exchanged.

55-54 To illustrate the equivalence of an indexed share option and the share option above, assume that an employee exercises the indexed share option when Entity T’s share price has increased 100 percent to $60 and the peer group index has increased 75 percent, from 400 to 700. The exercise price of the indexed share option thus is $52.50 ($30 x 1.75).


| Price of Entity T share | $60.00 |
| Less: Exercise price of share option | $52.50 |
| Intrinsic value of indexed share option | $7.50 |

55-55 That is the same as the intrinsic value of a share option to exchange 0.0750 shares of the index for 1 share of Entity T stock.

| Price of Entity T share | $60.00 |
| Less: Price of a share of the peer group index (.0750 x $700) | $52.50 |
| Intrinsic value at exchange | $7.50 |

55-56 Option-pricing models can be extended to value a share option to exchange one asset for another. The principal extension is that the volatility of a share option to exchange two noncash assets is based on the relationship between the volatilities of the prices of the assets to be exchanged—that is, their cross-volatility. In a share option with an exercise price payable in cash, the amount of cash to be paid has zero volatility, so only the volatility of the stock needs to be considered in estimating that option’s fair value. In contrast, the fair value of a share option to exchange two noncash assets depends on possible movements in the prices of both assets—in this Example, fair value depends on the cross-volatility of a share of the peer group index and a share of Entity T stock. Historical cross-volatility can be computed directly based on measures of Entity T’s share price in shares of the peer group index. For example, Entity T’s share price was $0.7500 shares at the grant date and $0.8857 (60 ÷ 700) shares at the exercise date. Those share amounts then are used to compute cross-volatility. Cross-volatility also can be computed indirectly based on the respective volatilities of Entity T stock and the peer group index and the correlation between them. The expected cross-volatility between Entity T stock and the peer group index is assumed to be 30 percent.
ASC 718-20 (continued)

55-57 In a share option with an exercise price payable in cash, the assumed risk-free interest rate (discount rate) represents the return on the cash that will not be paid until exercise. In this Example, an assumed share of the index, rather than cash, is what will not be paid until exercise. Therefore, the dividend yield on the peer group index of 1.25 percent is used in place of the risk-free interest rate as an input to the option-pricing model.

55-58 The initial exercise price for the indexed share option is the value of an equivalent share of the peer group index, which is $30 (0.0750 × $400). The fair value of each share option granted is $7.55 based on the following inputs.

| Share price | $ 30 |
| Exercise price | $ 30 |
| Dividend yield | 1.00% |
| Discount rate | 1.25% |
| Volatility | 30% |
| Contractual term | 10 years |
| Suboptimal exercise factor | 1.10 |

55-59 In this Example, the suboptimal exercise factor is 1.1. In Example 1 (see paragraph 718-20-55-4), the suboptimal exercise factor is 2.0. See paragraph 718-20-55-8 for an explanation of the meaning of a suboptimal exercise factor of 2.0.

55-60 The indexed share options have a three-year explicit service period. The market condition affects the grant-date fair value of the award and its exercisability; however, vesting is based solely on the explicit service period of three years. The at-the-money nature of the award makes the derived service period irrelevant in determining the requisite service period in this Example; therefore, the requisite service period of the award is three years based on the explicit service period. The accrual of compensation cost would be based on the number of options for which the requisite service is expected to be rendered (which is not addressed in this Example). That cost would be recognized over the requisite service period as shown in Example 1 (see paragraph 718-20-55-4).

Example 6: Share Unit with Performance and Market Conditions

55-61 This Example illustrates the guidance in paragraphs 718-10-25-20 through 25-21, 718-10-30-27, and 718-10-35-4.

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.

55-63 Appreciation or depreciation for Entity T’s share price and the S&P 500 index is measured from the grant date.

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.

55-65 The share units’ conversion feature is based on a variable target stock price (that is, the target stock price varies based on the S&P 500 index); hence, it is a market condition. That market condition affects the fair value of the share units that vest. Each vice president’s share units vest only if the individual’s performance condition is achieved; consequently, this award is accounted for as an award with a performance condition (see paragraphs 718-10-55-60 through 55-63). This Example assumes that all share units become fully vested; however, if the share units do not vest because the performance conditions are not achieved, Entity T would reverse any previously recognized compensation cost associated with the nonvested share units.
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ASC 718-20 (continued)

55-66 The grant-date fair value of each share unit is assumed for purposes of this Example to be $36. Certain option-pricing models, including Monte Carlo simulation techniques, have been adapted to value path-dependent options and other complex instruments. In this case, the entity concludes that a Monte Carlo simulation technique provides a reasonable estimate of fair value. Each simulation represents a potential outcome, which determines whether a share unit would convert into three, two, one, or zero shares of stock. For simplicity, this Example assumes that no forfeitures will occur during the vesting period. The grant-date fair value of the award is $36 million (1 million × $36); management of Entity T expects that all share units will vest because the performance conditions are probable of achievement. Entity T recognizes compensation cost of $12 million ($36 million ÷ 3) in each year of the 3-year service period; the following journal entries are recognized by Entity T in 20X5, 20X6, and 20X7.

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

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

55-67 Upon contractual maturity of the share units, four outcomes are possible; however, because all possible outcomes of the market condition were incorporated into the share units’ grant-date fair value, no other entry related to compensation cost is necessary to account for the actual outcome of the market condition. However, if the share units’ conversion ratio was based on achieving a performance condition rather than on satisfying a market condition, compensation cost would be adjusted according to the actual outcome of the performance condition (see Example 4 [paragraph 718-20-55-47]).

Example 7: Share Option with Exercise Price that Increases by a Fixed Amount or Fixed Percentage

55-68 This Example illustrates the guidance in paragraph 718-10-30-15.

55-69 Some entities grant share options with exercise prices that increase by a fixed amount or a constant percentage periodically. For example, the exercise price of the share options in Example 1 (see paragraph 718-20-55-4) might increase by a fixed amount of $2.50 per year. Lattice models and other valuation techniques can be adapted to accommodate exercise prices that change over time by a fixed amount. Such an arrangement has a market condition and may have a derived service period.

55-70 Share options with exercise prices that increase by a constant percentage also can be valued using an option-pricing model that accommodates changes in exercise prices. Alternatively, those share options can be valued by deducting from the discount rate the annual percentage increase in the exercise price. That method works because a decrease in the risk-free interest rate and an increase in the exercise price have a similar effect—both reduce the share option value. For example, the exercise price of the share options in Example 1 (see paragraph 718-20-55-4) might increase at the rate of 1 percent annually. For that example, Entity T’s share options would be valued based on a risk-free interest rate less 1 percent. Holding all other assumptions constant from that Example, the value of each share option granted by Entity T would be $14.34.

Example 8: Share Award Granted by a Nonpublic Entity

55-71 The Example illustrates the guidance in paragraphs 718-10-30-17 through 30-19 and 718-740-25-2 through 25-4. The accounting demonstrated in this Example also would be applicable to a public entity that grants share awards to its employees. The same measurement method and basis is used for both nonvested share awards and restricted share awards (which are a subset of nonvested share awards).

55-72 On January 1, 20X6, Entity W, a nonpublic entity, grants 100 shares of stock to each of its 100 employees. The shares cliff vest at the end of three years. Entity W estimates that the grant-date fair value of 1 share of stock is $7. The grant-date fair value of the share award is $70,000 (100 × 100 × $7). The fair value of shares, which is equal to their intrinsic value, is not subsequently remeasured. For simplicity, the example assumes that no forfeitures occur during the vesting period. Because the requisite service period is 3 years, Entity W recognizes $23,333 ($70,000 ÷ 3) of compensation cost for each annual period as follows.

Compensation cost $ 23,333
Additional paid-in capital $ 23,333
To recognize compensation cost.

Deferred tax asset $ 8,167
Deferred tax benefit $ 8,167
To recognize the deferred tax asset for the temporary difference related to compensation cost ($23,333 × .35 = $8,167).
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ASC 718-20 (continued)

55-73 After three years, all shares are vested. For simplicity, this Example assumes that no employees made an Internal Revenue Service (IRS) Code §83(b) election and Entity W has already recognized its income tax expense for the year in which the shares become vested without regard to the effects of the share award. (IRS Code §83(b) permits an employee to elect either the grant date or the vesting date for measuring the fair market value of an award of shares.)

55-74 The fair value per share on the vesting date, assumed to be $20, is deductible for tax purposes. Paragraph 718-740-45-2 requires that excess tax benefits be recognized as a credit to additional paid-in capital. Tax return deductions that are less than compensation cost recognized result in a charge to income tax expense in the period of vesting unless there are any remaining excess tax benefits from previous awards accounted for in accordance with a fair value based method of accounting, in which case, the amount of any tax deficiency is first offset against additional paid-in capital. Paragraphs 718-740-35-5 through 35-9 establish the requirements for the accounting for a tax deficiency. With the share price at $20 on the vesting date, the deductible amount is $200,000 (10,000 × $20). The entity has sufficient taxable income, and the tax benefit realized is $70,000 ($200,000 × .35).

55-75 At vesting the journal entries would be as follows.

Deferred tax expense $ 24,500
Deferred tax asset $ 24,500
To write off deferred tax asset related to deductible share award at vesting ($70,000 × .35 = $24,500).

Current taxes payable $ 70,000
Current tax expense $ 24,500
Additional paid-in capital 45,500
To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon vesting of share award. The credit to additional paid-in capital is the excess tax benefit: ($200,000 – $70,000) × .35 = $45,500.

Example 9: Share Award Granted by a Nonpublic Entity that Uses the Calculated Value Method

55-76 This Example illustrates the guidance in paragraph 718-10-30-20.

55-77 On January 1, 20X6, Entity W, a small nonpublic entity that develops, manufactures, and distributes medical equipment, grants 100 share options to each of its 100 employees. The share price at the grant date is $7. The options are granted at-the-money, cliff vest at the end of 3 years, and have a 10-year contractual term. Entity W estimates the expected term of the share options granted as 5 years and the risk-free rate as 3.75 percent. For simplicity, this Example assumes that no forfeitures occur during the vesting period and that no dividends are expected to be paid in the future, and this Example does not reflect the accounting for income tax consequences of the awards.

55-78 Entity W does not maintain an internal market for its shares, which are rarely traded privately. It has not issued any new equity or convertible debt instruments for several years and has been unable to identify any similar entities that are public. Entity W has determined that it is not practicable for it to estimate the expected volatility of its share price and, therefore, it is not possible for it to reasonably estimate the grant-date fair value of the share options. Accordingly, Entity W is required to apply the provisions of paragraph 718-10-30-20 in accounting for the share options under the calculated value method.

55-79 Entity W operates exclusively in the medical equipment industry. It visits the Dow Jones Indexes website and, using the Industry Classification Benchmark, reviews the various industry sector components of the Dow Jones U.S. Total Market Index. It identifies the medical equipment subsector, within the health care equipment and services sector, as the most appropriate industry sector in relation to its operations. It reviews the current components of the medical equipment index and notes that, based on the most recent assessment of its share price and its issued share capital, in terms of size it would rank among entities in the index with a small market capitalization (or small-cap entities). Entity W selects the small-cap version of the medical equipment index as an appropriate industry sector index because it considers that index to be representative of its size and the industry sector in which it operates. Entity W obtains the historical daily closing total return values of the selected index for the five years immediately before January 1, 20X6, from the Dow Jones Indexes website. It calculates the annualized historical volatility of those values to be 24 percent, based on 252 trading days per year.

55-80 Entity W uses the inputs that it has determined above in a Black-Scholes-Merton option-pricing formula, which produces a value of $2.05 per share option. This results in total compensation cost of $20,500 (10,000 × $2.05) to be accounted for over the requisite service period of 3 years.
For each of the 3 years ending December 31, 20X6, 20X7, and 20X8, Entity W will recognize compensation cost of $6,833 ($20,500 ÷ 3). The journal entry for each year is as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Calculated Value of Award</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6</td>
<td>$20,500 (10,000 × $2.05)</td>
<td>$6,833 ($20,500 ÷ 3)</td>
<td>$6,833</td>
</tr>
<tr>
<td>20X7</td>
<td>$20,500 (10,000 × $2.05)</td>
<td>$6,834 ($20,500 × 2/3 – $6,833)</td>
<td>$13,667</td>
</tr>
<tr>
<td>20X8</td>
<td>$20,500 (10,000 × $2.05)</td>
<td>$6,833 ($20,500 – $13,667)</td>
<td>$20,500</td>
</tr>
</tbody>
</table>

Assuming that all 10,000 share options are exercised on the same day in 20Y2, the accounting for the option exercise will follow the same pattern as in Example 1, Case A (see paragraph 718-20-55-10) and will result in the following journal entry.

At exercise the journal entry is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (10,000 × $7)</td>
<td>$70,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$20,500</td>
</tr>
<tr>
<td>Common stock</td>
<td>$90,500</td>
</tr>
</tbody>
</table>

To recognize the issuance of shares upon exercise of options and to reclassify previously recognized paid-in capital.

Example 10: Share Award with a Clawback Feature

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury stock</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Other income</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Cash</th>
<th>$4,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Other income</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

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

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

**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.

**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.

**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.

**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.

**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.

**55-92** Example 10 (see paragraph 718-20-55-84) provides an illustration of another noncompete agreement. That Example and this one are similar in that both noncompete agreements are not contingent upon employment termination (that is, both agreements may activate and lapse during a period of active employment after the vesting date). A key difference between the two Examples is that the award recipient in that Example must provide five years of service to vest in the award (as opposed to vesting immediately). Another key difference is that the award recipient in that Example receives the shares upon vesting and may sell them immediately without restriction as opposed to the restricted share units, which are transferred according to the delayed-transfer schedule. In that Example, the noncompete provision is not deemed to be an in-substance service condition. In making a determination about whether a noncompete provision may represent an in-substance service condition, the provision’s legal enforceability, the entity’s intent to enforce the provision and its past practice of enforcement, the employee’s rights to the instruments such as the right to sell them, the severity of the provision, the fair value of the award, and the existence or absence of an explicit employee service condition are all factors that shall be considered. Because noncompete provisions can be structured differently, one or more of those factors (such as the entity’s intent to enforce the provision) may be more important than others in making that determination. For example, if Entity K did not intend to enforce the provision, then the noncompete provision would not represent an in-substance service condition.
Example 12: Modifications and Settlements

55-93 The following Cases illustrate the accounting for modifications of the terms of an award (see paragraphs 718-20-35-3 through 35-4) and are based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5:

a. Modification of vested share options (Case A)
b. Share settlement of vested share options (Case B)
c. Modification of nonvested share options (Case C)
d. Cash settlement of nonvested share options (Case D).

Case A: Modification of Vested Share Options

55-94 On January 1, 20X9, after the share options have vested, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the outstanding share options to $20. In effect, Entity T issues new share options with an exercise price of $20 and a contractual term equal to the remaining contractual term of the original January 1, 20X5, share options, which is 6 years, in exchange for the original vested share options. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange, measured as shown in the following paragraph. A nonpublic entity using the calculated value would compare the calculated value of the original award immediately before the modification with the calculated value of the modified award unless an entity has ceased to use the calculated value, in which case it would follow the guidance in paragraph 718-20-35-3(a) through (b) (calculating the effect of the modification based on the fair value). The modified share options are immediately vested, and the additional compensation cost is recognized in the period the modification occurs.

\[
\begin{array}{ll}
\text{Fair value of modified share option at January 1, 20X9} & $7.14 \\
\text{Less: Fair value of original share option at January 1, 20X9} & 3.67 \\
\hline
\text{Additional compensation cost to be recognized} & 3.47
\end{array}
\]

55-95 The January 1, 20X9, fair value of the modified award is $7.14. To determine the amount of additional compensation cost arising from the modification, the fair value of the original vested share options assumed to be repurchased is computed immediately before the modification. The resulting fair value at January 1, 20X9, of the original share options is $3.67 per share option, based on their remaining contractual term of 6 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 3.4 percent, expected volatility of 35 percent to 50 percent and a 1.0 percent expected dividend yield. The additional compensation cost stemming from the modification is $3.47 per share option, determined as follows.

55-96 Compensation cost already recognized during the vesting period of the original award is $10,981,157 for 747,526 vested share options (see paragraphs 718-20-55-14 through 55-17). For simplicity, it is assumed that no share options were exercised before the modification. Previously recognized compensation cost is not adjusted. Additional compensation cost of $2,593,915 (747,526 vested share options × $3.47) is recognized on January 1, 20X9, because the modified share options are fully vested; any income tax effects from the additional compensation cost are recognized accordingly.

Case B: Share Settlement of Vested Share Options

55-97 Rather than modify the option terms, Entity T offers to settle the original January 1, 20X5, share options for fully vested equity shares at January 1, 20X9. The fair value of each share option is estimated the same way as shown in Case A, resulting in a fair value of $3.67 per share option. Entity T recognizes the settlement as the repurchase of an outstanding equity instrument, and no additional compensation cost is recognized at the date of settlement unless the payment in fully vested equity shares exceeds $3.67 per share option. Previously recognized compensation cost for the fair value of the original share options is not adjusted.

Case C: Modification of Nonvested Share Options

55-98 On January 1, 20X6, 1 year into the 3-year vesting period, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the share options to $20. The three-year cliff-vesting requirement is not changed. In effect, in exchange for the original nonvested share options, Entity T grants new share options with an exercise price of $20 and a contractual term equal to the 9-year remaining contractual term of the original share options granted on January 1, 20X5. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange determined in the manner described in paragraphs 718-20-55-95 through 55-96. Entity T adds that additional compensation cost to the remaining unrecognized compensation cost for the original share options at the date of modification and recognizes the total amount ratably over the remaining two years of the three-year vesting period. Because the original vesting provision is not changed, the modification has an explicit service period of two years, which represents the requisite service period as well. Thus, incremental compensation cost resulting from the modification would be recognized ratably over the remaining two years rather than in some other pattern.
**ASC 718-20 (continued)**

**55-99** The January 1, 20X6, fair value of the modified award is $8.59 per share option, based on its contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $20 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. The fair value of the original award immediately before the modification is $5.36 per share option, based on its remaining contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. Thus, the additional compensation cost stemming from the modification is $3.23 per share option, determined as follows.

Fair value of modified share option at January 1, 20X6 $8.59
Less: Fair value of original share option at January 1, 20X6 $5.36
Incremental value of modified share option at January 1, 20X6 $3.23

**55-100** On January 1, 20X6, the remaining balance of unrecognized compensation cost for the original share options is $9.79 per share option. Using a value of $14.69 for the original option as noted in paragraph 718-20-55-9 results in recognition of $4.90 ($14.69 ÷ 3) per year. The unrecognized balance at January 1, 20X6, is $9.79 ($14.69 – $4.90) per option. The total compensation cost for each modified share option that is expected to vest is $13.02, determined as follows.

Incremental value of modified share option $3.23
Unrecognized compensation cost for original share option $9.79
Total compensation cost to be recognized $13.02

**55-101** That amount is recognized during 20X6 and 20X7, the two remaining years of the requisite service period.

**Case D: Cash Settlement of Nonvested Share Options**

**55-102** Rather than modify the share option terms, Entity T offers on January 1, 20X6, to settle the original January 1, 20X5, grant of share options for cash. Because the share price decreased from $30 at the grant date to $20 at the date of settlement, the fair value of each share option is $5.36, the same as in Case C. If Entity T pays $5.36 per share option, it would recognize that cash settlement as the repurchase of an outstanding equity instrument and no incremental compensation cost would be recognized. However, the cash settlement of the share options effectively vests them. Therefore, the remaining unrecognized compensation cost of $9.79 per share option would be recognized at the date of settlement.

**Example 13: Modifications Due to an Equity Restructuring**

**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 A: Original Award Contains Antidilution Provisions**

**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 if 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 incremental fair value, no additional compensation cost would be recognized.

**Case B: Original Award Does Not Contain Antidilution Provisions**

**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. Because the modification to add antidilution provisions on July 26 is done in contemplation of an equity restructuring, there must be a comparison of the fair value of the award pre- and postmodification on July 26. The premodification fair value is based on the award without antidilution provisions taking into account the effect of the contemplated restructuring on its value. The postmodification fair value is based on an award with antidilution provisions, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation cost. Once the equity restructuring occurs, there is a second modification event 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 any incremental value is transferred as a result of the modification. Changes to the terms of an award in accordance with its antidilution provisions generally would not result in additional compensation cost if the antidilution provisions were properly structured. 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

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.

Example 14: Modifications of Awards with Performance and Service Vesting Conditions

55-107 Paragraphs 718-10-55-60 through 55-63 note that awards may vest based on service conditions, performance conditions, or a combination of the two. Modifications of market conditions that affect exercisability or the ability to retain the award are not addressed by this Example. A modification of vesting conditions is accounted for based on the principles in paragraph 718-20-35-3; that is, total recognized compensation cost for an equity award that is modified shall at least equal the fair value of the award at the grant date unless, at the date of the modification, the performance or service conditions of the original award are not expected to be satisfied. If awards are expected to vest under the original vesting conditions at the date of the modification, an entity shall recognize compensation cost if either of the following criteria is met:

a. The awards ultimately vest under the modified vesting conditions
b. The awards ultimately would have vested under the original vesting conditions.

55-108 In contrast, if at the date of modification awards are not expected to vest under the original vesting conditions, an entity shall recognize compensation cost only if the awards vest under the modified vesting conditions. Said differently, if the entity believes that the original performance or service vesting condition is not probable of achievement at the date of the modification, the cumulative compensation cost related to the modified award, assuming vesting occurs under the modified performance or service vesting condition, is the modified award’s fair value at the date of the modification. The following Cases illustrate the application of those requirements:

a. Type I probable to probable modification (Case A)
b. Type II probable to improbable modification (Case B)
c. Type III improbable to probable modification (Case C)
d. Type IV improbable to improbable modification (Case D).

55-109 Cases A through D are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (see paragraph 718-20-55-9). For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Example 15 (see paragraph 718-20-55-120) provides an additional illustration of a Type III modification.

55-110 Cases A through D assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

Case A: Type I Probable to Probable Modification

55-111 Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that it is probable that the sales target will be achieved. On January 1, 20X7, 102,000 units of Product A have been sold. During December 20X6, one of Entity T’s competitors declared bankruptcy after a fire destroyed a factory and warehouse containing the competitor’s inventory. To push the salespeople to take advantage of that situation, the award is modified on January 1, 20X7, to raise the sales target to 154,000 units of Product A (the modified sales target). Notwithstanding the nature of the modification’s probability of occurrence, the objective of this Case is to demonstrate the accounting for a Type I modification. Additionally, as of January 1, 20X7, the options are out-of-the-money because of a general stock market decline. No other terms or conditions of the original award are modified, and management of Entity T continues to believe that it is probable that the modified sales target will be achieved. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed to be $8 in this Case at the date of the modification). Moreover, because the modification does not affect the number of share options expected to vest, no incremental compensation cost is associated with the modification.
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**ASC 718-20 (continued)**

55-112 This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 154,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $146,900.

b. Outcome 2—achievement of the original sales target. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of Product A but less than 154,000 units (the modified sales target is not achieved). In that outcome, Entity T would recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award.

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T would recognize cumulative compensation cost of $0.

**Case B: Type II Probable to Improbable Modification**

55-113 It is generally believed that Type II modifications will be rare; therefore, this illustration has been provided for the sake of completeness. Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date, it is probable that the sales target (150,000 units of product A) will be achieved. At January 1, 20X7, 102,000 units of product A have been sold and the options are out-of-the-money because of a general stock market decline. Entity T's management implements a cash bonus program based on achieving an annual sales target for 20X7. The options are neither cancelled nor settled as a result of the cash bonus program. The cash bonus program would be accounted for using the same accounting as for other cash bonus arrangements. Concurrently, the sales target for the option awards is revised to 170,000 units of Product A. No other terms or conditions of the original award are modified. Management believes that the modified sales target is not probable of achievement; however, they continue to believe that the original sales target is probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Moreover, because the modification does not affect the number of share options expected to vest under the original vesting provisions, Entity T would determine incremental compensation cost in the following manner.

| Fair value of modified share option | $ 8 |
| Share options expected to vest under original sales target | 10,000 |
| Fair value of modified award | $ 80,000 |
| Fair value of original share option | $ 8 |
| Share options expected to vest under original sales target | 10,000 |
| Fair value of original award | $ 80,000 |

55-114 In determining the fair value of the modified award for this type of modification, an entity shall use the greater of the options expected to vest under the modified vesting condition or the options that previously had been expected to vest under the original vesting condition.

55-115 This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 170,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $146,900.

b. Outcome 2—achievement of the original sales target. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of Product A but less than 170,000 units (the modified sales target is not achieved). In that outcome, Entity T would recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award.

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T would recognize cumulative compensation cost of $0.
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ASC 718-20 (continued)

Case C: Type III Improbable to Probable Modification

55-116 Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that none of the options will vest because it is not probable that the sales target will be achieved. On January 1, 20X7, 80,000 units of Product A have been sold. To further motivate the salespeople, the sales target (150,000 units of Product A) is lowered to 120,000 units of Product A (the modified sales target). No other terms or conditions of the original award are modified. Management believes that the modified sales target is probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Since the modification affects the number of share options expected to vest under the original vesting provisions, Entity T will determine incremental compensation cost in the following manner.

| Fair value of modified share option | $8 |
| Share options expected to vest under modified sales target | 10,000 |
| Fair value of modified award | $80,000 |
| Fair value of original share option | $8 |
| Share options expected to vest under original sales target | — |
| Fair value of original award | — |
| Incremental compensation cost of modification | $80,000 |

55-117 This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 120,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $80,000.

b. Outcome 2—achievement of the original sales target and the modified sales target. In Outcome 2, Entity T would recognize cumulative compensation cost of $80,000 because in a Type III modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance).

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T would recognize cumulative compensation cost of $0.

Case D: Type IV Improbable to Improbable Modification

55-118 Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date it is not probable that the sales target will be achieved. On January 1, 20X7, 80,000 units of Product A have been sold. To further motivate the salespeople, the sales target is lowered to 130,000 units of Product A (the modified sales target). No other terms or conditions of the original award are modified. Entity T lost a major customer for Product A in December 20X6; hence, management continues to believe that the modified sales target is not probable of achievement. Immediately before the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this Case to be $8 at the modification date). Furthermore, the modification does not affect the number of share options expected to vest; hence, there is no incremental compensation cost associated with the modification.

55-119 This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes:

a. Outcome 1—achievement of the modified sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 130,000 units of Product A. In that outcome, Entity T would recognize cumulative compensation cost of $80,000 (10,000 × $8).

b. Outcome 2—achievement of the original sales target and the modified sales target. In Outcome 2, Entity T would recognize cumulative compensation cost of $80,000 because in a Type IV modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance).

c. Outcome 3—failure to achieve either sales target. In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T would recognize cumulative compensation cost of $0.
<table>
<thead>
<tr>
<th>paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-120</td>
<td>This Example illustrates the guidance in paragraph 718-20-35-3.</td>
</tr>
<tr>
<td>55-121</td>
<td>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; therefore, any compensation cost recognized 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.</td>
</tr>
<tr>
<td>55-122</td>
<td>A modification may affect the classification of an award (for example, change the award from an equity instrument to a liability instrument). If an entity modifies an award in that manner, the Compensation—Stock Compensation Topic requires that the entity account for that modification in accordance with paragraph 718-20-35-3. The following Cases illustrate modifications that change the classification of the award:</td>
</tr>
<tr>
<td>55-123</td>
<td>Entity T grants the same share options described in Example 1, Case A (see paragraph 718-20-55-10). For simplicity, this Case assumes that estimated forfeitures equal actual forfeitures. Thus, as shown in the table in paragraph 718-20-55-130, the fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69), and the compensation cost to be recognized during each year of the 3-year vesting period is $4,022,151 ($12,066,454 ÷ 3). The journal entries for 20X5 are the same as those in paragraph 718-20-55-12.</td>
</tr>
<tr>
<td>55-124</td>
<td>On January 1, 20X6, Entity T modifies the share options granted to allow the employee the choice of share settlement or net cash settlement; the options no longer qualify as equity because the holder can require Entity T to settle the options by delivering cash. Because the modification affects no other terms or conditions of the options, the fair value (assumed to be $7 per share option) of the modified award equals the fair value of the original award immediately before its terms are modified on the date of modification; the modification also does not change the number of share options for which the requisite service is expected to be rendered. On the modification date, Entity T recognizes a liability equal to the portion of the award attributed to past service multiplied by the modified award’s fair value. To the extent that the liability equals or is less than the amount recognized in equity for the original award, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount recognized in equity for the original award, the excess is recognized as compensation cost. In this Case, at the modification date, one-third of the award is attributed to past service (one year of service rendered/three-year requisite service period). The modified award’s fair value is $5,749,842 (821,406 × $7), and the liability to be recognized at the modification date is $1,916,614 (5,749,842 ÷ 3). The related journal entry follows.</td>
</tr>
<tr>
<td>55-125</td>
<td>No entry would be made to the deferred tax accounts at the modification date. The amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151 – $1,916,614).</td>
</tr>
<tr>
<td>55-126</td>
<td>Paragraph 718-20-35-3(b) specifies that total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the service or performance conditions of the original award are not expected to be satisfied. In accordance with that principle, Entity T would ultimately recognize cumulative compensation cost equal to the greater of the following:</td>
</tr>
<tr>
<td>55-127</td>
<td>a. The grant-date fair value of the original equity award</td>
</tr>
<tr>
<td>55-128</td>
<td>b. The fair value of the modified liability award when it is settled.</td>
</tr>
</tbody>
</table>
To the extent that the recognized fair value of the modified liability award is less than the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in that liability award's fair value through its settlement do not affect the amount of compensation cost recognized. To the extent that the fair value of the modified liability award exceeds the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in the liability award's fair value are recognized as compensation cost.

At December 31, 20X6, the fair value of the modified award is assumed to be $25 per share option; hence, the modified award's fair value is $20,535,150 (821,406 × $25), and the corresponding liability at that date is $13,690,100 ($20,535,150 × 2/3) because two-thirds of the requisite service period has been rendered. The increase in the fair value of the liability award is $11,773,486 ($13,690,100 – $1,916,614). Before any adjustments for 20X6, the amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151 × 2/3). The cumulative compensation cost at December 31, 20X6, associated with the grant-date fair value of the original equity award is $8,044,302 ($4,022,151 × 2). Entity T would record the following journal entries for 20X6.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$ 9,667,949</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>2,105,537</td>
</tr>
<tr>
<td>Share-based compensation liability</td>
<td>$ 11,773,486</td>
</tr>
</tbody>
</table>

To increase the share-based compensation liability to $13,690,100 and recognize compensation cost of $9,667,949 ($13,690,100 – $1,916,614).

Deferred tax asset $ 3,383,782
Deferred tax benefit $ 3,383,782
To recognize the deferred tax asset for additional compensation cost ($9,667,949 × .35 = $3,383,782).

At December 31, 20X7, the fair value is assumed to be $10 per share option; hence, the modified award's fair value is $8,214,060 (821,406 × $10), and the corresponding liability for the fully vested award at that date is $8,214,060. The decrease in the fair value of the liability award is $5,476,040 ($8,214,060 – $13,690,100). The cumulative compensation cost as of December 31, 20X7, associated with the grant-date fair value of the original equity award is $12,066,454 (see paragraph 718-20-55-123). Entity T would record the following journal entries for 20X7.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based compensation liability</td>
<td>$ 5,476,040</td>
</tr>
<tr>
<td>Compensation cost</td>
<td>$ 1,623,646</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>3,852,394</td>
</tr>
</tbody>
</table>

To recognize a share-based compensation liability of $8,214,060, a reduction of compensation cost of $1,623,646 ($13,690,100 – $12,066,454), and additional paid-in capital of $3,852,394 ($12,066,454 – $8,214,060).

Deferred tax expense $ 568,276
Deferred tax asset $ 568,276
To reduce the deferred tax asset for the reduction in compensation cost ($1,623,646 × .35 = $568,276).

The modified liability award is as follows.

### Modified Liability Award — Cliff Vesting

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>$12,066,454 (821,406 × $14.69)</td>
<td>$4,022,151 ($12,066,454 ÷ 3)</td>
<td>$ 4,022,151</td>
</tr>
<tr>
<td>20X6</td>
<td>$20,535,150 (821,406 × $25.00)</td>
<td>$9,667,949 ([$20,535,150 ÷ 2/3] – $4,022,151)</td>
<td>$ 13,690,100</td>
</tr>
<tr>
<td>20X7</td>
<td>$12,066,454 (821,406 × $14.69)</td>
<td>$(1,623,646 ($12,066,454 – $13,690,100)</td>
<td>$ 12,066,454</td>
</tr>
</tbody>
</table>

For simplicity, this Case assumes that all share option holders elected to be paid in cash on the same day, that the liability award's fair value is $10 per option, and that Entity T has already recognized its income tax expense for the year without regard to the effects of the settlement of the award. In other words, current tax expense and current taxes payable were recognized based on income and deductions before consideration of additional deductions from settlement of the award.
**ASC 718-20 (continued)**

55-132 The $8,214,060 in cash paid to the employees on the date of settlement is deductible for tax purposes. In the period of settlement, tax return deductions that are less than compensation cost recognized result in a charge to income tax expense except to the extent that there is any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards available to offset that deficiency. The entity has sufficient taxable income, and the tax benefit realized is $2,874,921 ($8,214,060 × .35). As tax return deductions are less than compensation cost recognized, the entity must write off the deferred tax assets recognized in excess of the tax benefit ultimately realized from the exercise of employee stock options. Entity T has sufficient paid-in capital available from excess tax benefits from previous share-based payment awards to offset the entire tax deficiency. (See Subtopic 718-740 for guidance on the treatment of income taxes on employee stock compensation.) Therefore, the result is a debit to additional paid-in capital. The journal entries to reflect settlement of the share options are as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based compensation liability</td>
<td>$8,214,060</td>
</tr>
<tr>
<td>Cash ($10 × 821,406)</td>
<td>$8,214,060</td>
</tr>
<tr>
<td>To recognize the cash paid to settle share options.</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>$4,223,259</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$4,223,259</td>
</tr>
<tr>
<td>To write off deferred tax asset related to compensation cost ($12,066,454 × .35 = $4,223,259).</td>
<td></td>
</tr>
<tr>
<td>Current taxes payable</td>
<td>$2,874,921</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$1,348,338</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>$4,223,259</td>
</tr>
<tr>
<td>To adjust current tax expense and current taxes payable for the tax benefit from deductible compensation cost upon settlement of share options.</td>
<td></td>
</tr>
</tbody>
</table>

55-133 If instead of requesting cash, employees had held their share options and those options had expired worthless, the share-based compensation liability account would have been eliminated over time with a corresponding increase to additional paid-in capital. Previously recognized compensation cost would not be reversed. Similar to the adjustment for the actual tax deduction realized described in the preceding paragraph, all of the deferred tax asset of $4,223,259 would be charged to income tax expense except to the extent that there was any remaining paid-in capital available from excess tax benefits from previous share-based payment awards available to offset that deficiency when the share options expired.

**Case B: Equity to Equity Modification (Share Options to Shares)**

55-134 Equity to equity modifications also are addressed in Examples 12 (see paragraph 718-20-55-93) and 14 (see paragraph 718-20-55-107). This Case is based on Example 1, Case A (see paragraph 718-20-55-10), in which Entity T granted its employees 900,000 options with an exercise price of $30 on January 1, 20X5. At January 1, 20X9, after 747,526 share options have vested, the market price of Entity T stock has declined to $8 per share, and Entity T offers to exchange 4 options with an assumed per-share-option fair value of $2 at the date of exchange for 1 share of nonvested stock, with a market price of $8 per share. The nonvested stock will cliff vest after two years of service. All option holders elect to participate, and at the date of exchange, Entity T grants 186,881 (747,526 ÷ 4) nonvested shares of stock. Because the fair value of the nonvested stock is equal to the fair value of the options, there is no incremental compensation cost. Entity T will not make any additional accounting entries for the shares regardless of whether they vest, other than possibly reclassifying amounts in equity; however, Entity T will need to account for the ultimate income tax effects related to the share-based compensation arrangement.

**Case C: Liability to Equity Modification (Cash-Settled to Share-Settled Stock Appreciation Rights)**

55-135 This Case is based on the facts given in Example 1 (see paragraph 718-30-55-1). Entity T grants cash-settled stock appreciation rights to its employees. The fair value of the award on January 1, 20X5, is $12,066,454 (821,406 × $14.69) (see paragraph 718-30-55-2).
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ASC 718-20 (continued)

55-136 On December 31, 20X5, the assumed fair value is $10 per stock appreciation right; hence, the fair value of the award at that date is $8,214,060 (821,406 × $10). The share-based compensation liability at December 31, 20X5, is $2,738,020 ($8,214,060 ÷ 3), which reflects the portion of the award related to the requisite service provided in 20X5 (1 year of the 3-year requisite service period). For convenience, this Case assumes that journal entries to account for the award are performed at year-end. The journal entries for 20X5 are as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>Share-based compensation liability</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>To recognize compensation cost</td>
<td></td>
</tr>
</tbody>
</table>

Deferred tax asset $ 958,307
Deferred tax benefit $ 958,307
To recognize the deferred tax asset for the temporary difference related to compensation cost ($2,738,020 × .35 = $958,307).

55-137 On January 1, 20X6, Entity T modifies the stock appreciation rights by replacing the cash-settlement feature with a net share settlement feature, which converts the award from a liability award to an equity award because Entity T no longer has an obligation to transfer cash to settle the arrangement. Entity T would compare the fair value of the instrument immediately before the modification to the fair value of the modified award and recognize any incremental compensation cost. Because the modification affects no other terms or conditions, the fair value, assumed to be $10 per stock appreciation right, is unchanged by the modification and, therefore, no incremental compensation cost is recognized. The modified award’s total fair value is $8,214,060. The modified award would be accounted for as an equity award from the date of modification with a fair value of $10 per share. Therefore, at the modification date, the entity would reclassify the liability of $2,738,020 recognized on December 31, 20X5, as additional paid-in capital. The related journal entry is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based compensation liability</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>To reclassify the award as equity</td>
<td></td>
</tr>
</tbody>
</table>

55-138 Entity T will account for the modified awards as equity going forward following the pattern given in Example 1, Case A (see paragraph 718-20-55-1), recognizing $2,738,020 of compensation cost in each of 20X6 and 20X7, for a cumulative total of $8,214,060.

Case D: Liability to Liability Modification (Cash-Settled to Cash-Settled Stock Appreciation Rights)

55-139 This Case is based on the facts given in Example 1 (see paragraph 718-30-55-1). 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).

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 entries to recognize compensation cost for 20X5 are as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$ 1,369,010</td>
</tr>
<tr>
<td>Share-based compensation liability</td>
<td>$ 1,369,010</td>
</tr>
<tr>
<td>To recognize compensation cost</td>
<td></td>
</tr>
</tbody>
</table>

Deferred tax asset $ 479,154
Deferred tax benefit $ 479,154
To recognize the deferred tax asset for the temporary difference related to compensation cost ($1,369,010 × .35 = $479,154).
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 per the method in Example 12 (see paragraph 718-20-55-93).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of modified stock appreciation right award (821,406 × $12)</td>
<td>$9,856,872</td>
</tr>
<tr>
<td>Less: Fair value of original stock appreciation right (821,406 × $5)</td>
<td>$4,107,030</td>
</tr>
<tr>
<td>Incremental value of modified stock appreciation right</td>
<td>$5,749,842</td>
</tr>
<tr>
<td>Divide by three to reflect earned portion of the award</td>
<td>$1,916,614</td>
</tr>
</tbody>
</table>

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 entries at the date of the modification.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$1,916,614</td>
</tr>
<tr>
<td>Share-based compensation liability</td>
<td>$1,916,614</td>
</tr>
</tbody>
</table>

To recognize incremental compensation cost.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>$670,815</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>$670,815</td>
</tr>
</tbody>
</table>

To recognize the deferred tax asset for the temporary difference related to additional compensation cost ($1,916,614 × .35 = $670,815).

55-143 Entity T would continue to remeasure the liability award at each reporting date until the award’s settlement.

Case E: Equity to Liability Modification (Share Options to Fixed Cash Payment)

55-144 Entity T grants the same share options described in Example 1, Case A (see paragraph 718-20-55-10) and records similar journal entries for 20X5 (see paragraphs 718-20-55-12 through 55-16). By January 1, 20X6, Entity T’s share price has fallen, and the fair value per share option is assumed to be $2 at that date. Entity T provides its employees with an election to convert each share option into an award of a fixed amount of cash equal to the fair value of each share option on the election date ($2) accrued over the remaining requisite service period, payable upon vesting. The election does not affect vesting; that is, employees must satisfy the original service condition to vest in the award for a fixed amount of cash. This transaction is considered a modification because Entity T continues to have an obligation to its employees that is conditional upon the receipt of future employee services. There is no incremental compensation cost because the fair value of the modified award is the same as that of the original award. At the date of the modification, a liability of $547,604 (821,406 × $2) × (1 year of requisite service rendered ÷ 3-year requisite service period)], which is equal to the portion of the award attributed to past service multiplied by the modified award’s fair value, is recognized by reclassifying that amount from additional paid-in capital. The total liability of $1,642,812 (821,406 × $2) should be fully accrued by the end of the requisite service period. Because the possible tax deduction of the modified award is capped at $1,642,812, Entity T also must adjust its deferred tax asset at the date of the modification to the amount that corresponds to the recognized liability of $547,604. That amount is $191,661 ($547,604 × .35), and the write-off of the deferred tax asset is $1,216,092 ($1,407,753 – $191,661). That write-off would be recognized in the income statement except to the extent that there is any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards available offset that deficiency. Compensation cost of $4,022,151 and a corresponding increase in additional paid-in capital would be recognized in each of 20X6 and 20X7 for a cumulative total of $12,066,454 (as calculated in Case A); however, that compensation cost has no associated income tax effect (additional deferred tax assets are recognized based only on subsequent increases in the amount of the liability).
### Awards Classified as Liabilities

<table>
<thead>
<tr>
<th>Illustrations — Example 1: Cash-Settled Stock Appreciation Right</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-1</strong>  This Example illustrates the guidance in paragraphs 718-30-35-2 through 35-4 and 718-740-25-2 through 25-4.</td>
</tr>
<tr>
<td><strong>55-2</strong>  Entity T, a public entity, grants share appreciation rights with the same terms and conditions as those described in Example 1 (see paragraph 718-20-55-4). Each stock appreciation right entitles the holder to receive an amount in cash equal to the increase in value of 1 share of Entity T stock over $30. Entity T determines the grant-date fair value of each stock appreciation right in the same manner as a share option and uses the same assumptions and option-pricing model used to estimate the fair value of the share options in that Example; consequently, the grant-date fair value of each stock appreciation right is $14.69 (see paragraphs 718-20-55-7 through 55-9). The awards cliff-vest at the end of three years of service (an explicit and requisite service period of three years). The number of stock appreciation rights for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 (900,000 x .973). Thus, the fair value of the award as of January 1, 20X5, is $12,066,454 (821,406 x $14.69). For simplicity, this Example assumes that estimated forfeitures equal actual forfeitures.</td>
</tr>
<tr>
<td><strong>55-3</strong>  Paragraph 718-30-35-4 permits a nonpublic entity to measure share-based payment liabilities at either fair value (or, in some cases, calculated value) or intrinsic value. If a nonpublic entity elects to measure those liabilities at fair value, the accounting demonstrated in this Example would be applicable. Paragraph 718-30-35-3 requires that share-based compensation liabilities be recognized at fair value or a portion thereof (depending on the percentage of requisite service rendered at the reporting date) and be 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 during each year thereafter through the date of settlement) will vary based on changes in the award’s fair value. As of December 31, 20X5, the assumed fair value is $10 per stock appreciation right; hence, the fair value of the award is $8,214,060 (821,406 x $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 (1 year of the 3-year requisite service period). For convenience, this Example assumes that journal entries to account for the award are performed at year-end. The journal entries for 20X5 are as follows.</td>
</tr>
<tr>
<td>Compensation cost $ 2,738,020</td>
</tr>
<tr>
<td>Share-based compensation liability $ 2,738,020</td>
</tr>
<tr>
<td>To recognize compensation cost.</td>
</tr>
<tr>
<td>Deferred tax asset $ 958,307</td>
</tr>
<tr>
<td>Deferred tax benefit $ 958,307</td>
</tr>
<tr>
<td>To recognize the deferred tax asset for the temporary difference related to compensation cost ($2,738,020 x .35 = $958,307).</td>
</tr>
<tr>
<td><strong>55-4</strong>  As of December 31, 20X6, the fair value is assumed to be $25 per stock appreciation right; hence, the award’s fair value is $20,535,150 (821,406 x $25), and the corresponding liability at that date is $13,690,100 ($20,535,150 x 2/3) because service has been provided for 2 years of the 3-year requisite service period. Compensation cost recognized for the award in 20X6 is $10,952,080 ($13,690,100 – $2,738,020). Entity T recognizes the following journal entries for 20X6.</td>
</tr>
<tr>
<td>Compensation cost $ 10,952,080</td>
</tr>
<tr>
<td>Share-based compensation liability $ 10,952,080</td>
</tr>
<tr>
<td>To recognize a share-based compensation liability of $13,690,100 and associated compensation cost.</td>
</tr>
<tr>
<td>Deferred tax asset $ 3,833,228</td>
</tr>
<tr>
<td>Deferred tax benefit $ 3,833,228</td>
</tr>
<tr>
<td>To recognize the deferred tax asset for additional compensation cost ($10,952,080 x .35 = $3,833,228).</td>
</tr>
</tbody>
</table>
ASC 718-30 (continued)

55-5 As of December 31, 20X7, the fair value is assumed to be $20 per stock appreciation right; hence, the award’s fair value is $16,428,120 (821,406 × $20), and the corresponding liability at that date is $16,428,120 ($16,428,120 × 1) 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). Entity T recognizes the following journal entries for 20X7.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation cost</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>Share-based compensation liability</td>
<td>$ 2,738,020</td>
</tr>
</tbody>
</table>

To recognize a share-based compensation liability of $16,428,120 and associated compensation cost.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset</td>
<td>$ 958,307</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>$ 958,307</td>
</tr>
</tbody>
</table>

To recognize the deferred tax asset for additional compensation cost ($2,738,020 × .35 = $958,307).

55-6 The share-based liability award is as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award at Year-End</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X5</td>
<td>$8,214,060 (821,406 × $10)</td>
<td>$2,738,020 ($8,214,060 ÷ 3)</td>
<td>$ 2,738,020</td>
</tr>
<tr>
<td>20X6</td>
<td>$20,535,150 (821,406 × $25)</td>
<td>$10,952,080 ([$20,535,150 × 2/3] – $2,738,020)</td>
<td>$ 13,690,100</td>
</tr>
<tr>
<td>20X7</td>
<td>$16,428,120 (821,406 × $20)</td>
<td>$2,738,020 ($16,428,120 – $13,690,100)</td>
<td>$ 16,428,120</td>
</tr>
</tbody>
</table>

55-7 For simplicity, this Example assumes that all of the stock appreciation rights are exercised on the same day, that the liability award’s fair value is $20 per stock appreciation right, and that Entity T has already recognized its income tax expense for the year without regard to the effects of the exercise of the employee stock appreciation rights. In other words, current tax expense and current taxes payable were recognized based on taxable income and deductions before consideration of additional deductions from exercise of the stock appreciation rights. The amount credited to cash for the exercise of the stock appreciation rights is equal to the share-based compensation liability of $16,428,120.

55-8 At exercise the journal entry is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based compensation liability</td>
<td>$ 16,428,120</td>
</tr>
<tr>
<td>Cash (821,406 × $20)</td>
<td>$ 16,428,120</td>
</tr>
</tbody>
</table>

To recognize the cash payment to employees from stock appreciation right exercise.

55-9 The cash paid to the employees on the date of exercise is deductible for tax purposes. Entity T has sufficient taxable income, and the tax benefit realized is $5,749,842 ($16,428,120 × .35).

55-10 At exercise the journal entry is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>$ 5,749,842</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$ 5,749,842</td>
</tr>
</tbody>
</table>

To write off the deferred tax asset related to the stock appreciation rights.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current taxes payable</td>
<td>$ 5,749,842</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>$ 5,749,842</td>
</tr>
</tbody>
</table>

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost.

55-11 If the stock appreciation rights had expired worthless, the share-based compensation liability account and deferred tax asset account would have been adjusted to zero through the income statement as the award’s fair value decreased.

Example 2: Award Granted by a Nonpublic Entity that Elects the Intrinsic Value Method

55-12 This Example illustrates the guidance in paragraphs 718-30-35-4 and 718-740-25-2 through 25-4.
ASC 718-30 (continued)

55-13 On January 1, 20X6, Entity W, a nonpublic entity that has chosen the accounting policy of using the intrinsic value method of accounting for share-based payments that are classified as liabilities in accordance with paragraphs 718-30-30-2 and 718-30-35-4, grants 100 cash-settled stock appreciation rights with a 5-year life to each of its 100 employees. Each stock appreciation right entitles the holder to receive an amount in cash equal to the increase in value of 1 share of Entity W's stock over $7. The awards cliff-vest at the end of three years of service (an explicit and requisite service period of three years). For simplicity, the Example assumes that no forfeitures occur during the vesting period and does not reflect the accounting for income tax consequences of the awards.

55-14 Because of Entity W's accounting policy decision to use intrinsic value, all of its share-based payments that are classified as liabilities are recognized at intrinsic value (or a portion thereof, depending on the percentage of requisite service that has been rendered) at each reporting date through the date of settlement; consequently, the compensation cost recognized in each year of the three-year requisite service period will vary based on changes in the liability award’s intrinsic value. As of December 31, 20X6, Entity W stock is valued at $10 per share; hence, the intrinsic value is $3 per stock appreciation right ($10 – $7), and the intrinsic value of the award is $30,000 (10,000 × $3). The compensation cost to be recognized for 20X6 is $10,000 ($30,000 ÷ 3), which corresponds to the service provided in 20X6 (1 year of the 3-year service period). For convenience, this Example assumes that journal entries to account for the award are performed at year-end. The journal entry for 20X6 is as follows.

\[
\begin{align*}
\text{Compensation cost} & \quad $10,000 \\
\text{Share-based compensation liability} & \quad $10,000
\end{align*}
\]

To recognize compensation cost.

55-15 As of December 31, 20X7, Entity W stock is valued at $8 per share; hence, the intrinsic value is $1 per stock appreciation right ($8 – $7), and the intrinsic value of the award is $10,000 (10,000 × $1). The decrease in the intrinsic value of the award is $20,000 ($10,000 – $30,000). Because services for 2 years of the 3-year service period have been rendered, Entity W must recognize cumulative compensation cost for two-thirds of the intrinsic value of the award, or $6,667 ($10,000 × 2/3); however, Entity W recognized compensation cost of $10,000 in 20X5. Thus, Entity W must recognize an entry in 20X7 to reduce cumulative compensation cost to $6,667.

\[
\begin{align*}
\text{Share-based compensation liability} & \quad $3,333 \\
\text{Compensation cost} & \quad $3,333
\end{align*}
\]

To adjust cumulative compensation cost ($6,667 – $10,000).

55-16 As of December 31, 20X8, Entity W stock is valued at $15 per share; hence, the intrinsic value is $8 per stock appreciation right ($15 – $7), and the intrinsic value of the award is $80,000 (10,000 × $8). The cumulative compensation cost recognized as of December 31, 20X8, is $80,000 because the award is fully vested. The journal entry for 20X8 is as follows.

\[
\begin{align*}
\text{Compensation cost} & \quad $73,333 \\
\text{Share-based compensation liability} & \quad $73,333
\end{align*}
\]

To recognize compensation cost ($80,000 – $6,667).

55-17 The share-based liability award at intrinsic value is as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award at Year-End</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X6</td>
<td>$30,000 (10,000 × $3)</td>
<td>$10,000 ($30,000 ÷ 3)</td>
<td>$10,000</td>
</tr>
<tr>
<td>20X7</td>
<td>$10,000 (10,000 × $1)</td>
<td>$(3,333) [(10,000 × 2/3) – $10,000]</td>
<td>$6,667</td>
</tr>
<tr>
<td>20X8</td>
<td>$80,000 (10,000 × $8)</td>
<td>$73,333 ($80,000 – $6,667)</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

55-18 For simplicity, this Example assumes that all of the stock appreciation rights are settled on the day that they vest, December 31, 20X8, when the share price is $15 and the intrinsic value is $8 per share. The cash paid to settle the stock appreciation rights is equal to the share-based compensation liability of $80,000.

55-19 At exercise the journal entry is as follows.

\[
\begin{align*}
\text{Share-based compensation liability} & \quad $80,000 \\
\text{Cash (10,000 × $8)} & \quad $80,000
\end{align*}
\]

To recognize the cash payment to employees for settlement of stock appreciation rights.

55-20 If the stock appreciation rights had not been settled, Entity W would continue to remeasure those remaining awards at intrinsic value at each reporting date through the date they are exercised or otherwise settled.
Employee Share Purchase Plans

ASC 718-50

Implementation Guidance — General

55-1  This Section may contain summaries or references to specific tax code or other regulations that existed at the time that the standard was issued. The Financial Accounting Standards Board (FASB) does not monitor such code or regulations and assumes no responsibility for the current accuracy of the summaries or references. Users must evaluate such code or regulations to determine consistency of the current code or regulation with that presented.

Variations on Basic Look-Back Plans

55-2  The following are some of the more common types of employee share purchase plans with a look-back option that currently exist and the features that differentiate each type:

- **a. Type A plan**—Maximum number of shares. This type of plan permits an employee to have withheld a fixed amount of dollars from the employee’s salary (or a stated percentage of the employee’s salary) over a one-year period to purchase stock. At the end of the one-year period, the employee may purchase stock at 85 percent of the lower of the grant date stock price or the exercise date stock price. If the exercise date stock price is lower than the grant date stock price, the employee may not purchase additional shares (that is, the maximum number of shares that may be purchased by an employee is established at the grant date based on the stock price at that date and the employee’s elected withholdings); any excess cash is refunded to the employee. This is the basic type of employee share purchase plan shown in Example 1, Case A (see paragraph 718-50-55-10).

- **b. Type B plan**—Variable number of shares. This type of plan is the same as the Type A plan except that the employee may purchase as many shares as the full amount of the employee’s withholdings will permit, regardless of whether the exercise date stock price is lower than the grant date stock price (see Example 1, Case B [paragraph 718-50-55-22]).

- **c. Type C plan**—Multiple purchase periods. This type of plan permits an employee to have withheld a fixed amount of dollars from the employee’s salary (or a stated percentage of the employee’s salary) over a two-year period to purchase stock. At the end of each six-month period, the employee may purchase stock at 85 percent of the lower of the grant date stock price or the exercise date stock price based on the amount of dollars withheld during that period (see Example 1, Case C [paragraph 718-50-55-26]).

- **d. Type D plan**—Multiple purchase periods with a reset mechanism. This type of plan is the same as the Type C plan except that the plan contains a reset feature if the market price of the stock at the end of any six-month purchase period is lower than the stock price at the original grant date. In that case, the plan resets so that during the next purchase period an employee may purchase stock at 85 percent of the lower of the stock price at either the beginning of the purchase period (rather than the original grant date price) or the exercise date (see Example 1, Case D [paragraph 718-50-55-28]).

- **e. Type E plan**—Multiple purchase periods with a rollover mechanism. This type of plan is the same as the Type C plan except that the plan contains a rollover feature if the market price of the stock at the end of any six-month purchase period is lower than the stock price at the original grant date. In that case, the plan is immediately cancelled after that purchase date, and a new two-year plan is established using the then-current stock price as the base purchase price (see Example 1, Case D [paragraph 718-50-55-28]).

- **f. Type F plan**—Multiple purchase periods with semifixed withholdings. This type of plan is the same as the Type C plan except that the amount (or percentage) that the employee may elect to have withheld is not fixed and may be changed (increased or decreased) at the employee’s election immediately after each six-month purchase date for purposes of all future withholdings under the plan (see Example 1, Case D [paragraph 718-50-55-28]).

- **g. Type G plan**—Single purchase period with variable withholdings. This type of plan permits an employee to have withheld an amount of dollars from the employee’s salary (or a stated percentage of the employee’s salary) over a one-year period to purchase stock. That amount (or percentage) is not fixed and may be changed (increased or decreased) at the employee’s election at any time during the term of the plan for purposes of all future withholdings under the plan. At the end of the one-year period, the employee may purchase stock at 85 percent of the lower of the grant date stock price or the exercise date stock price (see Example 1, Case D [paragraph 718-50-55-28]).

- **h. Type H plan**—Multiple purchase periods with variable withholdings. This type of plan combines the characteristics of the Type C and Type G plans in that there are multiple purchase periods over the term of the plan and an employee is permitted to change (increase or decrease) withholding amounts (or percentages) at any time during the term of the plan for purposes of all future withholdings under the plan (see Example 1, Case D [paragraph 718-50-55-28]).

- **i. Type I plan**—Single purchase period with variable withholdings and cash infusions. This type of plan is the same as the Type G plan except that an employee is permitted to remit catch-up amounts to the entity when (and if) the employee increases withholding amounts (or percentages). The objective of the cash infusion feature is to permit an employee to increase withholding amounts (or percentages) during the term of the plan and remit an amount to the entity such that, on the exercise date, it appears that the employee had participated at the new higher amount (or percentage) during the entire term of the plan (see Example 1, Case E [paragraph 718-50-55-32]).
The distinguishing characteristic between the Type A plan and the Type B plan is whether the maximum number of shares that an employee is permitted to purchase is fixed at the grant date based on the stock price at that date and the expected withholdings. Each of the remaining plans described above (Type C through Type I plans) incorporates the features of either a Type A plan or a Type B plan. The above descriptions are intended to be representative of the types of features commonly found in many existing plans. The accounting guidance in this Subtopic shall be applied to all plans with characteristics similar to those described above.

The measurement approach described in Example 1, Case A (see paragraph 718-50-55-10) was developed to illustrate how the fair value of an award under a basic type of employee share purchase plan with a look-back option could be determined at the grant date by focusing on the substance of the arrangement and valuing separately each feature of the award. Although that general technique of valuing an award as the sum of the values of its separate components applies to all types of employee share purchase plans with a look-back option, the fundamental components of an award may differ from plan to plan thus affecting the individual calculations. For example, the measurement approach described in that Case assumes that the maximum number of shares that an employee may purchase is fixed at the grant date based on the grant date stock price and the employee’s elected withholdings (that is, the Type A plan described in paragraph 718-50-55-2). That approach needs to be modified to appropriately determine the fair value of awards under the other types of plans described in that paragraph, including a Type B plan, that do not fix the number of shares that an employee is permitted to purchase.

Although many employee share purchase plans with a look-back option initially limit the maximum number of shares of stock that the employee is permitted to purchase under the plan (Type A plans), other employee share purchase plans (Type B plans) do not fix the number of shares that the employee is permitted to purchase if the exercise date stock price is lower than the grant date stock price. In effect, an employee share purchase plan that does not fix the number of shares that may be purchased has guaranteed that the employee can always receive the value associated with at least 15 percent of the stock price at the grant date (the employee can receive much more than 15 percent of the grant date value of the stock if the stock appreciates during the look-back period). That provision provides the employee with the equivalent of a put option on 15 percent of the shares with an exercise price equal to the stock price at the grant date. In contrast, an employee who participates in a Type A plan is only guaranteed 15 percent of the lower of the stock price as of the grant date or the exercise date, which is the equivalent of a call option on 85 percent of the shares (as described more fully in paragraph 718-50-55-16). A participant in a Type B plan receives the equivalent of both a put option and a call option.

Illustrations — Example 1: Look-Back Plans

The following Cases illustrate the guidance in paragraphs 718-50-30-1 through 30-2.

The following Cases illustrate the fundamental differences between different types of look back plans:

a. Basic look-back plans (Case A)

b. Look-back plan variable versus maximum number of shares (Case B)

c. Look-back plan with multiple purchase periods (Case C)

d. Look-back plans with reset or rollover mechanisms (Case D)

e. Look-back plans with retroactive cash infusion election (Case E).

The assumptions used for the numerical calculations in Cases B–E are not intended to be the same as those in Case A. Rather, they are independent and designed to illustrate how the component measurement approach in Case A would be modified to reflect various features of employee stock purchase plans.

This Example does not take into consideration the effect of interest forgone by the employee on the fair value of an award for which the exercise price is paid over time (for instance, through payroll withholdings). Awards for which part or all of the exercise price is paid before the exercise date are less valuable than awards for which the exercise price is paid at the exercise date, and it is appropriate to recognize that difference in applying the guidance in this Subtopic. However, for simplicity, the effect of forgone interest is not reflected in the fair value calculations in this Example.

Case A: Basic Look-Back Plans

Some entities offer share options to employees under Section 423 of the U.S. Internal Revenue Code, which provides that employees will not be immediately taxed on the difference between the market price of the stock and a discounted purchase price if several requirements are met. One requirement is that the exercise price may not be less than the smaller of either:

a. 85 percent of the stock’s market price when the share option is granted

b. 85 percent of the price at exercise.
A Roadmap to Accounting for Share-Based Payment Awards

Chapter 11 — Implementation Guidance

ASC 718-50 (continued)

55-11 A share option that provides the employee the choice of either option above may not have a term in excess of 27 months. Share options that provide for the more favorable of two (or more) exercise prices are referred to as look-back share options. A look-back share option with a 15 percent discount from the market price at either grant or exercise is worth more than a fixed share option to purchase stock at 85 percent of the current market price because the holder of the look-back share option is assured a benefit. If the share price rises, the holder benefits to the same extent as if the exercise price was fixed at the grant date. If the share price falls, the holder still receives the benefit of purchasing the stock at a 15 percent discount from its price at the date of exercise. An employee share purchase plan offering share options with a look-back feature would be compensatory because the look-back feature is an option feature (see paragraph 718-50-25-1).

55-12 For example, on January 1, 20X5, when its share price is $30, Entity A offers its employees the opportunity to sign up for a payroll deduction to purchase its stock at either 85 percent of the share’s current price or 85 percent of the price at the end of the year when the share options expire, whichever is lower. The exercise price of the share options is the lesser of $25.50 ($30 × 0.85) or 85 percent of the share price at the end of the year when the share options expire.

55-13 The look-back share option can be valued as a combination position. (This Note presents one of several existing valuation techniques for estimating the fair value of a look-back option. In accordance with this Topic, an entity shall use a valuation technique that reflects the substantive characteristics of the instrument being granted in the estimate of fair value.) In this situation, the components are as follows:
   a. 0.15 of a share of nonvested stock
   b. 0.85 of a 1-year share option held with an exercise price of $30.

55-14 Supporting analysis for the two components is discussed below.

55-15 Beginning with the first component, a share option with an exercise price that equals 85 percent of the value of the stock at the exercise date will always be worth 15 percent (100% – 85%) of the share price upon exercise. For a stock that pays no dividends, that share option is the equivalent of 15 percent of a share of the stock. The holder of the look-back share option will receive at least the equivalent of 0.15 of a share of stock upon exercise, regardless of the share price at that date. For example, if the share price falls to $20, the exercise price of the share option will be $17 ($20 × 0.85), and the holder will benefit by $3 ($20 – $17), which is the same as receiving 0.15 of a share of stock for each share option.

55-16 If the share price upon exercise is more than $30, the holder of the look-back share option receives a benefit that is worth more than 15 percent of a share of stock. At prices of $30 or more, the holder receives a benefit for the difference between the share price upon exercise and $25.50 – the exercise price of the share option ($30 × 0.85). If the share price is $40, the holder benefits by $14.50 ($40 – $25.50). However, the holder cannot receive both the $14.50 value of a share option with an exercise price of $25.50 and 0.15 of a share of stock. In effect, the holder gives up 0.15 of a share of stock worth $4.50 ($30 × 0.15) if the share price is above $30 at exercise. The result is the same as if the exercise price of the share option was $30 ($25.50 + $4.50) and the holder of the look-back share option held 85 percent of a 1-year share option with an exercise price of $30 in addition to 0.15 of a share of stock that will be received if the share price is $30 or less upon exercise.

55-17 An option-pricing model can be used to value the 1-year share option on 0.85 of a share of stock represented by the second component. Thus, assuming that the fair value of a share option on one share of Entity A’s stock on the grant date is $4, the compensation cost for the look-back option at the grant date is as follows.

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.15 of a share of nonvested stock ($30 × 0.15)</td>
<td>$4.50</td>
</tr>
<tr>
<td>Share option on 0.85 of a share of stock, exercise price of $30 ($4 × 0.85)</td>
<td>3.40</td>
</tr>
<tr>
<td>Total grant date value</td>
<td>$7.90</td>
</tr>
</tbody>
</table>

55-18 For a look-back option on a dividend-paying share, both the value of the nonvested stock component and the value of the share option component would be adjusted to reflect the effect of the dividends that the employee does not receive during the life of the share option. The present value of the dividends expected to be paid on the stock during the life of the share option (one year in this Case) would be deducted from the value of a share that receives dividends. One way to accomplish that is to base the value calculation on shares of stock rather than dollars by assuming that the dividends are reinvested in the stock.

55-19 For example, if Entity A pays a quarterly dividend of 0.625 percent (2.5% ÷ 4) of the current share price, 1 share of stock would grow to 1.0252 (the future value of 1 using a return of 0.625 percent for 4 periods) shares at the end of the year if all dividends are reinvested. Therefore, the present value of 1 share of stock to be received in 1 year is only 0.9754 of a share today (again applying conventional compound interest formulas compounded quarterly) if the holder does not receive the dividends paid during the year.
ASC 718-50 (continued)

55-20  The value of the share option component is easier to compute; the appropriate dividend assumption is used in an option-pricing model in estimating the value of a share option on a whole share of stock. Thus, assuming the fair value of the share option is $3.60, the compensation cost for the look-back share option if Entity A pays quarterly dividends at the annual rate of 2.5 percent is as follows.

\[
\begin{align*}
0.15 \text{ of a share of nonvested stock} \times 0.9754 & \times 30 = 4.39 \\
\text{Share option on 0.85 of a share of stock, $30 exercise price, 2.5
dividend yield ($3.60 \times 0.85)} & = 3.06 \\
\text{Total grant date value} & = 7.45
\end{align*}
\]

55-21  The first component, which is worth $4.39 at the grant date, is the minimum amount of benefits to the holder regardless of the price of the stock at the exercise date. The second component, worth $3.06 at the grant date, represents the additional benefit to the holder if the share price is above $30 at the exercise date.

Case B: Look-Back Plan Variable versus Maximum Number of Shares

55-22  On January 1, 20X0, when its stock price is $50, Entity A offers its employees the opportunity to sign up for a payroll deduction to purchase its stock at the lower of either 85 percent of the stock’s current price or 85 percent of the stock price at the end of the year when the options expire. Thus, the exercise price of the options is the lesser of $42.50 ($50 × 0.85 percent) or 85 percent of the stock price at the end of the year when the option is exercised. Two employees each agree to have $4,250 withheld from their salaries; however, Employee A is not allowed to purchase any more shares than the $4,250 would buy on the grant date (that is, 100 shares [$4,250/$42.50]) and Employee B is permitted to buy as many shares as the $4,250 will permit under the terms of the plan. In both cases, the 15 percent purchase price discount at the grant date is worth $750 (100 shares × $50 × 15 percent). Depending on the stock price at the end of the year, the value of the 15 percent discount for each employee is as follows.

<table>
<thead>
<tr>
<th>Scenario 1: (a)</th>
<th>Stock Price at the End of the Year</th>
<th>Number of Shares Purchased</th>
<th>Value of the 15 Percent Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee A (Type A plan)</td>
<td>$60</td>
<td>100</td>
<td>$1,750</td>
</tr>
<tr>
<td>Employee B (Type B plan)</td>
<td>$60</td>
<td>100</td>
<td>$1,750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 2: (b)</th>
<th>Stock Price at the End of the Year</th>
<th>Number of Shares Purchased</th>
<th>Value of the 15 Percent Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee A (Type A plan)</td>
<td>$50</td>
<td>100</td>
<td>$750</td>
</tr>
<tr>
<td>Employee B (Type B plan)</td>
<td>$50</td>
<td>100</td>
<td>$750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 3: (c)</th>
<th>Stock Price at the End of the Year</th>
<th>Number of Shares Purchased</th>
<th>Value of the 15 Percent Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee A (Type A plan)</td>
<td>$30</td>
<td>100</td>
<td>$450</td>
</tr>
<tr>
<td>Employee B (Type B plan)</td>
<td>$30</td>
<td>167</td>
<td>$750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 4: (d)</th>
<th>Stock Price at the End of the Year</th>
<th>Number of Shares Purchased</th>
<th>Value of the 15 Percent Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee A (Type A plan)</td>
<td>$10</td>
<td>100</td>
<td>$150</td>
</tr>
<tr>
<td>Employee B (Type B plan)</td>
<td>$10</td>
<td>500</td>
<td>$750</td>
</tr>
</tbody>
</table>

(a) The purchase price in this scenario would be $42.50 ($50 × 0.85) because the stock price increased during the withholding period.

(b) The purchase price in this scenario would be $42.50 ($50 × 0.85) because the stock price at the end of the period was the same as the stock price at the beginning of the period.

(c) The purchase price in this scenario would be $25.50 ($30 × 0.85) because the stock price decreased during the withholding period.

(d) The purchase price in this scenario would be $8.50 ($10 × 0.85) because the stock price decreased during the withholding period.
As illustrated above, both awards provide the same value to the employee if the stock price at the exercise date has increased (or remained unchanged) from the grant date stock price. However, the award under the Type B plan is more valuable to the employee if the stock price at the exercise date has decreased from the grant date stock price because it guarantees that the employee always will receive at least 15 percent of the stock price at the grant date, whereas the award under the Type A plan only guarantees that the employee will receive 15 percent of the ultimate (lower) stock purchase price.

Using the component measurement approach described in Case A as the base, the additional feature associated with a Type B plan that shall be included in the fair value calculation is 15 percent of a put option on the employer’s stock (valued by use of a standard option-pricing model, using the same measurement assumptions that were used to value the 85 percent of a call option). If the plan in that Case had the provisions of a Type B plan (that is, a plan that does not fix the number of shares that may be purchased), the fair value of the award would be calculated at the grant date as follows.

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.15 of a share of nonvested stock ($50 × 0.15)</td>
<td>$ 7.50</td>
</tr>
<tr>
<td>One-year call on 0.85 of a share of stock, exercise price of $50 ($7.56 × 0.85)</td>
<td>6.43</td>
</tr>
<tr>
<td>One-year put on 0.15 of a share of stock, exercise price of $50 ($4.27 × 0.15) (a)</td>
<td>0.64</td>
</tr>
<tr>
<td>Total grant date fair value</td>
<td>$ 14.57</td>
</tr>
</tbody>
</table>

\(a\) Other assumptions are the same as those used to value the call option; $50 stock price, an expected life of one year, expected volatility of 30 percent, risk-free interest rate of 6.8 percent, and a zero dividend yield.

With the same values the fair value of the Type A employee share purchase plan award described in Case A is determined as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.15 of a share of nonvested stock ($50 × 0.15)</td>
<td>$ 7.50</td>
</tr>
<tr>
<td>One-year call on 0.85 of a share of stock, exercise price of $50 ($7.56 × 0.85)</td>
<td>6.43</td>
</tr>
<tr>
<td>Total grant date fair value</td>
<td>$ 13.93</td>
</tr>
</tbody>
</table>

In Cases B through E, total compensation cost would be measured at the grant date based on the number of shares that can be purchased using the estimated total withholdings and market price of the stock as of the grant date, and not based on the potentially greater number of shares that may ultimately be purchased if the market price declines. In other words, assume that on January 1, 20X0, Employee A elects to have $850 withheld from his pay for the year to purchase stock. Total compensation cost for the Type B plan award to Employee A would be $291 ($14.57 × 20 grant-date-based shares [$850/$42.50]). For purposes of determining the number of shares on which to measure compensation cost, the stock price as of the grant date less the discount, or $50 × 85 percent in this case, is used.

**Case C: Look-Back Plan with Multiple Purchase Periods**

In substance, an employee share purchase plan with multiple purchase periods (a Type C plan) is a series of linked awards, similar in nature to how some view a graded vesting stock option plan. Accordingly, the fair value of an award under an employee share purchase plan with multiple purchase periods shall be determined at the grant date in the same manner as an award under a graded vesting stock option plan. Under the graded vesting approach, awards under a two-year plan with purchase periods at the end of each year would be valued as having two separate option tranches both starting on the initial grant date (using the Case A approach if the plan has the characteristics of a Type A plan or using the Case B approach if the plan has the characteristics of a Type B plan) but with different lives of 12 and 24 months, respectively. All other measurement assumptions would need to be consistent with the separate lives of each tranche.
ASC 718-50 (continued)

**55-27** For example, if the plan in Case A was a two-year Type C plan with purchase periods at the end of each year, the fair value of each tranche of the award would be calculated at the grant date as follows.

*Tranche No. 1:*

- 0.15 of a share of nonvested stock ($50 × 0.15) $7.50
- One-year call on 0.85 of a share of stock, exercise price of $50 ($7.56 × 0.85) (a) 6.43
- Total grant date fair value of the first tranche $13.93

*Tranche No. 2:*

- 0.15 of a share of nonvested stock ($50 × 0.15) $7.50
- Two-year call on 0.85 of a share of stock, exercise price of $50 ($11.44 × 0.85) (a) 9.72
- Total grant date fair value of the second tranche $17.22

(a) The other assumptions are $50 stock price, an expected life of 1 year, expected volatility of 30 percent, risk-free interest rate of 6.8 percent, and a zero dividend yield (same assumptions as in footnote [a] of the table in paragraph 718-55-24). To simplify the illustration, the fair value of each of the tranches is based on the same assumptions about volatility, the risk-free interest rate, and expected dividend yield. In practice, each of those assumptions would be related to the expected life of the respective tranche, which means that at least the risk-free interest rate, and perhaps all three assumptions, would differ for each tranche.

*Case D: Look-Back Plans with Reset or Rollover Mechanisms*

**55-28** The basic measurement approach described in Case C for a Type C plan also should be used to value awards under employee share purchase plans with multiple purchase periods that incorporate reset or rollover mechanisms (that is, Type D and Type E plans). The fair value of those awards initially can be determined at the grant date using the graded vesting measurement approach. However, at the date that the reset or rollover mechanism becomes effective, the terms of the award have been modified (the exercise price has been decreased and, for a grant under a Type E plan, the term of the award has been extended), which, in substance, is similar to an exchange of the original award for a new award with different terms. Share-based payment modification accounting (see paragraphs 718-20-35-3 through 35-9) shall be applied at the date that the reset or rollover mechanism becomes effective to determine the amount of any incremental fair value associated with the modified grant.

**55-29** Likewise, although not a change to the terms of the employee share purchase plan, an election by an employee to increase withholding amounts (or percentages) for future services (Type F through Type H plans) is a modification of the terms of the award to that employee, which, in substance, is similar to an exchange of the original award for a new award with different terms. Accordingly, the fair value of an award under an employee share purchase plan with variable withholdings shall be determined at the grant date (using the Type A, Type B, or Type C measurement approach, as applicable) based on the estimated amounts (or percentages) that a participating employee initially elects to withhold under the terms of the plan. After the grant date (except as noted in paragraph 718-50-35-1), any increases in withholding amounts (or percentages) for future services shall be accounted for as a plan modification in accordance with the guidance in paragraph 718-20-35-3.
To illustrate, if the plan described in Case C allowed an employee to elect to change withholdings at the end of the first year, modification accounting would be applied at the date the employee elected to increase withholdings to determine the amount, if any, of incremental compensation cost. Assume that on January 1, 20X0, Employee A initially elected to have $850 per year withheld from his pay for each purchase period. However, at the end of Year 1 when the stock price is $60 (and assume that no other factors have changed), Employee A elects to have a total of $1,275 withheld for the second purchase period. At that date, $1,275 is equivalent to 30 shares eligible for purchase at the end of the second year ($1,275/42.50). At the date Employee A elects to increase withholdings, modification accounting shall be applied to determine the amount of any incremental fair value associated with the modified award as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the old option (Tranche No. 2) before modification:</td>
<td></td>
</tr>
<tr>
<td>Fair value of the old option (Tranche No. 2) before modification:</td>
<td></td>
</tr>
<tr>
<td>0.15 of a share of nonvested stock ($60 × 0.15)</td>
<td>$9.00</td>
</tr>
<tr>
<td>One-year call on 0.85 of a share of stock, exercise price of $50 ($15.10 × 0.85)</td>
<td>12.84</td>
</tr>
<tr>
<td>Total fair value of each option</td>
<td>$21.84</td>
</tr>
<tr>
<td>Number of grant date shares ($850 ÷ $42.50)</td>
<td>× 20</td>
</tr>
<tr>
<td>Total fair value</td>
<td>$437</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the new option after modification:</td>
<td></td>
</tr>
<tr>
<td>Fair value of the new option after modification:</td>
<td></td>
</tr>
<tr>
<td>0.15 of a share of nonvested stock ($60 × 0.15)</td>
<td>$9.00</td>
</tr>
<tr>
<td>One-year call on 0.85 of a share of stock, exercise price of $50 ($15.10 × 0.85)</td>
<td>12.84</td>
</tr>
<tr>
<td>Total fair value of each option</td>
<td>$21.84</td>
</tr>
<tr>
<td>Number of grant date shares ($850 ÷ $42.50)</td>
<td>× 30</td>
</tr>
<tr>
<td>Total fair value</td>
<td>$655</td>
</tr>
<tr>
<td>Incremental compensation</td>
<td>$218</td>
</tr>
</tbody>
</table>

The incremental value is determined based on the fair value measurements at the date of the modification using the then-current stock price. To simplify the illustration, the fair value at the modification date is based on the same assumptions about volatility, the risk-free interest rate, and expected dividend yield as at the grant date.

Case E: Look-Back Plans with Retroactive Cash Infusion Election

As with all employee share purchase plans, the objective of the measurement process for employee share purchase plans with a look-back option is to reasonably measure the fair value of the award at the grant date. Unlike Type F through Type H plans, which permit an employee to increase withholding amounts (or percentages) only prospectively, the Type I plan permits an employee to make a retroactive election to increase withholdings. Under a Type I plan, an employee may elect not to participate (or to participate at a minimal level) in the plan until just before the exercise date, thus making it difficult to determine when there truly is a mutual understanding of the terms of the award, and thus the date at which the grant occurs. For example, assume that the Type A employee share purchase plan in Case A permits an employee to remit catch-up amounts (up to a maximum aggregate withholding of 15 percent of annual salary) to Entity A at any time during the term of the plan. On January 1, 20X0, Employee A elects to participate in the plan by having $100 (0.04 percent) of her $250,000 salary withheld monthly from her pay over the year. On December 20, 20X0, when the stock price is $65, Employee A elects to remit a check to Entity A for $36,300, which, together with the $1,200 withheld during the year, represents 15 percent of her salary.

In that situation, December 20, 20X0 is the date at which Entity A and Employee A have a mutual understanding of the terms of the award in exchange for the services already rendered and Entity A becomes contingently obligated to issue equity instruments to Employee A upon the fulfillment of vesting requirements. The fair value of the entire award to Employee A is therefore measured as of December 20, 20X0.

Example 2: Limitations for Noncompensatory Treatment

Paragraph 718-50-25-1 stipulates the criteria that an employee share purchase plan must satisfy to be considered noncompensatory. One of those criteria specifies that substantially all employees that meet limited employment qualifications may participate on an equitable basis. Examples of limited employment qualifications might include customary employment of greater than 20 hours per week or completion of at least 6 months of service.
Another criterion is that the terms are no more favorable than those available to all holders of the same class of shares. For example, Entity A offers all full-time employees and all nonemployee shareholders the right to purchase $10,000 of its common stock at a 5 percent discount from its market price at the date of purchase, which occurs in 1 month. The arrangement is not compensatory because its terms are no more favorable than those available to all holders of the same class of shares. In contrast, assume Entity B has a dividend reinvestment program that permits shareholders of its common stock the ability to reinvest dividends by purchasing shares of its common stock at a 10 percent discount from its market price on the date that dividends are distributed and Entity B offers all full-time employees the right to purchase annually up to $10,000 of its common stock at a 10 percent discount from its market price on the date of purchase. Entity B’s common stock is widely held; hence, many shareholders will not receive dividends totaling at least $10,000 during the annual period. Assuming that the 10 percent discount cannot be justified as the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering, the arrangement is compensatory because the number of shares available to shareholders at a discount is based on the quantity of shares held and the amounts of dividends declared. Whereas, the number of shares available to employees at a discount is not dependent on shares held or declared dividends; therefore, the terms of the employee share purchase plan are more favorable than the terms available to all holders of the same class of shares. Consequently, the entire 10 percent discount to employees is compensatory. If, on the other hand, the 10 percent discount can be justified as the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering, then the entire 10 percent discount to employees is not compensatory. If an entity justifies a purchase discount in excess of 5 percent, it would be required to reassess that discount at least annually and no later than the first share purchase offer during the fiscal year. If upon reassessment that discount is not deemed justifiable, subsequent grants using that discount would be compensatory.

### Equity-Based Payments to Non-Employees

**ASC 505-50**

**Illustrations — General**

55-1 This Section, which is an integral part of the requirements of this Subtopic, provides Examples of applying the required accounting for equity-based transactions for goods and services with nonemployees to some specific situations. The Examples do not illustrate all possible combinations of circumstances.

**Example 1: Identification of Situations in Which Performance Commitment Exists Before Performance Is Complete**

55-2 Section 505-50-30 provides guidance on the relevance of determining whether a performance commitment exists relative to establishing a measurement date in a share-based payment transaction with nonemployees. This Example consists of three Cases that describe arrangements in which a performance commitment exists before the counterparty’s performance is complete. These arrangements contain performance commitments before performance is complete despite the fact that in some Cases the quantity or some of the terms of the equity instruments are not known when the arrangement is entered into and for that matter may not be known until some time after the counterparty has provided or, in the case of sales incentives, purchased the requisite goods or services. Each Case assumes that the fair value of the equity instruments to be issued is more reliably measurable than the fair value of the corresponding goods or services. The three Cases depict the following arrangements:

a. Construction services of a manufacturer subject to a significant penalty (Case A)

b. Legal services subject to damages (Case B)

c. Marketing services subject to damages (Case C).

**Case A: Construction Services of a Manufacturer Subject to a Significant Penalty**

55-3 A telecommunications entity agrees to issue shares of its stock in exchange for the construction services of a manufacturer to build a new version of a satellite, with a contract delivery date not to exceed four years. The manufacturer is subject to a significant penalty if it does not complete construction of the satellite. This penalty is considered to be of a magnitude that is a sufficiently large disincentive for nonperformance; thus, the arrangement contains a performance commitment.

**Case B: Legal Services Subject to Damages**

55-4 An entity agrees to issue stock options in exchange for the services of a lawyer to defend it in a product liability case. The quantity, exercise price, and exercise period of the stock options are dependent on whether the lawyer wins or loses the case. If the lawyer quits the case, the lawyer is subject to damages. The damages are considered to be a sufficiently large disincentive for nonperformance; thus, this arrangement contains a performance commitment.

**Case C: Marketing Services Subject to Damages**

55-5 An entity agrees to issue stock options in exchange for the services of a marketer to sell the entity’s products. The entity may determine at any time whether to purchase the marketer’s services, with no obligation to purchase them. If the entity does not purchase the services, the marketer is subject to damages. The marketer is not a customer of the entity, and the entity does not have significant value in the marketer. The arrangement contains a performance commitment regardless of the fact that both the quantity and some of the terms of the stock options are unknown when the arrangement is established.
ASC 505-50 (continued)

Case C: Marketing Services Subject to Damages

55-5 A retailer agrees to issue stock options to an advertising freelancer in exchange for designing a marketing campaign for a particular chain of its stores. The exercise price of the stock options is based on a formula that ties the exercise price to the cumulative percentage increase in sales from the date the new marketing campaign is rolled out until a particular stock option’s exercise date. If the freelancer quits, then the freelancer is subject to specified monetary damages that, in the circumstances, constitute a sufficiently large disincentive for nonperformance. This transaction thus contains a performance commitment regardless of the fact that the exercise price of a particular stock option is not known until the date it is exercised.

Example 2: Identification of Situations in Which Performance Commitment Does Not Exist Before Performance Is Complete

55-6 Section 505-50-30 provides guidance on the relevance of determining whether a performance commitment exists relative to establishing a measurement date in a share-based payment transaction with nonemployees. The following Cases describe arrangements that do not contain performance commitments before the counterparty’s performance is complete, for the reasons specified:

a. Construction services of a manufacturer not subject to a significant penalty (Case A)
b. Acquisition of goods not assured until delivery (Case B)
c. Marketing services not subject to damages (Case C)
d. Sales incentive with provision to change terms based on purchases (Case D).

Case A: Construction Services of a Manufacturer Not Subject to a Significant Penalty

55-7 A telecommunications entity agrees to pay cash in exchange for a manufacturer to build a new kind of satellite, with a contract delivery date not to exceed four years. However, the terms of the arrangement provide that if the manufacturer completes the satellite within three years, the issuer agrees to also compensate the manufacturer with stock options. This transaction does not contain a performance commitment with respect to the stock options (although it may contain a performance commitment with respect to the cash) because there is no penalty if the satellite is not finished within three years. If the satellite is completed within three years, the stock options would be measured on the date the satellite is completed.

Case B: Acquisition of Goods Not Assured Until Delivery

55-8 A clothing manufacturer commits to issue 100 shares of stock in exchange for clothing of historical significance if its bid at an auction is accepted. The transfer of the stock for the auctioned goods occurs 30 days after the date of the auction. The auctioning party has the 30 days in which to either accept the bid received at the auction or, if it believes the winning bid is too low, decide not to accept it. Even after the auctioning party accepts a bid it may change its mind up until the time the auctioned goods are delivered without incurring a penalty that constitutes a significant disincentive for nonperformance. This transaction does not contain a performance commitment on the date the clothing manufacturer commits to issue 100 shares nor thereafter, because there is no disincentive for nonperformance on the part of the auctioning party other than loss of the shares of stock that were to be received for the auctioned clothing. Accordingly, if the auctioned goods are received, the shares of stock would be measured on the date they are received.

Case C: Marketing Services Not Subject to Damages

55-9 A retailer agrees to issue a combination of cash and stock options to a freelancer in exchange for the design of a new advertising campaign. If the freelancer decides not to complete the entire campaign, the freelancer earns only the cash and stock options attributable to the components of the campaign, if any, that were completed. This transaction does not contain a performance commitment because the freelancer has no disincentive for nonperformance other than loss of the cash and stock options attributable to the work not performed. Accordingly, the stock options related to a particular completed component of the campaign would be measured at their then-current fair value when the component of the campaign to which they relate is completed.

Case D: Sales Incentive with Provision to Change Terms Based on Purchases

55-10 A manufacturer invents a new kind of plastic piping that can withstand the cold at record temperatures. To stimulate sales, the manufacturer sends letters to all its existing plastic piping customers offering them stock options if they will purchase a minimum amount of the new plastic piping within a five-year period. If a customer purchases more than the minimum amount of plastic piping, the exercise period of the options increases based on a sliding scale relative to the quantity purchased. This transaction does not contain a performance commitment because a potential customer can, but is not required to, purchase the plastic piping. Accordingly, the stock options earned by buying the minimum amount would be measured as of the date purchases of the minimum amount of plastic piping have been made. This measured amount would be adjusted (using modification accounting) as the length of the exercise period is modified as a result of subsequent purchases. See paragraph 505-50-35-7 for guidance on the use of modification accounting in this situation.
Example 3: Arrangement Contains a Market Condition

55-11 Paragraphs 505-50-30-28 and 505-50-30-31 provide guidance on accounting for transactions with market conditions, including transactions that also contain performance conditions. The following Cases illustrate how to apply the guidance regarding the date the equity instruments are to be measured to a transaction that contains a market condition:

a. Transaction with only a market condition (Case A)

b. Transaction with both a market condition and counterparty performance condition (Case B).

55-12 Cases A and B initially share the following assumptions.

55-13 An entity agrees to pay cash and issue 1,000 stock options in exchange for an architectural design firm to design for the entity a new research laboratory and to deliver the plans within a year. The design firm is subject to a significant penalty if it does not complete the design of the research laboratory within one year. This penalty is considered to be of a magnitude that is a sufficiently large disincentive for nonperformance; thus, the arrangement contains a performance commitment. The quantity and terms of the stock options are known at the performance commitment date, except that if 2 years after the design firm has received the 1,000 stock options the entity’s stock price is below $35 per share, the entity will issue to the design firm, based on a sliding scale, up to 250 additional stock options.

Case A: Transaction with Only a Market Condition

55-14 The entity would measure the 1,000 stock options on the performance commitment date pursuant to the requirements of paragraph 505-50-30-28. Assume this fair value is $10,000. At the performance commitment date the entity would also measure the fair value of the issuer’s commitment to potentially issue another 250 stock options, regardless of whether this commitment is in the money at that date. Assume this fair value is $2,000. The total cost of the transaction to be recognized is thus $12,000. After the performance commitment date, the entity would account for the commitment to potentially issue the 250 additional stock options in accordance with the relevant accounting guidance on financial instruments, including Subtopic 815-40.

Case B: Transaction with Both a Market Condition and Counterparty Performance Condition

55-15 In this Case, the assumptions are changed such that the exercise price of the 1,000 stock options was not known at the performance commitment date because it would ultimately be determined based on a matter stemming from the design firm’s performance in designing the research laboratory. The entity would measure the 1,000 stock options on the performance commitment date pursuant to the requirements of paragraph 505-50-30-31. (Assume the lowest aggregate fair value of the stock options is $8,000.) Thereafter, the entity would account for the arrangement in accordance with paragraph 505-50-35-9 through the time that the exercise price became known. If the exercise price becomes known before the time that the 2-year, $35 stock price guarantee elapses, then, at the time the exercise price becomes known, the issuer would apply modification accounting (see paragraph 505-50-35-9) to the change in exercise price (assume this results in an additional cost of $1,500) and determine the then-current fair value of the stock price commitment and recognize that fair value as additional cost of the transaction (assume the then-current fair value was $1,000). Thereafter, that is, from the time the exercise price becomes known, the entity would account for the commitment to potentially issue 250 additional stock options in accordance with the relevant accounting literature on financial instruments, including Subtopic 81S-40. The total cost of the exchange transaction with the counterparty would be $10,500.

55-16 If, however, the exercise price had become known after the 2-year, $35 stock price guarantee had lapsed, then the entity would account for the actual issuance of any of the 250 additional stock options in accordance with the modification accounting provisions referred to in paragraph 505-50-35-9.

Example 4: Accounting After the Performance Commitment Date Through Completion of Performance

55-17 This Example illustrates the guidance in paragraph 505-50-30-30. The Cases in this Example illustrate grantor and grantee accounting for transactions that have a performance commitment before counterparty performance is complete. In Case A, both the quantity and all the terms of the equity instruments are known up front; whereas in Cases B and C they are not. The Cases illustrate the following:

a. Grantor accounting—all terms known up front (Case A)

b. Grantor accounting—terms dependent on performance (Case B)

c. Grantee accounting—terms dependent on performance (Case C).

55-18 Cases A, B, and C share the assumption that a performance commitment has been achieved before the counterparty’s performance is complete.

55-19 Cases A and B initially share the following further assumptions.

55-20 On December 31, 20X1, Entity A enters into an arrangement with an attorney to defend it in a lawsuit. On December 31, 20X1, the attorney commits to perform the services in exchange for 1,000 stock options with an exercise price of $10 and an exercise period of 10 years. If the attorney quits, then the attorney is subject to specified monetary damages that, in the circumstances, constitute a sufficiently large disincentive for nonperformance. The attorney commences work on the case on January 1, 20X2, and finishes work on the case on December 31, 20X3. The judge decides the case in Entity A’s favor on January 31, 20X4.
### ASC 505-50 (continued)

**Case A: Grantor Accounting—All Terms Known up Front**

**55-21** December 31, 20X1, is the performance commitment date and, thus, the date at which Entity A will measure the fair value of the 1,000 stock options with an exercise price of $10. Assume this aggregate fair value is $22,000. Entity A will recognize $22,000 during the course of 20X2 – 20X3 in the same period(s) and in the same manner as if it had agreed to pay $22,000 in cash for the lawyer’s services.

**Case B: Grantor Accounting—Terms Dependent on Performance**

**55-22** In this Case, the assumptions are changed such that the attorney will receive 1,000 stock options with an exercise price of $10 that are exercisable for 10 years if the case is won, whereas the attorney will receive 500 stock options with an exercise price of $15 that are exercisable for 5 years if the case is lost. As in Case A, the judge also decides the case in Entity A’s favor on January 31, 20X4.

**55-23** December 31, 20X1, is the performance commitment date, and thus the date at which Entity A will measure the fair value of the 1,000 stock options with an exercise price of $10 and the 500 stock options with an exercise price of $15. Entity A will select whichever fair value is lower, in the aggregate, and recognize that cost during the course of 20X2 – 20X3 in the same period(s) and in the same manner as if it had agreed to pay cash for the services.

**55-24** Assume the aggregate fair values at December 31, 20X1, are $22,000 and $16,000 for the $10 and $15 options, respectively. Entity A will select the lower fair value, $16,000, and recognize it during the course of 20X2 – 20X3 in the same period(s) and in the same manner as if it had agreed to pay cash for the lawyer’s services. At January 31, 20X4, when the case is won, Entity A will measure, using current assumptions as of that date, both the $10 and the $15 stock options and recognize additional cost equal to the difference between those two fair values. Assume that on January 31, 20X4, the $10 stock options are worth, in the aggregate, $54,000 and the $15 stock options are worth, in the aggregate, $43,000. Entity A will recognize an additional $11,000 (that is, $54,000 – $43,000) of transaction cost on January 31, 20X4, to reflect the fact that the case was won and thus the terms of the options have been revised from those assumed to calculate the $16,000 cost that Entity A previously recognized.

**Case C: Grantee Accounting—Terms Dependent on Performance**

**55-25** This Case illustrates the application of measurement date guidance for a transaction in which a performance commitment exists before the time that the grantee’s performance is complete and the terms of the equity instrument are subject to adjustment after the measurement date based on the achievement of specified performance conditions. This Case does not address when revenue is recognized. However, a liability (deferred revenue) or revenue would be recognized in the same period(s) and in the same manner as it would if the entity was to receive cash for the goods or services instead of the equity instruments.

**55-26** On January 1, X2, Entity B grants Service Provider 100,000 options with a life of 2 years. The options vest if Service Provider advertises products of Entity B on Service Provider's website for 18 months ending June 30, X3. Entity B also agrees that if Service Provider provides 3 million hits or clickthroughs during the first year of the agreement, the life of the options will be extended from 2 years to 5 years. If Service Provider fails to provide the agreed upon minimum of 18 months of advertising through June 30, X3, Service Provider will pay Entity B specified monetary damages that, in the circumstances, constitute a sufficiently large disincentive for nonperformance.

**55-27** Service Provider would measure the 100,000 stock options for revenue recognition purposes on the performance commitment date of January 1, X2, using the 2-year option life. Assume that at the measurement date (January 1, X2) the fair value of the options is $400,000. On December 1, X2, Service Provider has provided 3 million hits and the life of the option is adjusted to 5 years. Service Provider would measure additional revenue pursuant to the achievement of the performance condition as the difference between the fair value of the adjusted instrument at December 1, X2 (that is, the option with the 5-year life assumed to be $700,000), and the then fair value of the old instrument at December 1, X2 (that is, the option with the 2-year life, which is assumed to be $570,000). Accordingly, additional revenue of $130,000 would be measured. The remaining $170,000 increase in fair value of the instrument should be accounted for in accordance with the relevant guidance on the accounting and reporting for investments in equity instruments, such as that in Topics 320; 323; 325; and 815.

**Example 5: Accounting if There Is No Performance Commitment Until Completion of Performance**

**55-28** This Example illustrates the guidance in paragraphs 505-50-30-21; 505-50-30-25; and 505-50-30-30. The Cases in this Example illustrate grantor accounting for transactions that do not have a performance commitment before counterparty performance is complete. In Case A, both the quantity and all the terms of the equity instruments are known up front, whereas in Cases B and C they are not. The Cases illustrate the following:

a. Advertising campaign services—all terms known up front (Case A)

b. Advertising campaign services—terms dependent on performance (Case B)

c. Outsourcing services—terms dependent on performance (Case C).

**55-29** Cases A, B, and C, in contrast to Example 4 (see paragraph 505-50-55-17), share the assumption that a performance commitment has not been achieved before the counterparty’s performance is complete.

**55-30** Cases A and B initially share the following further assumptions.

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Entity A enters into an arrangement with a freelancer to create a new advertising campaign. The freelancer will be compensated with a combination of cash and stock options. The freelancer earns the cash and stock options attributable to each component of the five-component campaign, if any, that the freelancer designs. The only ramification for the freelancer of quitting the assignment before completing all its components is the lost opportunity to earn the cash and stock options associated with any unfinished components. The freelancer commences work on the campaign on January 1, 20X2, delivers the first component on March 31, 20X2, and delivers the second component on November 30, 20X2, then quits the assignment. For every component of the advertising campaign completed, the freelancer will earn $50,000 in cash and 600 stock options. The stock options have an exercise price of $10 and are exercisable for 10 years from the date the related component of the campaign is completed. Case A contains the calculations associated with these assumptions. Case B modifies the assumptions to introduce terms that vary based on performance and presents revised calculations.

**Case A: Advertising Campaign Services—All Terms Known up Front**

There is no performance commitment date before the completion of performance; thus, the appropriate quantity of stock options is measured at its then-current fair value as of the financial reporting dates, if any, at which the cost of the freelancer’s work on the component of the advertising campaign in question needs to be recognized. This continues until the freelancer completes the component of the advertising campaign in question, at which time the set of 600 stock options is adjusted for the last time to its then-current fair value. If the fair value of the first set of 600 stock options is $25,000 on March 31, 20X2, then $25,000 is the cost recognized for the first set of 600 stock options. If the fair value of the second set of 600 stock options is $27,000 on June 30, 20X2, $28,000 on September 30, 20X2, and $24,000 on November 30, 20X2, then $24,000 is the cost ultimately recognized for the second set of 600 stock options. Interim measurements that Entity A would make, if any, to recognize the appropriate portion of the cost of the freelancer’s services during each period the work is performed would be based on the $27,000 and the $28,000 for the quarters ended June 30, 20X2, and September 30, 20X2, respectively.

**Case B: Advertising Campaign Services—Terms Dependent on Performance**

In this Case, the assumptions are modified such that the exercise price of a particular stock option is based on the percentage increase in store revenue from the time the freelancer earns the option until the time the stock option is exercised, but in no case will it exceed $15.

There is no performance commitment date before the completion of performance; thus, each set of 600 stock options is measured at its then-current fair value as of the financial reporting dates, if any, at which Entity A would make interim measurements of the cost of the freelancer’s work on the component of the advertising campaign in question. This continues until the freelancer completes the component of the advertising campaign in question, at which time the set of 600 stock options is adjusted for the last time to its then-current fair value. The calculations are as follows.

At March 31, 20X2, the freelancer has earned the first set of 600 stock options. The fair value of those stock options is $15,000 at an exercise price of $15. Because $15,000 is the lowest possible fair value (because $15 is the highest possible exercise price), the stock options earned on March 31, 20X2, are measured at $15,000. The $15,000 is recognized in the same period(s) as would be a payment by Entity A to the freelancer of $15,000 in cash in addition to the first $50,000 in cash.

At November 30, 20X2, the freelancer has earned the second set of 600 stock options. The fair value of those stock options at November 30, 20X2, is $21,000 at an exercise price of $15. Because $21,000 is the lowest possible fair value (because $15 is the highest possible exercise price), the stock options earned on November 30, 20X2, are measured at $21,000. The $21,000 is recognized in the same period(s) as would be a payment by Entity A to the freelancer of $21,000 in cash in addition to the second $50,000 in cash. Interim measurements that Entity A would make, if any, to recognize the appropriate portion of the cost of the freelancer’s services during each period the work is performed, such as during the quarters ended June 30, 20X2, and September 30, 20X2, would be based on the lowest possible fair value of the stock options as of those dates.

On July 10, 20X6, the freelancer exercises all of the stock options earned on March 31, 20X2, and on November 30, 20X2. Based on the exercise price sliding scale, on July 10, 20X6, the options earned on March 31, 20X2, have an exercise price of $9 and the options earned on November 30, 20X2, have an exercise price of $12. The aggregate fair value on July 10, 20X6, of the 600 stock options earned on March 31, 20X2, is $60,000 assuming an exercise price of $9 and $45,000 assuming an exercise price of $15. Similarly, the aggregate fair value of the 600 stock options earned on November 30, 20X2, is $33,000 assuming an exercise price of $12 and $21,000 assuming an exercise price of $15. On July 10, 20X6, Entity A will thus recognize an additional cost of $27,000 (that is, $60,000 – $45,000) + ($33,000 – $21,000)) to reflect the fact that the growth in sales fostered revisions in the exercise price from the $15 used to calculate the cost that Entity A previously recognized.

**Case C: Outsourcing Services—Terms Dependent on Performance**

Entity B enters into an outsourcing contract with a large data processing firm. Entity B’s employees currently working in the management information systems department are to be terminated by Entity B and hired by the data processing firm. As part of its arrangement with the data processing firm, management of Entity B elects to grant these individuals stock options that will also contain performance provisions. Based on the hiring status of these individuals and the terms of the arrangement, Entity B considers the accounting for the stock options granted to these individuals to be within the scope of this Subtopic.
Awards Issued/Exchanged in a Business Combination

ASC 805-30

Implementation Guidance — Acquirer Share-Based Payment Awards Exchanged for Awards Held by the Employees of the Acquiree

55-6 If the acquirer is obligated to replace the acquiree’s share-based payment awards, paragraph 805-30-30-9 requires the acquirer to include either all or a portion of the fair-value-based measure of the replacement awards in the consideration transferred in the business combination. Paragraphs 805-30-55-7 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-30-55-17) provide additional guidance on and illustrate how to determine the portion of an award to include in consideration transferred in a business combination and the portion to recognize as compensation cost in the acquirer’s postcombination financial statements.

55-7 To determine the portion of a replacement award that is part of the consideration exchanged for the acquiree and the portion that is compensation for postcombination service, the acquirer first measures both the replacement awards and the acquiree awards as of the acquisition date in accordance with the requirements of Topic 718. In most situations, those requirements result in use of the fair-value-based measurement method, but that Topic permits use of the calculated value method or the intrinsic value method in specified circumstances. This discussion focuses on the fair-value-based method, but the guidance in paragraphs 805-30-30-9 through 30-13 and the additional guidance cited in the preceding paragraph also apply in situations in which Topic 718 permits use of either the calculated value method or the intrinsic value method for both the acquiree awards and the replacement awards.

55-8 The portion of the replacement award attributable to precombination service is the fair-value-based measure of the acquiree award multiplied by the ratio of the precombination service period to the greater of the total service period or the original service period of the acquiree award. (Example 2, Cases C and D [see paragraphs 805-30-55-21 through 55-24] illustrate that calculation.) The total service period is the sum of the following amounts:

a. The part of the requisite service period for the acquiree award that was completed before the acquisition date

b. The postcombination requisite service period, if any, for the replacement award.

55-9 The requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of Topic 718).

55-10 The portion of a nonvested replacement award attributable to postcombination service, and therefore recognized as compensation cost in the postcombination financial statements, equals the total fair-value-based measure of the replacement award less the amount attributed to precombination service. Therefore, the acquirer attributes any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination service and recognizes that excess as compensation cost in the postcombination financial statements.

55-11 The portion of a nonvested replacement award attributable to postcombination service, as well as the portion attributable to postcombination service, shall reflect the acquirer’s estimate of the number of replacement awards for which the requisite service is expected to be rendered. For example, if the fair-value-based measure of the portion of a replacement award attributable to precombination service is $100 and the acquirer expects that the requisite service will be rendered for only 95 percent of the instruments awarded, the amount included in consideration transferred in the business combination is $95. Changes in the number of replacement awards for which the requisite service is expected to be rendered are reflected in compensation cost for the periods in which the changes or forfeitures occur—not as adjustments to the consideration transferred in the business combination.
### Case A: No Required Postcombination Service, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date

The acquirer issues replacement awards of $110 (fair-value-based measure) at the acquisition date for Target awards of $100 (fair-value-based measure) at the acquisition date. No postcombination services are required for the replacement awards, and Target’s employees had rendered all of the required service for the acquiree awards as of the acquisition date.

### Case B: Postcombination Service Required, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date

Acquirer exchanges replacement awards that require one year of postcombination service for share-based payment awards of Target for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. As of the acquisition date, the Target employees had rendered all of the required service for the acquiree awards as of the acquisition date.

### Case C: Postcombination Service Required, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date

Acquirer exchanges replacement awards that require one year of postcombination service for share-based payment awards of Target for which employees had not yet rendered all of the required services as of the acquisition date. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, the awards of Target had a requisite service period of four years. As of the acquisition date, the Target employees had rendered two years’ service, and they would have been required to render two additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of Target’s awards is attributable to precombination service.
### ASC 805-30 (continued)

#### 55-22  
The replacement awards require only one year of postcombination service. Because employees have already rendered two years of service, the total requisite service period is three years. The portion attributable to precombination services equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (2 years) to the greater of the total service period (3 years) or the original service period of Target’s award (4 years). Thus, $50 ($100 x 2 ÷ 4 years) is attributable to precombination service and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination service and therefore recognized as compensation cost in Acquirer’s postcombination financial statements.

Case D: No Required Postcombination Service, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date

#### 55-23  
Assume the same facts as in Case C, except that Acquirer exchanges replacement awards that require no postcombination service for share-based payment awards of Target for which employees had not yet rendered all of the requisite service as of the acquisition date. The terms of the replaced Target awards did not eliminate any remaining requisite service period upon a change in control. (If the Target awards had included a provision that eliminated any remaining requisite service period upon a change in control, the guidance in Case A would apply.) The fair-value-based measure of both awards is $100. Because employees have already rendered two years of service and the replacement awards do not require any postcombination service, the total service period is two years.

#### 55-24  
The portion of the fair-value-based measure of the replacement awards attributable to precombination services equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination service period (2 years) to the greater of the total service period (2 years) or the original service period of Target’s award (4 years). Thus, $50 ($100 x 2 ÷ 4 years) is attributable to precombination service and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination service. Because no postcombination service is required to vest in the replacement award, Acquirer recognizes the entire $50 immediately as compensation cost in the postcombination financial statements.
Chapter 12 — SEC Staff Guidance

This chapter contains relevant portions of the SEC’s guidance on share-based payments that has been incorporated into the S99 section of the FASB Accounting Standards Codification. This guidance includes SAB Topic 14 and communications from the SEC staff and observers at EITF meetings.

SEC Staff Guidance Staff Accounting Bulletins

SAB Topic 14, Share-Based Payment

ASC 718-10-S99-1

The following is the text of SAB Topic 14, Share-Based Payment.

The interpretations in this SAB express views of the staff regarding the interaction between FASB ASC Topic 718, Compensation—Stock Compensation, and certain SEC rules and regulations and provide the staff’s views regarding the valuation of share-based payment arrangements for public companies. FASB ASC Topic 718 is based on the underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value.1 Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information.2

FASB ASC Topic 718 addresses a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

FASB ASC Topic 718 replaces guidance as originally issued in 1995, that established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of FASB ASC Topic 718 and enhance the information received by investors and other users of financial statements, thereby assisting them in making investment and other decisions. This SAB includes interpretive guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity3 status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of FASB ASC Topic 718, the modification of employee share options prior to adoption of FASB ASC Topic 718 and disclosures in MD&A subsequent to adoption of FASB ASC Topic 718.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement FASB ASC Topic 718, and the interpretive guidance provided by this SAB, particularly during the period of the Topic’s initial implementation. Thus, throughout this SAB the use of the terms “reasonable” and “reasonably” is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of FASB ASC Topic 718 and the interpretive guidance provided by this SAB in any given situation. In addition, as discussed in the Interpretive Response to Question 1 of Section C, Valuation Methods, estimates of fair value are not intended to predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made under FASB ASC Topic 718. Over time, as issuers and accountants gain more experience in applying FASB ASC Topic 718 and the guidance provided in this SAB, the staff anticipates that particular approaches may begin to emerge as best practices and that the range of reasonable conduct, conclusions and methodologies will likely narrow.

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1 FASB ASC paragraphs 718-10-30-2 through 718-10-30-4.
2 [Original footnote removed by SAB 114.]
3 Defined in the FASB ASC Master Glossary.

ASC 718-10-S99-1

**Question:** Are share-based payment transactions with nonemployees included in the scope of FASB ASC Topic 718?

**Interpretive Response:** Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by FASB ASC Topic 718. This Topic explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments;
- Requires that an entity record the value of a transaction with a nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued.

FASB ASC Topic 718 does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, FASB ASC Topic 718 does not specify the measurement date for share-based payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued. For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to FASB ASC Subtopic 505-50, Equity — Equity-Based Payments to Non-Employees.

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in FASB ASC Topic 718 would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in FASB ASC Topic 718 by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in FASB ASC Topic 718 would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement. For example, the staff believes the guidance in FASB ASC Topic 718 on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

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4 FASB ASC paragraph 718-10-30-2.
5 Ibid.
6 [Original footnote removed by SAB 114.]
7 For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service termination, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the options expected term rather than the contractual term. If these features (i.e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.
SAB Topic 14.B, Transition from Nonpublic to Public Entity Status

**Facts:** Company A is a nonpublic entity\(^6\) that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8.\(^7\) 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,\(^8\) 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 1:** How should Company A account for the share options that were granted to its employees prior to January 2, 20X8 for which the requisite service has not been rendered by January 2, 20X8?

**Interpretive Response:** Prior to becoming a public entity, Company A had been assigning value to its share options under the calculated value method. The staff believes that Company A should continue to follow that approach for those share options that were granted prior to January 2, 20X8, unless those share options are subsequently modified, repurchased or cancelled.\(^12\) If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of FASB ASC Topic 718. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under FASB ASC subparagraph 718-20-35-3(a), as the fair value of the modified share options over the fair value of the original share options measured immediately before the terms were modified.\(^13\)

**Question 2:** How should Company A account for its liability awards granted to its employees prior to January 2, 20X8 which are fully vested but have not been settled by January 2, 20X8?

**Interpretive Response:** As a nonpublic entity, Company A had elected to measure its liability awards subject to FASB ASC Topic 718 at intrinsic value.\(^14\) When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with FASB ASC Topic 718.\(^15\) In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under FASB ASC Topic 718 and intrinsic value. For example, assume the intrinsic value in the period ended December 31, 20X7 was $10 per award. At the end of the first reporting period ending after January 2, 20X8 (when Company A becomes a public entity), assume the intrinsic value of the award is $12 and the fair value as determined in accordance with FASB ASC Topic 718 is $15. The measured cost in the first reporting period after December 31, 20X7 would be $5.\(^16\)

**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 granted to the Company’s employees. 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.\(^17\)

**Question 4:** Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by FASB ASC Topic 718?\(^18\)

**Interpretive Response:** In the registration statement filed on January 2, 20X8, Company A should clearly describe in MD&A the change in accounting policy that will be required by FASB ASC Topic 718 in subsequent periods and the reasonably likely material future effects.\(^19\) In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition, Company A should consider the applicability of SEC Release No. FR-60\(^20\) and Section V, “Critical Accounting Estimates,” in SEC Release No. FR-72\(^21\) regarding critical accounting policies and estimates in MD&A.

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\(^6\) Defined in the FASB ASC Master Glossary.

\(^7\) For the purposes of these illustrations, assume all of Company A’s equity-based awards granted to its employees were granted after the adoption of FASB ASC Topic 718.

\(^8\) For purposes of this staff accounting bulletin, the phrase “share options” is used to refer to “share options or similar instruments.”

\(^9\) FASB ASC paragraph 718-10-30-20 requires a nonpublic entity to use the calculated value method when it is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. FASB ASC paragraph 718-10-55-51 indicates that a nonpublic entity may be able to identify similar public entities for which share or option price information is available and may consider the historical, expected, or implied volatility of those entities share prices in estimating expected volatility. The staff would expect an entity that becomes a public entity and had previously measured its share options under the calculated value method to be able to support its previous decision to use calculated value and to provide the disclosures required by FASB ASC subparagraph 718-10-50-2(f)(2)(ii).

\(^10\) This view is consistent with the FASB’s basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

\(^11\) FASB ASC paragraph 718-20-55-94. The staff believes that because Company A is a public entity as of the date of the modification, it would be inappropriate to use the calculated value method to measure the original share options immediately before the terms were modified.

\(^12\) FASB ASC paragraph 718-30-30-2.

\(^13\) FASB ASC paragraph 718-30-35-3.

\(^14\) $15 fair value less $10 intrinsic value equals $5 of incremental cost.

\(^15\) This view is consistent with the FASB’s basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

\(^16\) FASB ASC Section 718-10-50.


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SAB Topic 14.C, Valuation Methods

ASC 718-10-S99-1

FASB ASC paragraph 718-10-30-6 (Compensation—Stock Compensation Topic) indicates that the measurement objective for equity instruments awarded to employees is to estimate at the grant date the fair value of the equity instruments 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. The Topic also states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement for equity and liability instruments awarded in a share-based payment transaction with employees. However, if observable market prices of identical or similar equity or liability instruments are not available, the fair value shall be estimated by using a valuation technique or model that complies with the measurement objective, as described in FASB ASC Topic 718.

**Question 1:** If a valuation technique or model is used to estimate fair value, to what extent will the staff consider a company’s estimates of fair value to be materially misleading because the estimates of fair value do not correspond to the value ultimately realized by the employees who received the share options?

**Interpretive Response:** The staff understands that estimates of fair value of employee share options, while derived from expected value calculations, cannot predict actual future events. The estimate of fair value represents the measurement of the cost of the employee services to the company. The estimate of fair value should reflect the assumptions marketplace participants would use in determining how much to pay for an instrument on the date of the measurement (generally the grant date for equity awards). For example, valuation techniques used in estimating the fair value of employee share options may consider information about a large number of possible share price paths, while, of course, only one share price path will ultimately emerge. If a company makes a good faith fair value estimate in accordance with the provisions of FASB ASC Topic 718 in a way that is designed to take into account the assumptions that underlie the instruments value that marketplace participants would reasonably make, then subsequent future events that affect the instruments value do not provide meaningful information about the quality of the original fair value estimate. As long as the share options were originally so measured, changes in employee share options value, no matter how significant, subsequent to its grant date do not call into question the reasonableness of the grant date fair value estimate.

**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.

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.

**Question 3:** In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?

**Interpretive Response:** FASB ASC paragraph 718-10-55-17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.

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22 FASB ASC paragraph 718-10-55-10.
23 FASB ASC paragraph 718-10-55-11.
24 FASB ASC paragraph 718-10-55-15, states “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.”
26 FASB ASC paragraph 718-10-55-17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.
SAB Topic 14.D, Certain Assumptions Used in Valuation Methods

ASC 718-10-S99-1

FASB ASC Topic 718’s (Compensation—Stock Compensation Topic) fair value measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value 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. In order to meet this fair value measurement objective, management will be required to develop estimates regarding the expected volatility of its company’s share price and the exercise behavior of its employees. The staff is providing guidance in the following sections related to the expected volatility and expected term assumptions to assist public entities in applying those requirements.

The staff understands that companies may refine their estimates of expected volatility and expected term as a result of the guidance provided in FASB ASC Topic 718 and in sections (1) and (2) below. Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes.

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 options value is dependent on potential share returns over the options term. The higher the volatility, the more the returns on the share can be expected to vary—up or down. Because an options 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.

Questions:

Question 2: What is implied volatility?

Interpretive Response: Implied volatility is the volatility assumption inherent in the market prices of a company’s traded options or other financial instruments that have option-like features. Implied volatility is derived by entering the market price of the traded financial instrument, along with assumptions specific to the financial options being valued, into a model based on a constant volatility estimate (e.g., the Black-Scholes-Merton closed-form model) and solving for the unknown assumption of volatility.
### ASC 718-10-S99-1 (continued)

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. (See the Interpretive Responses to Questions 3 and 4 below.)

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.

**Question 2:** What should Company B consider if computing historical volatility?**38**

**Interpretive Response:** The following should be considered in the computation of historical volatility:

1. **Method of Computing Historical Volatility** —
   
   The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B’s expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B’s historical volatility much more heavily than earlier periods. For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history.

2. **Amount of Historical Data** —
   
   FASB ASC subparagraph 718-10-55-37(a) indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

3. **Frequency of Price Observations** —
   
   FASB ASC subparagraph 718-10-55-37(d) indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate. Company B should select a consistent point in time within each interval when selecting data points.

4. **Consideration of Future Events** —
   
   The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option. Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

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37 The staff believes implied volatility derived from embedded options can be utilized in determining expected volatility if, in deriving the implied volatility, the company considers all relevant features of the instruments (e.g., value of the host instrument, value of the option, etc.). The staff believes the derivation of implied volatility from other than simple instruments (e.g., a simple convertible bond) can, in some cases, be impracticable due to the complexity of multiple features.

38 See FASB ASC paragraph 718-10-55-37.

39 For purposes of this staff accounting bulletin, the phrase expected or contractual term, as applicable has the same meaning as the phrase expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of an employee share option.

40 FASB ASC subparagraph 718-10-55-37(a) states that entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. Accordingly, the staff believes methods that place extreme emphasis on the most recent periods may be inconsistent with this guidance.

41 Generalized Autoregressive Conditional Heteroskedasticity (GARCH) is an example of a method that demonstrates this characteristic.

42 Further, if shares of a company are thinly traded the staff believes the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations. The volatility calculation using daily observations for such shares could be artificially inflated due to a larger spread between the bid and asked quotes and lack of consistent trading in the market.

43 FASB ASC paragraph 718-10-55-40 states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, FASB ASC paragraph 718-10-55-27 indicates that assumptions used to estimate the fair value of instruments granted to employees should be determined in a consistent manner from period to period.

44 FASB ASC paragraph 718-10-55-35.
The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the volatility derived from a traded option with a similar term. However, if there are no traded options with a term of one year or greater, the staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If the staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of $52, but the only traded options available have exercise prices of $50 and $55, then the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant. If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.

The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share options contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater. However, when using traded options with a term of less than one year, the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option.

The staff believes Company B’s evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the markets expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.

**Question 3:** What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

**Interpretive Response:** To achieve the objective of estimating expected volatility as stated in FASB ASC paragraphs 718-10-55-35 through 718-10-55-41, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and 4) the similarity of the length of the term of the traded and employee share options.

1. **Volume of Market Activity**
   - The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect marketplace participants expectations regarding expected volatility.

2. **Synchronization of the Variables**
   - Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. **Similarity of the Exercise Prices**
   - The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant. If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.

4. **Similarity of Length of Terms**
   - The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share options contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater. However, when using traded options with a term of less than one year, the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option.

The staff believes Company B’s evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the markets expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.

**Question 4:** Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?

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45 FASB ASC paragraph 718-10-55-37.
47 Implied volatilities of options differ systematically over the “moneyness” of the option. This pattern of implied volatilities across exercise prices is known as the “volatility smile” or “volatility skew.” Studies such as “Implied Volatility” by Stewart Mayhew, Financial Analysts Journal, July-August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.
48 The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of $52, but the only traded options available have exercise prices of $50 and $55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of $55 and a 60% weight on the option with an exercise price of $50.
49 The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.
50 The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.
Interpretive Response: As stated above, FASB ASC Topic 718 does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity’s estimate of expected volatility be reasonable and supportable.\(^{51}\) Many of the factors listed in FASB ASC Topic 718 are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in FASB ASC Topic 718, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option.\(^{52}\) The staff believes that a company, after considering the factors listed in FASB ASC Topic 718, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

The staff would not object to Company B placing exclusive reliance on implied volatility when the following factors are present, as long as the methodology is consistently applied:

- Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options;\(^{53}\)
- The implied volatility is derived from options that are actively traded;
- The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;
- The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options;\(^{54}\) and
- The remaining maturities of the traded options on which the estimate is based are at least one year.

The staff would not object to Company B placing exclusive reliance on historical volatility when the following factors are present, so long as the methodology is consistently applied:

- Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past;\(^{55}\)
- 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 of the share option, as applicable, is used; and
- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.\(^{56}\)

Question 5: What disclosures would the staff expect Company B to include in its financial statements and MD&A regarding its assumption of expected volatility?

Interpretive Response: FASB ASC paragraph 718-10-50-2 prescribes the minimum information needed to achieve the Topic’s disclosure objectives.\(^{57}\) Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it.\(^{58}\) Accordingly, the staff expects that at a minimum Company B would disclose in a footnote to its financial statements how it determined the expected volatility assumption for purposes of determining the fair value of its share options in accordance with FASB ASC Topic 718. For example, at a minimum, the staff would expect Company B to disclose whether it used only implied volatility, historical volatility, or a combination of both.

In addition, Company B should consider the applicability of SEC Release No. FR-60 and Section V, “Critical Accounting Estimates,” in SEC Release No. FR-72 regarding critical accounting policies and estimates in MD&A. The staff would expect such disclosures to include an explanation of the method used to estimate the expected volatility of its share price. This explanation generally should include a discussion of the basis for the company’s conclusions regarding the extent to which it used historical volatility, implied volatility or a combination of both. A company could consider summarizing its evaluation of the factors listed in Questions 2 and 3 of this section as part of these disclosures in MD&A.

Facts: Company C is a newly public entity with limited historical data on the price of its publicly traded shares and no other traded financial instruments. Company C believes that it does not have sufficient company specific information regarding the volatility of its share price on which to base an estimate of expected volatility.

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51 FASB ASC paragraphs 718-10-55-36 through 718-10-55-37.
52 FASB ASC paragraph 718-10-55-35.
53 FASB ASC paragraphs 718-10-55-18 and 718-10-55-39 discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the options contractual term should consider the factors listed in FASB ASC Topic 718, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.
54 When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.
55 See FASB ASC paragraph 718-10-55-38. A change in a company’s business model that results in a material alteration to the company’s risk profile is an example of a circumstance in which the company’s future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company’s business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.
56 If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.
57 FASB ASC Section 718-10-50.
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 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 should consider the industry, stage of life cycle, size and financial leverage of such other entities.

The staff would not object to Company C looking at 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.

2. Expected Term

FASB ASC paragraph 718-10-55-29 states, “The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to the holder to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable (or tradable) share options in that employees cannot sell (or hedge) their share options—they can only exercise them; because of this, employees generally exercise their options before the end of the options contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the options value [compared to a transferable option] because exercise prior to the options expiration terminates its remaining life and thus its remaining time value.” Accordingly, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework the fair value of employee share options be based on the share options expected term rather than the contractual term.

The staff believes the estimate of expected term should be based on the facts and circumstances available in each particular case. Consistent with our guidance regarding reasonableness immediately preceding Topic 14.A, the fact that other possible estimates are later determined to have more accurately reflected the term does not necessarily mean that the particular choice was unreasonable. The staff reminds registrants of the expected term disclosure requirements described in FASB ASC subparagraph 718-10-50-2(f)(2)(i).

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.
Facts:
Company E grants equity share options to its employees that have the following basic characteristics:

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
- The share options are nontransferable and nonhedgeable.

Company E utilizes the Black-Scholes-Merton closed-form model for valuing its employee share options.

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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 employees render the requisite 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 “...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. While such comparative information may not be widely available at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data.

Facts: Company E grants equity share options to its employees that have the following basic characteristics:

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
- The share options are nontransferable and nonhedgeable.

Company E utilizes the Black-Scholes-Merton closed-form model for valuing its employee share options.

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67 FASB ASC paragraph 718-10-30-11.
68 FASB ASC paragraph 718-10-55-31.
69 The staff believes the focus should be on groups of employees with significantly different expected exercise behavior. Academic research suggests two such groups might be executives and non-executives. A study by S. Huddart found executives and other senior managers to be significantly more patient in their exercise behavior than more junior employees. (Employee rank was proxied for by the number of options issued to that employee.) See S. Huddart, “Patterns of stock option exercise in the United States,” in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142. See also S. Huddart and M. Lang, “Employee stock option exercises: An empirical analysis,” Journal of Accounting and Economics, 1996, pp. 5-43.
70 FASB ASC paragraph 718-10-55-13.
71 Historical share option exercise experience encompasses data related to share option exercise, post-vesting termination, and share option contractual term expiration.
72 For example, if a company had historically granted share options that were always in-the-money, and will grant at-the-money options prospectively, the exercise behavior related to the in-the-money options may not be sufficient as the sole basis to form the estimate of expected term for the at-the-money grants.
73 For example, if a company had a history of previous equity-based share option grants and exercises only in periods in which the company’s share price was rising, the exercise behavior related to those options may not be sufficient as the sole basis to form the estimate of expected term for current option grants.
74 FASB ASC paragraph 718-10-55-30.
75 Employee share options with these features are sometimes referred to as plain-vanilla options.
76 In this fact pattern the requisite service period equals the vesting period.
**Question 6:** As share options with these plain-vanilla characteristics have been granted in significant quantities by many companies in the past, is the staff aware of any simple methodologies that can be used to estimate expected term?

**Interpretive Response:** As noted above, the staff understands that an entity that is unable to rely on its historical exercise data may find that certain alternative information, such as exercise data relating to employees of other companies, is not easily obtainable. As such, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, if a company concludes that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term, the staff will accept the following simplified method for plain vanilla options consistent with those in the fact set above: expected term = ((vesting term + original contractual term) / 2). Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years.\(^77\) Academic research on the exercise of options issued to executives provides some general support for outcomes that would be produced by the application of this method.\(^78\)

Examples of situations in which the staff believes that it may be appropriate to use this simplified method include the following:

- A company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time its equity shares have been publicly traded.
- A company significantly changes the terms of its share option grants or the types of employees that receive share option grants such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.
- A company 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 expected term.

The staff understands that a company may have sufficient historical exercise data for some of its share option grants but not for others. In such cases, the staff will accept the use of the simplified method for only some but not all share option grants. The staff also does not believe that it is necessary for a company to consider using a lattice model before it decides that it is eligible to use this simplified method. Further, the staff will not object to the use of this simplified method in periods prior to the time a company’s equity shares are traded in a public market.

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.

Also, as noted above in Question 5, the staff believes that more detailed external information about exercise behavior will, over time, become readily available to companies. As such, the staff does not expect that such a simplified method would be used for share option grants when more relevant detailed information becomes widely available.

\(^77\) Calculated as \[\frac{\left(\frac{1\text{ year vesting term (for the first 25% vested) plus 2 year vesting term (for the second 25% vested) plus 3 year vesting term (for the third 25% vested) plus 4 year vesting term (for the last 25% vested)}}{4}\right) + 10\text{ year contractual life}}{2}\] \[= 6.25\text{ years.}\]

\(^78\) J.N. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial Economics, 1998, pp.127-158 studies a sample of 40 NYSE and AMEX firms over the period 1979-1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The "mean time to exercise" is shorter than expected term since the study’s sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bozik; and Michael L. Lemmon, "Exercise behavior, valuation, and the incentive effects of employee stock options," forthcoming in the Journal of Financial Economics. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, “Patterns of stock option exercise in the United States,” in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142.

ASC 718-10-599-1

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. 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. SEC Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stocks,” and related guidance 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 with employees 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.

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 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 issuers 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 value of the option should be presented as temporary equity at that date.

The terminology outside the control of the issuer is used to refer to any of the three redemption conditions described in Rule 5-02.28 of Regulation S-X that would require classification outside of 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.

ASR 268, July 27, 1979, Rule 5-02.28 of Regulation S-X.

Related guidance includes FASB ASC paragraph 480-10-599-3A (Distinguishing Liabilities from Equity Topic).

FASB ASC paragraph 718-10-35-13, states that an instrument ceases to be subject to this Topic when “the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing services).”

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. See FASB ASC paragraph 815-40-25-11, which states in part: “. . . the events or actions necessary to deliver registered shares are not controlled by an entity and, therefore, except under the circumstances described in FASB ASC paragraph 815-40-25-16, if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract.” See also FASB ASC subparagraph 718-10-25-15(a).

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

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.
**ASC 718-10-S99-1 (continued)**

**Question 3:** Would the methodology described for employee awards in the Interpretive Response to Question 2 above apply to nonemployee awards to be issued in exchange for goods or services with similar terms to those described above?

**Interpretive Response:** See Topic 14.A for a discussion of the application of the principles in FASB ASC Topic 718 to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

**SAB Topic 14.F, Classification of Compensation Expense Associated with Share-based Payment Arrangements**

**ASC 718-10-S99-1**

**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. 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.


**SAB Topic 14.I, Capitalization of Compensation Cost Associated with Share-Based Arrangements**

**ASC 718-10-S99-1**

**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.

**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, is effective.


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87 FASB ASC 718 does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

94 FASB ASC paragraph 718-10-25-2.

Announcements Made by SEC Staff at EITF Meetings

SEC Staff Announcement: Escrowed Share Arrangements and the Presumption of Compensation

**ASC 718-10-S99-2**

This SEC staff announcement provides the SEC staff’s views regarding Escrowed Share Arrangements and the Presumption of Compensation.

The SEC Observer made the following announcement of the SEC staff’s position on escrowed share arrangements. The SEC Observer has been asked to clarify SEC staff views on overcoming the presumption that for certain shareholders these arrangements represent compensation.

Historically, the SEC staff has expressed the view that an escrowed share arrangement involving the release of shares to certain shareholders based on performance-related criteria is presumed to be compensatory, equivalent to a reverse stock split followed by the grant of a restricted stock award under a performance-based plan.1

When evaluating whether the presumption of compensation has been overcome, registrants should consider the substance of the arrangement, including whether the arrangement was entered into for purposes unrelated to, and not contingent upon, continued employment. For example, as a condition of a financing transaction, investors may request that specific significant shareholders, who also may be officers or directors, participate in an escrowed share arrangement. If the escrowed shares will be released or canceled without regard to continued employment, specific facts and circumstances may indicate that the arrangement is in substance an inducement made to facilitate the transaction on behalf of the company, rather than as compensatory. In such cases, the SEC staff generally believes that the arrangement should be recognized and measured according to its nature and reflected as a reduction of the proceeds allocated to the newly-issued securities.2, 3

The SEC staff believes that an escrowed share arrangement in which the shares are automatically forfeited if employment terminates is compensation, consistent with the principle articulated in paragraph 805-10-55-25(a).

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Announcements Made by SEC Staff at EITF Meetings

SEC Staff Announcement: Grantor Balance Sheet Presentation of Unvested, Forfeitable Equity Instruments Granted to a Nonemployee

**ASC 505-50-S99-1**

The following is the text of SEC Staff Announcement: Grantor Balance Sheet Presentation of Unvested, Forfeitable Equity Instruments Granted to a Nonemployee.

The SEC staff has received inquiries on the appropriate balance sheet presentation of arrangements where unvested, forfeitable equity instruments are issued to an unrelated nonemployee (the counterparty) as consideration for future services. The arrangements addressed by the staff entitle the grantor to recover the specific consideration paid, plus a substantial mandatory penalty, as minimum measure of damages for counterparty nonperformance. Consequently, pursuant to paragraph 505-50-30-12, sufficiently large disincentives for counterparty nonperformance exist such that a performance commitment and measurement date have been achieved as of the date of issuance. The fair value of these arrangements is measured in accordance with paragraph 505-50-30-6. Practice appears mixed as to whether such transactions are recorded at the measurement date. Some registrants make no entries until performance occurs, while others record the fair value of the equity instruments as equity at the measurement date and record the offset either as an asset or as a reduction of stockholders’ equity (contra-equity). This announcement sets forth the SEC staff’s position on the appropriate accounting at the measurement date.

In evaluating the appropriate balance sheet classification for the above arrangements, the staff considered the following guidance:

Paragraph 505-50-25-4, which states that the guidance does not address the period(s) or the manner (that is, capitalize versus expense) in which an enterprise should recognize the fair value of equity instruments that were issued, other than to reach a consensus that an asset or expense should be recognized in the same period(s) and in the same manner (capitalize or expense) as if the enterprise had paid cash for the goods or services instead of issuing equity instruments.

The SEC staff believes that if the issuer receives a right to receive future services in exchange for unvested, forfeitable equity instruments, those equity instruments should be treated as unissued for accounting purposes until the future services are received (that is, the instruments are not considered issued until they vest). Consequently, there would be no recognition at the measurement date and no entry should be recorded.

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1 Under these arrangements, which can be between shareholders and a company or directly between the shareholders and new investors, shareholders agree to place a portion of their shares in escrow in connection with an initial public offering or other capital-raising transaction. Shares placed in escrow are released back to the shareholders only if specified performance-related criteria are met.

2 The SEC staff notes that discounts on debt instruments are amortized using the effective interest method as discussed in Section 835-30-35, while discounts on common equity are not generally amortized.

3 Consistent with the views in paragraph 225-10-599-4, SAB Topic 5T., Accounting for Expenses or Liabilities Paid by Principal Stockholder(s), and paragraph 225-10-599-3, SAB Topic 1.B., Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity, the SEC staff believes that the benefit created by the shareholder’s escrow arrangement should be reflected in the company’s financial statements even when the company is not party to the arrangement.


Comments Made by SEC Observer at EITF Meetings

SEC Observer Comment: Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees

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<thead>
<tr>
<th><strong>ASC 505-50-599-2</strong></th>
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<tr>
<td>The following is the text of the SEC Observer Comment: Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees.</td>
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<tr>
<td>SEC registrants can expect the SEC Staff to challenge accounting by the grantee or grantor in transactions involving equity instruments granted to other than employees (paragraph 505-50-25-2) if their accounting does not reflect the same commitment date or similar values.</td>
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Appendix A — Glossary of Topics, Standards, and Regulations

The standards and literature below were cited or linked to in this publication.

**FASB Literature**

For titles of citations to the *FASB Accounting Standards Codification* (ASC) used in this publication, see Deloitte’s “Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*.”

See the FASB’s Web site for the titles of citations to:

- Accounting Standards Updates.
- Exposure documents open for comment.
- Exposure documents issued for public comment (archive).
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

**SEC Literature**

Staff Accounting Bulletins (SABs) — Topics

- SAB Topic 1, “Financial Statements”
    - SAB Topic 1.B.1, “Costs Reflected in Historical Financial Statements”
  - SAB Topic 5.T, “Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)”
  - SAB Topic 14, “Share-Based Payment”
      - 14.D.1, “Expected Volatility”
      - 14.D.2, “Expected Term”
    - SAB Topic 14.F, “Classification of Compensation Expense Associated With Share-Based Payment Arrangements”

Staff Accounting Bulletins (SABs) — Releases

- SAB No. 110, “Use of a Simplified Method in Developing an Estimate of Expected Term of ‘Plain Vanilla’ Share Options”
Form:
• Form S-8, “Registration Statement Under the Securities Act of 1933”

Regulation S-K:
• Item 402, “Executive Compensation”

Regulation S-X:
• Article 5, “Commercial and Industrial Companies”
  • Rule 5-02, “Balance Sheets”
• Article 10, “Interim Financial Statements”
  • Rule 10-01, “Interim Financial Statements”

SEC Division of Corporation Finance’s Financial Reporting Manual:
• Topic 7, “Related Party Matters”
  • Section 7520, “Expenses Incurred on Behalf of Registrant”
• Topic 9, “Management’s Discussion and Analysis of Financial Position and Results of Operations (MD&A)”
  • Section 9520, “Share-Based Compensation in IPOs”

SEC Securities Act of 1933 Rules:
• Rule 144A, “Private Resales of Securities to Institutions”

AICPA Literature
AICPA Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation (also referred to as the “Cheap Stock Guide”)

AICPA Technical Inquiry Service (TIS) Sections:
• TIS Section 4110, “Issuance of Capital Stock”

Internal Revenue Code (IRC)
• IRC Section 83, “Property Transferred in Connection With Performance of Services”
• IRC Section 421, “General Rules”
• IRC Section 422, “Incentive Stock Options”
• IRC Section 423, “Employee Stock Purchase Plans”
• IRC Section 424, “Definitions and Special Rules”

International Standards
See Deloitte’s IAS Plus Web site for the titles of citations to:
• International Financial Reporting Standards (IFRS).
• International Accounting Standards (IAS).
• International Financial Reporting (IFRIC) Interpretations.
• Standing Interpretations Committee (SIC) Interpretations.
Appendix B — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AETR</td>
<td>annual effective tax rate</td>
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<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>AMT</td>
<td>alternative minimum tax</td>
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<tr>
<td>APB</td>
<td>Accounting Principles Board</td>
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<td>APIC</td>
<td>additional paid-in capital</td>
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<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<td>FASB Accounting Standards Update</td>
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<td>chief executive officer</td>
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<td>chief financial officer</td>
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<td>CPI</td>
<td>consumer price index</td>
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<td>CU</td>
<td>currency unit</td>
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<td>DECS</td>
<td>debt exchangeable for common stock</td>
</tr>
<tr>
<td>DRIP</td>
<td>dividend reinvestment program</td>
</tr>
<tr>
<td>DTA</td>
<td>deferred tax asset</td>
</tr>
<tr>
<td>DTL</td>
<td>deferred tax liability</td>
</tr>
<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation and amortization</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>earnings per share</td>
</tr>
<tr>
<td>ESOARS</td>
<td>employee stock option appreciation rights securities</td>
</tr>
<tr>
<td>ESOP</td>
<td>employee share ownership plan</td>
</tr>
<tr>
<td>ESPP</td>
<td>employee share purchase plan</td>
</tr>
<tr>
<td>FAS</td>
<td>FASB Statement of Financial Accounting Standards</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>-------------</td>
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</tr>
<tr>
<td>FRR</td>
<td>financial reporting release</td>
</tr>
<tr>
<td>FSP</td>
<td>FASB Staff Position</td>
</tr>
<tr>
<td>FTSE</td>
<td>Financial Times Stock Exchange</td>
</tr>
<tr>
<td>FVTOCI</td>
<td>fair value through other comprehensive income</td>
</tr>
<tr>
<td>FVTPL</td>
<td>fair value through profit or loss</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>IFRIC</td>
<td>International Financial Reporting Interpretations Committee</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>IRC</td>
<td>Internal Revenue Code</td>
</tr>
<tr>
<td>IRR</td>
<td>internal rate of return</td>
</tr>
<tr>
<td>IRS</td>
<td>Internal Revenue Service</td>
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<tr>
<td>ISO</td>
<td>incentive stock option</td>
</tr>
<tr>
<td>LTIP</td>
<td>long-term incentive plan</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion &amp; Analysis</td>
</tr>
<tr>
<td>MPA</td>
<td>modified prospective application</td>
</tr>
<tr>
<td>NOL</td>
<td>net operating loss</td>
</tr>
<tr>
<td>NQSO or NSO</td>
<td>nonqualified stock option</td>
</tr>
<tr>
<td>OEA</td>
<td>SEC’s Office of Economic Analysis</td>
</tr>
<tr>
<td>PHLX</td>
<td>Philadelphia Exchange</td>
</tr>
<tr>
<td>PRIDES</td>
<td>preferred redeemable increased dividend equity securities</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<td>SAB</td>
<td>Staff Accounting Bulletin</td>
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<td>SAR</td>
<td>stock appreciation right</td>
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<tr>
<td>SAYE</td>
<td>save as you earn</td>
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<tr>
<td>S&amp;P</td>
<td>Standard &amp; Poor’s rating service</td>
</tr>
<tr>
<td>SEC</td>
<td>U.S. Securities and Exchange Commission</td>
</tr>
<tr>
<td>SFAS</td>
<td>Statement of Financial Accounting Standards</td>
</tr>
<tr>
<td>SOP</td>
<td>AICPA Statement of Position</td>
</tr>
<tr>
<td>TIS</td>
<td>AICPA Technical Information Service</td>
</tr>
<tr>
<td>TSR</td>
<td>total shareholder return</td>
</tr>
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Appendix C — Glossary of Terms

This appendix includes a glossary of terms that is used throughout this publication. These terms are included within the glossaries for the ASC sections referenced within this publication (i.e., ASC 718, ASC 505-50, and ASC 805-30).

**Acquiree**
The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

**Acquirer**
The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

**Acquisition Date**
The date on which the acquirer obtains control of the acquiree.

**Award**
The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award.

**Blackout Period**
A period of time during which exercise of an equity share option is contractually or legally prohibited.

**Broker-Assisted Cashless Exercise**
The simultaneous exercise by an employee of a share option and sale of the shares through a broker (commonly referred to as a broker-assisted exercise).

Generally, under this method of exercise:

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

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

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

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

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

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

**Business Combination**
A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations.

**Calculated Value**
A measure of the value of a share option or 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.
**Call Option**
A contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period.

**Carryforwards**
Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.

**Closed-Form Model**
A valuation model that uses an equation to produce an estimated fair value. The Black-Scholes-Merton formula is a closed-form model. In the context of option valuation, both closed-form models and lattice models are based on risk-neutral valuation and a contingent claims framework. The payoff of a contingent claim, and thus its value, depends on the value(s) of one or more other assets. The contingent claims framework is a valuation methodology that explicitly recognizes that dependency and values the contingent claim as a function of the value of the underlying asset(s). One application of that methodology is risk-neutral valuation in which the contingent claim can be replicated by a combination of the underlying asset and a risk-free bond. If that replication is possible, the value of the contingent claim can be determined without estimating the expected returns on the underlying asset. The Black-Scholes-Merton formula is a special case of that replication.

**Combination Award**
An award with two or more separate components, each of which can be separately exercised. Each component of the award is actually a separate award, and compensation cost is measured and recognized for each component.

**Control**
The same as the meaning of controlling financial interest in paragraph 810-10-15-8.

**Counterparty Performance Conditions**
Conditions that relate to the achievement of a specified performance target, for example, attaining a specified increase in market share for a specified product. A counterparty performance condition might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division.

**Cross-Volatility**
A measure of the relationship between the volatilities of the prices of two assets taking into account the correlation between movements in the prices of the assets. See Volatility.

**Customer**
A user or reseller.

**Deductible Temporary Difference**
Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference.

**Deferred Tax Asset**
The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

**Deferred Tax Expense (or Benefit)**
The change during the year in an entity’s deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense (or benefit) for the year is allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders’ equity.
**Derived Service Period**

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

**Economic Interest in an Entity**

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

**Employee**

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

A leased individual is deemed to be an employee of the lessee if all of the following requirements are met:

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

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

1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
4. The individual has the ability to participate in the lessee’s employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.
A nonemployee director does not satisfy this definition of employee. Nevertheless, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were elected by the employer’s shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees.

**Employee Stock Ownership Plan**

An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.

**Equity Restructuring**

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.

**Event**

A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity.

**Excess Tax Benefits**

The realized tax benefit related to the amount (caused by changes in the fair value of the entity’s shares after the measurement date for financial reporting) of deductible compensation cost reported on an employer’s tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes.

**Explicit Service Period**

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

**Fair Value**

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.

**Freestanding Financial Instrument**

A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity’s other financial instruments or equity transactions.

b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

**Goodwill**

An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29.

**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. See Service Inception Date.

**Implicit Service Period**

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

**Income Taxes**

Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.

**Intrinsic Value**

The amount by which the fair value of the underlying stock exceeds the exercise price of an option. 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 nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.)

**Lattice Model**

A model that produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time 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 for the purpose of valuing a financial instrument. In this context, a lattice model is based on risk-neutral valuation and a contingent claims framework. See Closed-Form Model for an explanation of the terms risk-neutral valuation and contingent claims framework.

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

**Measurement Date**

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.

**Modification**

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

**Nonpublic Entity**

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.
Nonvested Shares
Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

Option
Unless otherwise stated, a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. Options include, but are not limited to, options granted to employees and stock purchase agreements entered into with employees. Options are considered securities. See Call Option.

Owners
Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities.

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 event or events are likely to occur.

Public Entity
An entity that meets any of the following criteria:
   a. Has equity securities that trade in a public market, either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally
   b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market
   c. Is controlled by an entity covered by the preceding criteria. That is, a subsidiary of a public entity is itself a public entity.

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 not a public entity.

Purchased Call Option
A contract that allows the reporting entity to buy a specified quantity of its own stock from the writer of the contract at a fixed price for a given period. See Call Option.

Related Parties
Related parties include:
   a. Affiliates of the entity
   b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

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

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

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

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

**Reload Feature and Reload Option**

A reload feature provides for automatic grants of additional options whenever an employee exercises previously granted options using the entity’s shares, rather than cash, to satisfy the exercise price. At the time of exercise using shares, the employee is automatically granted a new option, called a reload option, for the shares used to exercise the previous option.

**Replacement Award**

An award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

**Requisite Service Period**

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

**Restricted Share**

A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed nonvested shares because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. The term restricted shares refers only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time. Vested equity instruments that are transferable to an employee’s immediate family members or to a trust that benefits only those family members are restricted if the transferred instruments retain the same prohibition on sale to third parties. See Nonvested Shares.

**Restriction**

A contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time.

**Securities and Exchange Commission Registrant**

An entity (or an entity that is controlled by an entity) that meets any of the following criteria:

a. It has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.
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.

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

Settlement of an Award
An action or event that irrevocably extinguishes the issuing entity’s obligation under a share-based payment award. Transactions and events that constitute settlements include the following:
   a. Exercise of a share option or lapse of an option at the end of its contractual term
   b. Vesting of shares
   c. Forfeiture of shares or share options due to failure to satisfy a vesting condition
   d. An entity’s repurchase of instruments in exchange for assets or for fully vested and transferable equity instruments.

The vesting of a share option is not a settlement because the entity remains obligated to issue shares upon exercise of the option.

Share Option
A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options.

Share Unit
A contract under which the holder has the right to convert each unit into a specified number of shares of the issuing entity.

Share-Based Payment Arrangements
An arrangement under which either of the following conditions is met:
   a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.
   b. The entity incurs liabilities to suppliers that meet either of the following conditions:
      1. The amounts are based, at least in part, on the price of the entity’s shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity’s shares and something other than either the price of the entity’s shares or a market, performance, or service condition.)
      2. The awards require or may require settlement by issuance of the entity’s shares.

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

Also called share-based compensation arrangements.

Share-Based Payment Transactions
A transaction under a share-based payment arrangement, including a transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity awards a share-based payment to an employee or other supplier of goods or services for the entity’s benefit.

Also called share-based compensation transactions.
**Short-Term Inducement**

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.

**Tandem Award**

An award with two or more components in which exercise of one part cancels the other(s).

**Terms of a Share-Based Payment Award**

The contractual provisions that determine the nature and scope of a share-based payment award. For example, the exercise price of share options is one of the terms of an award of share options. As indicated in paragraph 718-10-25-15, the written terms of a share-based payment award and its related arrangement, if any, usually provide the best evidence of its terms. However, an entity’s past practice or other factors may indicate that some aspects of the substantive terms differ from the written terms. The substantive terms of a share-based payment award, as those terms are mutually understood by the entity and a party (either an employee or a nonemployee) who receives the award, provide the basis for determining the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the award and related arrangement, if any, are structured. See paragraph 718-10-30-5.

**Temporary Difference**

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites eight examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements
b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

**Time Value**

The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5. If the fair value of that option is $7, the time value of the option is $2 ($7 – $5).

**Valuation Allowance**

The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

**Vest**

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

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

**Volatility**

A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.
Appendix D — Example Disclosure of Share-Based Payment Awards

The example disclosure included within this appendix is taken directly from ASC 718-10-55-134 through 55-137.

ASC 718-10

Example 9: Disclosure
This Example illustrates disclosures (see paragraphs 718-10-50-1 through 50-2) of a public entity’s share-based compensation arrangements. The illustration assumes that compensation cost has been recognized in accordance with this Topic for several years. The amount of compensation cost recognized each year includes both costs from that year’s grants and costs from prior years’ grants. The number of options outstanding, exercised, forfeited, or expired each year includes options granted in prior years.

On December 31, 20Y1, the Entity has two share-based compensation plans: The compensation cost that has been charged against income for those plans was $29.4 million, $28.7 million, and $23.3 million for 20Y1, 20Y0, and 20X9, respectively. The total income tax benefit recognized in the income statement for share-based compensation arrangements was $10.3 million, $10.1 million, and $8.2 million for 20Y1, 20Y0, and 20X9, respectively. Compensation cost capitalized as part of inventory and fixed assets for 20Y1, 20Y0, and 20X9 was $0.5 million, $0.2 million, and $0.4 million, respectively.

Case A: Share Option Plan
The following illustrates disclosure for a share option plan.

The Entity’s 20X4 employee share option plan, which is shareholder-approved, permits the grant of share options and shares to its employees for up to 8 million shares of common stock. Entity A believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of Entity A’s stock at the date of grant; those option awards generally vest based on 5 years of continuous service and have 10-year contractual terms. Share awards generally vest over five years. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the employee share option plan).

The fair value of each option award is estimated on the date of grant using a lattice-based option valuation model that uses the assumptions noted in the following table. Because lattice-based option valuation models incorporate ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based on implied volatilities from traded options on Entity A’s stock, historical volatility of Entity A’s stock, and other factors. Entity A uses historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; the range given below results from certain groups of employees exhibiting different behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

<table>
<thead>
<tr>
<th></th>
<th>20Y1</th>
<th>20Y0</th>
<th>20X9</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected volatility</td>
<td>25%–40%</td>
<td>24%–38%</td>
<td>20%–30%</td>
</tr>
<tr>
<td>Weighted-average volatility</td>
<td>33%</td>
<td>30%</td>
<td>27%</td>
</tr>
<tr>
<td>Expected dividends</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Expected term (in years)</td>
<td>5.3–7.8</td>
<td>5.5–8.0</td>
<td>5.6–8.2</td>
</tr>
<tr>
<td>Risk-free rate</td>
<td>6.3%–11.2%</td>
<td>6.0%–10.0%</td>
<td>5.5%–9.0%</td>
</tr>
</tbody>
</table>
Appendix D — Example Disclosure of Share-Based Payment Awards
A Roadmap to Accounting for Share-Based Payment Awards

**ASC 718-10 (continued)**

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.

<table>
<thead>
<tr>
<th>Options</th>
<th>Shares (000)</th>
<th>Weighted-Average Exercise Price</th>
<th>Weighted-Average Remaining Contractual Term</th>
<th>Aggregate Intrinsic Value ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding at January 1, 20Y1</td>
<td>4,660</td>
<td>$42</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Granted</td>
<td>950</td>
<td>60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercised</td>
<td>(800)</td>
<td>36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forfeited or expired</td>
<td>(80)</td>
<td>59</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outstanding at December 31, 20Y1</td>
<td>4,730</td>
<td>$47</td>
<td>6.5</td>
<td>$85,140</td>
</tr>
<tr>
<td>Exercisable at December 31, 20Y1</td>
<td>3,159</td>
<td>$41</td>
<td>4.0</td>
<td>$75,816</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Nonvested Shares</th>
<th>Shares (000)</th>
<th>Weighted-Average Grant-Date Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonvested at January 1, 20Y1</td>
<td>980</td>
<td>$40.00</td>
</tr>
<tr>
<td>Granted</td>
<td>150</td>
<td>63.50</td>
</tr>
<tr>
<td>Vested</td>
<td>(100)</td>
<td>35.75</td>
</tr>
<tr>
<td>Forfeited</td>
<td>(40)</td>
<td>55.25</td>
</tr>
<tr>
<td>Nonvested at December 31, 20Y1</td>
<td>990</td>
<td>$43.35</td>
</tr>
</tbody>
</table>

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.

**Case B: Performance Share Option Plan**

The following illustrates disclosure for a performance share option plan.

Under its 20X7 performance share option plan, which is shareholder-approved, each January 1 Entity A grants selected executives and other key employees share option awards whose vesting is contingent upon meeting various departmental and company-wide performance goals, including decreasing time to market for new products, revenue growth in excess of an index of competitors’ revenue growth, and sales targets for Segment X. Share options under the performance share option plan are generally granted at-the-money, contingently vest over a period of 1 to 5 years, depending on the nature of the performance goal, and have contractual lives of 7 to 10 years. The number of shares subject to options available for issuance under this plan cannot exceed 5 million.

The fair value of each option grant under the performance share option plan was estimated on the date of grant using the same option valuation model used for options granted under the employee share option plan and assumes that performance goals will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost is reversed. The inputs for expected volatility, expected dividends, and risk-free rate used in estimating those options’ fair value are the same as those noted in the table related to options issued under the employee share option plan. The expected term for options granted under the performance share option plan in 20Y1, 20Y0, and 20X9 is 3.3 to 5.4 years, 2.4 to 6.5 years, and 2.5 to 5.3 years, respectively.
### ASC 718-10 (continued)

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.

<table>
<thead>
<tr>
<th>Performance Options</th>
<th>Shares (000)</th>
<th>Weighted-Average Exercise Price</th>
<th>Weighted-Average Remaining Contractual Term</th>
<th>Aggregate Intrinsic Value ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding at January 1, 20Y1</td>
<td>2,533</td>
<td>$44</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Granted</td>
<td>995</td>
<td>60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercised</td>
<td>(100)</td>
<td>36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forfeited</td>
<td>(604)</td>
<td>59</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outstanding at December 31, 20Y1</td>
<td>2,824</td>
<td>$47</td>
<td>7.1</td>
<td>$ 50,832</td>
</tr>
<tr>
<td>Exercisable at December 31, 20Y1</td>
<td>936</td>
<td>$40</td>
<td>5.3</td>
<td>$ 23,400</td>
</tr>
</tbody>
</table>

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 realized 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.
Appendix E — Sample SEC Comments: Share-Based Payment Awards

This appendix extracts sample SEC staff comments to registrants relating to share-based payment awards. These comments result from the staff’s review of registrants’ periodic filings over the last few years and have been included to provide insight about the nature of the staff’s questions to registrants. While these are actual SEC comments, registrants are encouraged to consider them in light of their particular facts and circumstances — in particular, whether the topics discussed in the staff’s comments are relevant and material.¹

For additional information on comment letter trends affecting share-based payments and other topics, see Deloitte’s SEC Comment Letters — Including Industry Insights.

Disclosures

<table>
<thead>
<tr>
<th>Examples of SEC Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Please review the disclosure requirements for stock-based compensation found at ASC 718-10-50 and provide the following disclosures in future annual filings:</td>
</tr>
<tr>
<td>o [Please] revise future filings to include the total intrinsic value of options exercised during the year pursuant to ASC 718-10-50-2d2;</td>
</tr>
<tr>
<td>o Please disclose the weighted-average remaining contractual term of options currently exercisable pursuant to ASC 718-10-50-2e; and</td>
</tr>
<tr>
<td>o Please revise future filings to include the method used to estimate the fair value of all of your options, as well as, the significant assumptions used to determine fair value pursuant to ASC 718-10-50-2b &amp; f.</td>
</tr>
<tr>
<td>• Please revise your future filings to conform to the disclosure requirements of ASC 718-10-50 and specifically include the following:</td>
</tr>
<tr>
<td>o the weighted-average exercise price of share grants outstanding at the beginning and end of the year; share grants exercisable at year-end; and share grants granted, forfeited and distributed during the period;</td>
</tr>
<tr>
<td>o the total intrinsic value of share grants exercised during the year;</td>
</tr>
<tr>
<td>o the weighted-average remaining contractual term of share grants fully vested and those expected to vest; and</td>
</tr>
<tr>
<td>o the method used to estimate fair value of the share grants and the related significant assumptions.</td>
</tr>
<tr>
<td>• In future periodic filings, please include all disclosures required by ASC 718-10-50, including 1) for each year for which an income statement is provided, the weighted-average grant-date fair value of equity options or other equity instruments granted during the year, and 2) as of the latest balance sheet date presented, the total compensation cost related to non-vested awards not yet recognized and the weighted-average period over which it is expected to be recognized.</td>
</tr>
<tr>
<td>• We note your disclosures that you have restricted stock and stock options outstanding as of December 31, [201X]. Please revise your disclosure . . . to include the disclosures required by ASC 718-10-50. These disclosures include detail of the number and weighted average exercise prices for share options outstanding at the beginning of the year, granted during the year, exercised or converted, forfeited or expired. Please revise accordingly.</td>
</tr>
<tr>
<td>• Please disclose for the most recent year for which an income statement is provided the number and weighted-average grant date fair value for each of the following groups of restricted shares: (a) those nonvested at the beginning of the year, (b) those nonvested at the end of the year, and those (c) granted, (d) vested, or (e) forfeited during the year. Refer to FASB ASC 718-10-50-2.c. For each year for which an income statement is provided, please disclose the weighted average grant date fair value of restricted stock granted during the year and the total fair value of restricted shares vested during the year.</td>
</tr>
</tbody>
</table>

¹ In recent remarks, SEC commissioners and staff have emphasized disclosure effectiveness. Specifically, the staff has noted that registrants can help to make disclosures more effective by tailoring them to the registrant’s facts and circumstances and focusing disclosures on matters that are relevant and material for an investor in making a voting decision.
Example of an SEC Comment

- In future filings please provide all of the disclosures required by [ASC 718-10-50-1 and 50-2], including the following:
  - Significant assumptions underlying your Black Scholes valuations such as expected term, expected volatility, and the risk-free rate;
  - For each year for which an income statement is presented, present total compensation cost for share-based payment arrangements recognized in income as well as the total recognized tax benefit related thereto and the total compensation cost capitalized as part of the cost of an asset; and
  - Disclose, as of the latest balance sheet date presented, the total compensation cost related to non-vested awards not yet recognized and the weighted-average period over which you expected to recognize these costs.

Registrants should ensure that their disclosures address the following objectives outlined in ASC 718-10-50-1:

- The “nature and terms” of share-based payment arrangements.
- The “effect of [the related] compensation cost . . . on the income statement.”
- The “method [for determining] the fair value of the equity instruments granted.”
- The “cash flow effects [of] share-based payment arrangements.”

Accordingly, the SEC staff’s comments on share-based payment disclosures have focused on items such as:

- The nature of, and reason for, a modification in the share-based payment award’s terms and how the registrant accounted for that modification.
- The terms and conditions of awards, including whether award holders are entitled to dividends or dividend equivalents.
- The number of options that are expected to vest and the assumptions used in developing those expectations.
- The registrant’s valuation method, including significant assumptions used (e.g., volatility).

In its comments about disclosures, the SEC staff frequently refers to ASC 718-10-50-2, which describes the “minimum information needed to achieve the objectives in [ASC 718-10-50-1].”

In addition to commenting on the types of share-based payment transactions discussed above, the SEC staff often asks registrants about share-based payment information they are required to include in a proxy statement (e.g., those disclosures required by Regulation S-K, Item 402).

Financial Statement Presentation

Examples of SEC Comments

- We note you have presented certain line items of expenses classified based on the payment arrangement (i.e. cash and stock based) separately. Please revise to remove stock-based expenses presented as separate line items and classify such expenses related to stock based payment arrangement into respective expense captions where related cash compensation costs are ordinarily classified.
- In future filings, please revise your presentation of stock compensation to include such amounts in the same line or lines [of the financial statements as] cash compensation paid to the same individuals is presented. For reference see SAB Topic 14.F.
- Please show us how to reconcile stock-based compensation expense for the years presented in the footnotes and statements of cash flows to amounts of stock-based compensation, restricted share activity and issuance of common stock presented in the statements of shareholders’ equity.

Under SAB Topic 14.F, share-based compensation expenses should be classified in the same manner as other cash compensation costs, and the presentation should not be driven by the form of consideration paid. Share-based compensation expense should be allocated to items such as cost of sales, R&D, and SG&A (as applicable) and should not be separately presented in a single share-based compensation line item. Further, SAB Topic 14.F states, “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.”
Share-Based Payment Awards Issued by Privately Held Companies

**Example of an SEC Comment**

Please tell us about each significant factor contributing to the difference between the estimated IPO Price and the fair value of your shares since the September 2013 grant and any subsequent grants through the date of your response. In your response, please tell us about significant intervening events and reasons for changes in assumptions, as well as the weighting of expected outcomes and selection of valuation techniques employed.

Calculating share-based compensation for privately held companies can be complex and may require registrants to use significant judgment in determining the fair value of the equity instrument because there is typically no active market for the common stock of such companies. The SEC staff continues to comment on registrants’ accounting and valuation assumptions for equity securities issued as compensation in periods before an IPO (commonly referred to as “cheap stock” considerations). The AICPA’s accounting and valuation guide (known as the “Cheap Stock Guide”) contains guidance on these accounting considerations.

A registrant preparing for an IPO should also refer to paragraph 7520.1 of the FRM, which outlines considerations for registrants when the “estimated fair value of the stock is substantially below the IPO price.” In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

While the SEC staff has historically asked registrants to expand the disclosures in their critical accounting estimates to provide additional information about the valuation methods and assumptions used for share-based compensation in an IPO, it recently updated its FRM to indicate that registrants should significantly reduce such disclosures. Specifically, the staff revised Section 9520 of the FRM to clarify what disclosures are expected in an IPO registration statement and thereby encourage registrants to provide less information about cheap stock. However, paragraph 9520.2 of the FRM notes that the staff may continue to “issue comments asking companies to explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO).” Such requests are meant to ensure that a registrant’s analysis and assessment support its accounting for share-based compensation and do not necessarily indicate that the registrant’s disclosures need to be enhanced.

At the Practising Law Institute’s “SEC Speaks in 2014” Conference, the SEC staff provided insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM (and thereby reduce their share-based compensation disclosures):

- **The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares.** A registrant need only state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would not be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a statement indicating that “a discounted cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate”; no additional details would be needed.

- **Registrants would have to include a statement indicating that the estimates in their share-based compensation valuations are “highly complex and subjective.”** They would not need to provide additional details about the estimates.

- **Registrants would also need to include a statement disclosing that such “valuations and estimates will no longer be necessary once the company goes public [because] once it goes public, it will rely on the market price to determine the market value of [its] common stock.”**
Valuation of Awards

Examples of SEC Comments

- Please revise this note in future filings to disclose the significant assumptions such as the volatility, risk free interest rate, expected life, etc. utilized in the Black-Scholes Model used to value your outstanding warrants. Refer to the guidance in 718-10-50-2 of the FASB Accounting Standard Codification.

- Please tell us why you generally base the grant date fair value of options on the closing price of your common stock on the date of grant. Explain other methods of valuation you used and the circumstances in which you used them.

- We noted that you determined expected volatility for stock options based upon a combination of the historical volatility of your common stock, historical volatility of comparable companies’ common stock, implied volatility of your traded options and implied volatility of comparable companies’ traded options. Please describe and tell us how you considered disclosing the basis for using a combination of these volatilities in determining the expected volatility of your stock options including how you weight each of these categories. Refer to Question 5 of SAB Topic 14.D.1.

- We note from your disclosure on pages [X] and [Y] that you value your restricted stock, including [restricted stock plan A], based on their intrinsic value. Please explain your methodology in more detail and clarify whether the value is based on the market value of your common stock. Include reference to authoritative literature used as guidance.

- We note your disclosure that in computing your expected volatility in valuing your option awards you use a combination of historical and market-based implied volatility. This appears to be a change from your policy at the end of [prior] fiscal year . . . in which you disclose that you use historical volatility for determining your expected volatility. Please revise your future filings to include a discussion of the basis for your conclusions regarding the extent to which you used historical volatility and implied volatility. Please also summarize your evaluation of the factors in Question 3 and Question 6 of SAB Topic 14.D.1. Refer to Question 5 of SAB Topic 14.D.1.

Registrants have been asked to disclose more specific information about the valuation methods they use for sharebased awards, including significant assumptions. The staff is particularly interested in how registrants determine the expected volatility and the expected term. Assumptions about these matters are subjective and can significantly affect the award’s fair-value-based amount. Sometimes, the staff may question whether the assumptions are based on the best available information. For example, if registrants disclose that they have employee and director options and use the same assumptions to determine the expected life and volatility for both types of options, the staff may question why this is appropriate.

In addition, the SEC staff has asked about the valuation of share-based awards made before a registrant’s IPO. Examples of common questions are:

- Whether the valuation was a contemporaneous or retrospective valuation of the stock on the issuance date of the award.

- Whether an unrelated valuation specialist did the valuation.

- Whether the registrant used the best practices identified in the AICPA Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation.

In this regard, the SEC may also request a copy of the valuation.
Simplified Method

Examples of SEC Comments

- We note your disclosure that you used the simplified method to estimate the expected term as you do not have sufficient historical exercise data due to the limited period of time the equity shares have been publicly traded. In light of the fact that you became a publicly traded company (more than five years ago), please explain to us why you believe it is appropriate to use the simplified method for stock option grants (in the current year).
- With a view towards future disclosure, please tell us when or if you expect to discontinue your use of the “simplified method” to calculate the expected holding periods of your options.
- We note from your disclosures on page [X] that you use the simplified method to estimate the expected term in your option valuation model. Please tell us whether information is available from other sources to make more refined estimates of the expected term. If so, explain further why you continue to use the simplified method or tell us when management expects that sufficient information will be available such that use of the simplified method will no longer be necessary. We refer you to Question 6 of SAB Topic 14.D.2.
- We note your disclosure that expected life in years for all stock option awards was determined using the simplified method. Please explain to us and disclose in future filings the reason why the simplified method was used.
- We note that you continue to use the simplified method for determining the expected life of your stock options as your historical data does not provide a reasonable basis on which to estimate the expected term due to the period of time that individuals were unable to exercise options while the company was not current with its filings. Considering the passage of time since you achieved compliance, clarify for us why you continue to believe that you do not have sufficient historical data upon which to estimate the expected term. Also, tell us when management expects that sufficient information will be available. We refer you to Question 6 of SAB Topic 14.D.2.

Under ASC 718, the term that an option is expected to be outstanding is a key factor in measuring its fair-value-based amount and the related compensation cost. SAB Topic 14.D.2 outlines the simplified method of estimating the expected term of “plain vanilla” share options and permits entities, under certain circumstances, to continue to use the simplified method if a conclusion is reached that it is not reasonable to base the estimate of expected term on historical share option exercise experience. In certain instances, however, the SEC staff has asked registrants to explain why they believe the historical share option experience does not provide a reasonable basis for estimating expected term.

Accelerated Vesting

Examples of SEC Comments

- We note that you accelerated the vesting of certain stock option and stock appreciation rights due to declines in your stock price. Please explain to us how you considered FASB ASC 718-10-55-67 related to the acceleration of vesting of these awards.
- We note . . . you accelerated the vesting of [SX] million “out-of-the-money” stock options previously awarded to your non-officer and non-director employees and that you will record the related . . . unrecognized stock-based compensation over the remainder of the original vesting period. . . . As we note that your accounting would only be applicable to the acceleration of deep out-of-the-money stock options, please tell us and revise future filings to describe to us your policy for identifying a stock option as “deep out-of-the-money.” In addition, tell us and revise future filings to disclose whether all of the options for which you accelerated vesting were ‘deep out-of-the-money’ and if not, explain how you accounted for the acceleration of those stock options that were not.
- We note that you accelerated the vesting of certain stock option and stock appreciation rights due to declines in your stock price. Please explain to us how you considered FASB ASC 718-10-55-67 related to the acceleration of vesting of these awards.
- Please revise footnote (f) to disclose how the additional $[X] million of compensation expense as a result of accelerated vesting was calculated or determined.
- We note your disclosure in the [X] paragraph regarding exclusion of the value of any accelerated vesting stock awards. Please disclose the number of stock awards that are subject to acceleration.

The SEC staff has previously indicated that the guidance in ASC 718-10-55-67 applies to modifications of share option awards that are deep out of the money. That is, the acceleration of the vesting of a deep out-of-the-money award is not substantive because the explicit service period is replaced with a derived service period. Accordingly, any remaining unrecognized compensation cost should not be recognized immediately. In addition, the staff indicated that because the acceleration of the vesting of the award is not substantive, an entity should generally continue to recognize the compensation cost over the remaining original service period.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs

The primary source of U.S. GAAP guidance on accounting for share-based payment awards, as discussed in this publication, is ASC 718 (for employees) and ASC 505-50 (for nonemployees), while the primary source of guidance on this topic under IFRSs is IFRS 2. Although much of the U.S. GAAP guidance is converged with that in IFRSs, differences do exist. Some of the more notable differences include the following:

- **Accounting for group transactions** — Share-based payment awards that are issued by a subsidiary to employees of the subsidiary and that are settled in the parent’s equity are generally classified as equity awards in the stand-alone financial statements of the subsidiary under U.S. GAAP; however, such awards are classified as liability awards under IFRSs.

- **Graded vesting awards** — Under U.S. GAAP, entities may elect, as an accounting policy, to recognize and measure graded vesting share-based payment awards (that only contain a service condition) as either a single award or, in substance, multiple awards; however, such awards may only be recognized and measured as, in substance, multiple awards under IFRSs.

- **Classification: risks and rewards for a reasonable period** — Under U.S. GAAP, a share-based payment award that can be redeemed for cash at fair value is not classified as a liability if the award requires the employee to bear the risks and rewards of share ownership for a reasonable period; such awards must be classified, at least in part, as a liability under IFRSs.

- **Contingent features** — Under U.S. GAAP, certain contingent features (i.e., clawback) of a share-based payment award are excluded from the grant-date fair-value-based measure and accounted for if and when the contingent event occurs; under IFRSs, a contingent feature is considered a nonvesting condition and included in the grant-date fair value of the award.

- **Modification of awards for which vesting is improbable but becomes probable** — Compensation cost is recognized on the basis of the modified award’s fair value under U.S. GAAP; under IFRSs, compensation cost is recognized on the basis of the grant-date fair value of the original award plus the incremental value of the modified award on the modification date.

- **Measurement of deferred taxes** — Under U.S. GAAP, a DTA is recorded for tax-deductible awards on the basis of the GAAP expense recognized and adjusted only when the related compensation cost is recognized for tax purposes; under IFRSs, entities must use the tax deduction that would be available on the basis of current share prices as of each reporting date when measuring the DTA.

- **Income tax deductions** — Under U.S. GAAP, the tax deficiency related to the shortfall between the tax deduction and the compensation cost recognized for equity-classified awards is recorded as a debit to equity to the extent that prior excess tax benefits exist (i.e., APIC pool) and as an income tax expense in the absence of prior excess tax benefits. In contrast, under IFRSs, the tax deficiency related to the shortfall between the tax deduction and the compensation cost recognized is always recorded as income tax expense.

- **Nonpublic company exceptions** — Under U.S. GAAP, nonpublic entities may use a calculated or intrinsic value instead of fair value to measure share-based payment awards when certain conditions are met; IFRSs do not provide the same exception.

- **ESPPs** — Compensation cost does not have to be recognized for ESPPs that meet certain conditions under U.S. GAAP; under IFRSs, however, compensation cost must be recognized for all share-based payment awards (including ESPPs).
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

The following is an excerpt from Chapter A16, “Share-based Payment,” of Deloitte’s iGAAP publication. Requirements extracted from official IASB material are shown as unshaded text. Interpretive material supplementing the IASB’s guidance is highlighted by gray shading or in example boxes.


1 Introduction

1.1 Overview of IFRS 2

IFRS 2 Share-based Payment requires an entity to recognise share-based payment transactions (such as granted shares, share options or share appreciation rights) in its financial statements, including transactions with employees or other parties to be settled in cash, other assets or equity instruments of the entity. Specific requirements are included for equity-settled and cash-settled share-based payment transactions, as well as those for which the entity or the supplier has a choice of settlement by cash or equity instruments.

It is important to appreciate that IFRS 2 may be applicable even when the counterparty receives cash from the entity. This is because the scope of the Standard includes cash-settled share-based payment transactions, as explained in section 2.

The expense recognised under IFRS 2 is unaffected by whether the award is satisfied by an issue of new shares or by shares being purchased in the market. When shares are purchased in the market, an employee share trust may be involved (see section 9).

1.2 Amendments to IFRS 2 since the last edition of this manual

IFRS 2 was most recently amended in December 2013 by Annual Improvements to IFRSs: 2010–2012 Cycle. The amendments are intended to clarify the definition of ‘vesting condition’ so as to ensure consistent classification of conditions attached to share-based payments. In addition, separate definitions for ‘performance condition’ and ‘service condition’ (which were previously part of the definition of vesting condition) have been added to the Standard to make the description of each condition clearer (see section 4).

2 Scope

2.1 Scope — general

IFRS 2 should be applied to each ‘share-based payment transaction’ as defined in IFRS 2:Appendix A (see 2.2.1) subject to the exceptions in IFRS 2:3A to 6 (see 2.4 to 2.7).

2.2 Scope — definitions

2.2.1 Share-based payment transaction — definition

The definition of a share-based payment transaction is as follows.

[IFRS 2:Appendix A]

“A transaction in which the entity

  (a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

  (b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.”

2.2.2 Share-based payment arrangement — definition

The definition of a share-based payment transaction in 2.2.1 uses the term ‘share-based payment arrangement’ which is also defined in IFRS 2:Appendix A. The definition is as follows.

[IFRS 2:Appendix A]
“An agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) equity instruments (including shares or share options) of the entity or another group entity,

provided that the specified vesting conditions, if any, are met.”

A footnote to IFRS 2 notes that, for this purpose, a ‘group’ is defined in Appendix A of IFRS 10 Consolidated Financial Statements as “a parent and its subsidiaries” from the perspective of the reporting entity’s ultimate parent.

Cash-settled Share Appreciation Rights (SARs) are the most common example of an arrangement under which the entity acquires goods or services by incurring a liability to transfer cash or other assets for amounts based on the price (or value) of the entity’s shares or other equity instruments; such arrangements are sometimes referred to as ‘phantom option schemes’. Typically, these schemes put the employees in the same position as if they had been granted options, but they involve a cash payment to the employees equal to the gain that would have been made by exercising the notional options and immediately selling the shares in the market.

2.2.3 Equity instrument — definition
‘Equity instrument’ is defined as follows.
[IFRS 2:Appendix A]
“A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”

This definition is consistent with paragraph 11 of IAS 32 Financial Instruments: Presentation.

2.2.4 Equity instrument granted — definition
‘Equity instrument granted’ is defined as follows.
[IFRS 2:Appendix A]
“The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.”

2.2.5 Meaning of ‘goods or services’

IFRS 2 does not include a formal definition of either goods or services, although IFRS 2:5 specifies that goods would include inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets, and that equity instruments granted to employees are within the scope of the Standard. As discussed at 2.8, IFRS 2:2 confirms that goods or services do not have to be identifiable to be within the scope of IFRS 2.

IFRS 2 does not apply to transactions in which an entity acquires goods as part of the net assets acquired in a business combination as defined by IFRS 3 Business Combinations or to the contribution of a business on formation of a joint venture as defined in IFRS 11 Joint Arrangements (see section 2.6).

2.3 Identifying share-based payment transactions — examples

2.3.1 Cash payment based on earnings multiple

Example 2.3.1
Cash payment based on earnings multiple

Company N, an unlisted entity, issued instruments to its employees that entitle them to a cash payment equal to the increase in Company N’s ‘share price’ (as defined) between the grant date and the vesting date. The terms and conditions of the instrument define the ‘share price’ as a specified multiple of EBITDA divided by the number of shares in issue.

Arrangements of this nature will not usually be in the scope of IFRS 2 because a specified multiple of EBITDA will not necessarily reflect the fair value of the shares; historical earnings is only one of the inputs used to determine the fair value of shares in an entity. Such arrangements will more likely fall within the scope of IAS 19 Employee Benefits.
2.3.2 Remuneration scheme based on a profit formula

Company A has a deferred bonus incentive scheme. The value of the entitlements is based on a formula derived from Company A’s net profit (adjusted for specified items) and then divided by a fixed number. This entitlement vests over 3 years. The payment to the employee on vesting date, or the date that the employee chooses to receive settlement after the entitlement has vested, is funded by the cash resources of Company A.

Example 2.3.2 Remuneration scheme based on a profit formula

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUm</td>
<td>CUm</td>
<td>CUm</td>
</tr>
<tr>
<td>3,000</td>
<td>3,500</td>
<td>4,100</td>
</tr>
<tr>
<td>CU</td>
<td>CU</td>
<td>CU</td>
</tr>
<tr>
<td>300</td>
<td>350</td>
<td>410</td>
</tr>
</tbody>
</table>

A participant who exercises his or her right to receive settlement for a vested entitlement will receive the difference between the current entitlement value and the grant date entitlement value in cash.

A participant who exercises his or her right to receive settlement for a vested entitlement will receive the difference between the current entitlement value and the grant date entitlement value in cash.

In the example, if a participant received 100 entitlements at an entitlement value of CU250, the participant would receive CU16,000 (100 × (CU410 – CU250)) at the end of Year 3.

This remuneration scheme does not fall within the scope of IFRS 2. The entitlements issued by Company A represent a bonus scheme that does not result in the issue of equity instruments or in a liability that is linked to the price of Company A’s shares or other equity instruments of Company A; the scheme is an employee benefits scheme within the scope of IAS 19. The benefits payable under the scheme do not meet the definition of ‘short-term employee benefits’ under IAS 19 because they are not expected to be settled wholly within twelve months after the end of the annual reporting period in which the related service is rendered. Therefore, the recognition and measurement requirements of IAS 19 for other long-term employee benefits should be applied.

2.3.3 Employee share loan plans

In November 2005, the IFRIC (now the IFRS Interpretations Committee) was asked to consider the accounting treatment of employee share loan plans. Under many such plans, employee share purchases are facilitated by means of a loan from the grantor with recourse only to the shares. The IFRIC was asked whether the loan should be considered as part of a potential share-based payment, with the entire arrangement treated as an option under IFRS 2, or whether the loan should be accounted for separately as a financial asset. The IFRIC noted that when the loan is with recourse only to the shares (sometimes referred to as ‘limited recourse’ or ‘non-recourse’), the issue of shares using the proceeds of the loan would be treated as a grant of options that are exercised when the loan is repaid. The IFRIC determined that it would not expect diversity in practice and, therefore, did not take this item onto its agenda.

Example 2.3.3A and example 2.3.3B illustrate the application of this principle to a non-recourse loan. Example 2.3.3C examines the contrasting position of a full recourse loan.

Example 2.3.3A Employee share loan plans

Company R grants loans to its employees that subsequently are to be used by the employees to buy shares in Company R. For the purpose of obtaining settlement of the loans, Company R only has recourse to the shares bought by the employees.

Should these loans be considered part of a share-based payment arrangement accounted for under IFRS 2 (with the entire arrangement treated as an option), or should they be accounted for as financial assets in accordance with IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement)?

The employee share loan plan should be accounted for in accordance with IFRS 2 because it falls within the scope of IFRS 2.2(c) — i.e. it results in “transactions in which the entity receives . . . services and the terms of the arrangement provide . . . the supplier of those . . . services with a choice of whether the entity settles the transaction in cash . . . or by issuing equity instruments”.

Because, for the purpose of obtaining settlement of the loans, Company R only has recourse to the shares bought by the employees, Company R effectively issues share options to its employees who use the loans granted to pay for the shares. Exercise of the options would be on the date or dates when the loan is repaid by the employee.
### Example 2.3.3B
**Non-recourse loan to purchase shares**

Company L provides an interest-free loan in the amount of CU100 to one of its executives to purchase shares with a fair value of CU100 in the open market. The shares are used as collateral for the loan balance and, therefore, cannot be sold by the executive during the four-year vesting period. If the executive remains employed with Company L at the end of four years, the entire amount of the loan is forgiven and the shares are released from all restrictions. If the executive leaves Company L's employment during the vesting period, the shares are transferred to Company L and, regardless of value, are considered full payment of the loan.

Because the executive has no risk of owing more than the shares are worth, the substance of the transaction is the issue of restricted shares that vest at the end of four years and, therefore, the transaction is within the scope of IFRS 2. As a result, the fair value of the restricted shares at the grant date should be expensed over the vesting period.

### Example 2.3.3C
**Full recourse loan to purchase shares**

Company L provides an interest-free loan in the amount of CU100 to one of its executives to purchase shares with a fair value of CU100 in the open market under the following terms:

- the shares are used as collateral for the loan balance and, therefore, cannot be sold by the executive during the four-year vesting period;
- if the executive remains employed with Company L at the end of the four years, the entire amount of the loan is forgiven and the shares are released from all restrictions;
- if the executive leaves Company L’s employment during the vesting period, the shares are returned to Company L; and
- if the market price of the shares at the date the executive leaves Company L is less than the amount repayable under the loan, Company L has recourse to the personal assets of the executive.

To conclude whether the substance of this arrangement represents the granting of share options under IFRS 2, all facts and circumstances should be assessed carefully. In particular, the following factors should be considered:

- whether the employer intends to seek repayment beyond the shares issued; and
- whether the employer has a history of demanding repayment of loan amounts in excess of the fair value of shares.

If it is concluded that the loan represents a full recourse lending arrangement, Company L should account for the loan in accordance with IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39), including the recognition of any interest-free component as an expense. If the loan is subsequently forgiven, the resulting expense is recognised under IAS 19 as an employee benefit.

### 2.3.4 Bonus to be settled either in cash or in shares ‘to the value of’

**Bonus to be settled either in cash or in shares ‘to the value of’**

Entity P agrees to pay its employees a bonus based on performance criteria unrelated to its share price. The bonus is determined as a monetary sum. The terms of the arrangement permit Entity P the choice of settlement in cash (e.g. CU5,000) or shares to the value of that cash (CU5,000/market value of shares at date of settlement); Entity P has a practice of settling in shares.

The arrangement meets the definition of a share-based payment arrangement under IFRS 2. An equity-settled share-based payment transaction is defined in IFRS 2:Appendix A as a share-based payment transaction “in which the entity receives goods or services as consideration for equity instruments of the entity”. Because Entity P has a practice of settling in shares and has not created a constructive obligation to settle in cash, the award is not a cash-settled share-based payment and, accordingly, is classified as an equity-settled share-based payment.

IFRS 2:BC266 specifically notes that classification as equity-settled or cash-settled on this basis is not consistent with the requirements of IAS 32 for other circumstances when the entity has a choice regarding the manner of settlement. IAS 32 requires arrangements under which the entity has a choice of settlement to be classified either wholly as a liability (if the contract is a derivative contract) or as a compound instrument (if the contract is a non-derivative contract).

Refer to example 5.2.3.4 for guidance on the measurement of an award of shares to a monetary value.
2.3.5 Employees’ taxes on share-based payments paid by employer

**Example 2.3.5**

**Employees’ taxes on share-based payments paid by employer**

Entity A grants share options to senior employees under a share-based payment arrangement within the scope of IFRS 2. Options granted under the arrangement vest after four years if the employees remain in Entity A’s employment at that date.

Under the tax regime in which Entity A operates, the employee is taxed at the grant date based on the market value of the shares at that date. The tax paid at grant date cannot be recovered in the event that the share options do not vest.

Under the terms of the share-based payment arrangement, Entity A has agreed to pay the employees’ taxes on behalf of the employees. The employees have no obligation to refund the taxes paid on their behalf.

The employees’ tax should be expensed in the period in which it is due.

The employees’ tax is paid at grant date and it is not reimbursable. Payment of the employees’ tax by Entity A on behalf of its employees is a separate benefit from the grant of share options. In substance, it is a cash-settled share-based payment award with no vesting period because it cannot be recovered by Entity A if the employees leave before the end of the four-year vesting period.

2.3.6 Preference shares with conversion option issued as consideration for purchase of goods

**Example 2.3.6**

**Preference shares with conversion option issued as consideration for purchase of goods**

Company A acquires an intellectual property intangible asset from Company X. Consideration is in the form of preference shares issued at the time of the transaction.

The issued preference shares have the following characteristics:

- entitlement to an annual non-discretionary 8 per cent dividend to perpetuity;
- the holder of the shares has the right to convert the preference shares to ordinary shares of Company A (adjusted only for capital reorganisations or capitalisation issues that affect all holders of the ordinary shares). The holder can exercise this option at any time from the date of issue of the instruments;
- entitlement to a share of net assets on liquidation after distribution to another class of preference shareholders; and
- no maturity date (i.e. will remain in existence unless converted).

Should the arrangement be accounted for in accordance with the requirements of IFRS 2, or in accordance with IAS 32 and IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39)?

The arrangement should be accounted for as a share-based payment transaction under IFRS 2. Company A has received goods from Company X and has, in return, provided Company X with a choice of settlement in cash (perpetual dividend stream) or equity (ordinary shares). Consequently, the transaction falls within the scope of IFRS 2:2(c).

IFRS 2:35 clarifies that if an entity has granted the counterparty the right to choose whether a share-based payment transaction is settled in cash or by the issue of equity instruments, the entity has granted a compound instrument. The instrument has:

- a liability component — Company X’s right to receive a perpetual stream of 8 per cent dividends; and
- an equity component — Company X’s right to convert to ordinary shares.

Each component is accounted for separately as required by IFRS 2:35:

- the liability component is measured at fair value; and
- the equity component is measured as the difference between the fair value of the intangible asset received and the fair value of the liability component, at the date when the goods or services are received.

The liability component should, in accordance with IFRS 2:30, be recognised in the statement of financial position at fair value and remeasured at the end of each accounting period, with all movements in fair value being recognised in profit or loss. The fair value of the equity component is recognised in equity, with no further remeasurement.

If Company X chooses to exercise the conversion option, at the date of conversion, the liability component is remeasured to its fair value and is transferred directly to equity as the consideration for the equity instruments issued (see IFRS 2:39).

The recognition of liability and equity components at the date of issue of the preference shares is similar to the equivalent requirements of IAS 32, however, the treatment of the liability component subsequent to the issue of the preference shares differs from the equivalent requirements of IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39), which would not require the liability component to be remeasured to fair value on an ongoing basis.

The application of these requirements is illustrated in example 7.2.3.
2.3.7 Share options purchased by employees at fair value but including a service condition

**Example 2.3.7**

**Share options purchased by employees at fair value but including a service condition**

Entity A grants one share option to each of its 100 employees. The share options will vest at the end of two years provided that (1) the employee remains in Entity A's employment at that date, and (2) the EBITDA of Entity A for the second year achieves a specified target.

At the grant date, each recipient is required to make a cash payment of CU100 to Entity A based on an estimated fair value of the share option which reflects the probability that the target EBITDA will be achieved in the second year. Excluding the effect of the EBITDA condition, the fair value of each option would be CU300.

Cash paid by the employees is not refundable in any circumstances. If an employee leaves the employment of Entity A, or if Entity A does not achieve the target EBITDA, no shares will be issued and the employee will not be entitled to a repayment. Accordingly, both the service and the non-market vesting condition are deemed to be substantive.

The transaction should be accounted for as a share-based payment arrangement, with the EBITDA target treated as a non-market vesting condition.

Notwithstanding that the employee is required to pay ‘fair value’ for the share option, the terms of the arrangement are such that the entity receives additional consideration for the share option in the form of the employee’s service for two years. Therefore, the transaction meets IFRS 2’s definition of an equity-settled share-based payment transaction and falls within the scope of IFRS 2. The value of the employee’s service is measured at CU200, which is the difference between the value assigned to the option in accordance with IFRS 2 (i.e. CU300 – excluding the effect of non-market vesting conditions) and the price paid by the employee (CU100).

Payments by employees are accounted for as equity transactions when the cash is received, with no subsequent adjustment made other than a possible transfer between components of equity when shares are issued or options lapse unexercised.

2.3.8 Awards made by shareholders

IFRS 2.3A states that a share-based payment transaction may be settled by a shareholder (of any group entity) and still be within the scope of IFRS 2 (see also 2.4.1).

When a shareholder provides shares for the purposes of an employee share scheme, it will generally be clear that these benefits form part of the remuneration of the employees for their services to the entity. A charge to profit or loss will, therefore, be required in accordance with IFRS 2 for the services received.

On the other hand, a shareholder may make a gift of shares to a close relative who is coincidentally an employee of the entity. Such a gift might not form part of the remuneration of the employee but it will be necessary to look carefully at the facts of each case. For example, it would be necessary to consider whether similar benefits were given to other employees and whether the gift of shares was in any way conditional on continuing employment with the entity.

The most common instance when equity instruments are provided by a shareholder rather than the entity that has received the goods or services is within groups.

2.4 Groups

2.4.1 Parent and subsidiaries

It is often the case that employees of a subsidiary will receive part of their remuneration in the form of shares in the parent, or less commonly in shares of some other group entity. In such circumstances, IFRS 2 requires the entity that has received the benefit of the services to recognise an expense. This is so even if the equity instruments issued are those of another group entity.

The scope of the Standard includes an entity that:

[IFRS 2:3A]

- receives goods or services when another entity in the same group (or a shareholder of any group entity) has the obligation to settle the share-based payment transaction; or
- has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services;

unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them.
Example 2.4.1

Services received in equity-settled share-based payment transaction

Company P is a publicly listed entity that applies US GAAP. Company P has a majority-owned subsidiary, Company S, which applies IFRSs. Company P issues share options in Company P’s ordinary shares to certain employees of Company S.

Company S receives the benefit of the services provided by its employees. As a result, Company S should recognise the expense related to the share-based payment, regardless of whether Company S, or another group entity, issues the share options and regardless of any accounting applied by Company P under US GAAP. When Company P issues the share options, it may also be appropriate to recognise a capital contribution from Company P to Company S (see section 8).

2.4.2 Meaning of ‘entity’ in the context of groups

The definition of a share-based payment arrangement (see 2.2.2) refers when appropriate to an ‘entity or another group entity’.

IFRS 2 is clear that an expense must be recognised by the entity that has received the benefit of the goods or services. When the parent provides the shares, the other side of this accounting entry is a credit to equity which is in the nature of a capital contribution. IFRS 2 addresses the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when the entity has no obligation to settle the share-based payment transactions. The Standard also provides guidance on the circumstances in which an arrangement is equity-settled from the perspective of the group but cash-settled from the perspective of the subsidiary (and vice versa). However, IFRS 2 does not address the effect of charges made between group entities in connection with share-based payment arrangements. The requirements of IFRS 2 for group share-based payment arrangements and some related issues not addressed by the Standard are considered in detail in section 8.

2.5 Transactions with owners in their capacity as owners

The requirements of IFRS 2 should not be applied to transactions with parties (e.g. employees) in their capacity as holders of equity instruments of the entity (referred to as ‘owners’ in IAS 1 Presentation of Financial Statements). For example, a rights issue may be offered to all holders of a particular class of equity (e.g. a right to acquire additional shares at a price that is less than the fair value of those instruments). If an employee is offered the chance to participate purely because he/she is a holder of that class of equity, IFRS 2 is not applied. The requirements of IFRS 2 are only relevant for transactions in which goods or services are acquired. [IFRS 2:4]

Example 2.5

Shares purchased from employee shareholders at fair value

Company D purchases its own shares from employees (in their capacity as shareholders) for an amount that equals the fair value of those shares. This transaction would be considered a purchase of treasury shares and is not within the scope of IFRS 2. However, if Company D pays an amount in excess of fair value only to its employees, that excess would be considered a remuneration expense (see example 5.5.2D).

2.6 Business combinations and formations of joint ventures

2.6.1 Goods acquired in a business combination or on formation of a joint venture generally excluded from the scope of IFRS 2

IFRS 2 applies to share-based payment transactions in which an entity acquires or receives goods or services. Goods include inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. However, IFRS 2 is not applied to transactions in which an entity acquires goods as part of the net assets acquired in a business combination (as defined by IFRS 3 Business Combinations), in a combination of entities or businesses under common control (as described in IFRS 3:B1 to B4), or the contribution of a business on formation of a joint venture (as defined by IFRS 11 Joint Arrangements). [IFRS 2:5]

2.6.2 Equity instruments granted to employees of the acquiree in their capacity as employees

Equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of IFRS 2. But equity instruments granted to employees of the acquiree in their capacity as employees (e.g. in return for continued services in the post-combination period) are within the scope of IFRS 2. Similarly,
cancellation, replacement or other modification of share-based payment arrangements because of a business combination or other equity restructuring are accounted for in accordance with IFRS 2. [IFRS 2:5]

2.6.3 Equity instruments granted to previous owners of the acquiree who are also employees

When shares are issued in a business combination to previous owners of the acquiree who are also employees of the acquiree, it is necessary to determine to what extent they are purchase consideration and to what extent they are share-based payments. IFRS 3 provides guidance for determining whether equity instruments issued in a business combination are part of the consideration transferred in exchange for control of the acquiree (and, therefore, within the scope of IFRS 3) or are in return for continued service to be recognised in the post-combination period (and, therefore, within the scope of IFRS 2). This guidance is considered in section 8.3.3 of [iGAAP] chapter A25.

IFRS 3 also provides guidance on the appropriate accounting for pre-existing acquiree share-based payment awards, both vested and unvested, by an acquirer, including those that lapse, are replaced or are un-replaced (see section 8.3.4 of [iGAAP] chapter A25).

2.6.4 Shares issued by joint ventures in exchange for contributions received

When joint ventures are formed, they frequently issue shares in exchange for contributions from venturers. These contributions can be received in various forms (e.g. cash, assets or businesses).

When the contribution is in the form of cash and the shares are not issued as consideration for goods or services, the cash contribution is received from the venturers in their capacity as owners. It is, therefore, outside the scope of IFRS 2 for the joint venture and should be accounted for in accordance with IAS 32.

However, when a venturer contributes assets that do not comprise a business (e.g. property, plant and equipment or an intangible asset) on the formation of a joint venture, these transactions are within the scope of IFRS 2 for the joint venture because the joint venture issues shares as consideration for goods. Such transactions should be accounted for as equity-settled share-based payment transactions with non-employees.

Transactions in which a venturer contributes a business in exchange for shares in the joint venture are outside the scope of IFRS 2 and IFRS 3 for the joint venture. The selection of appropriate accounting policies for such transactions involves similar considerations to those for combinations of entities or businesses under common control which are also outside the scope of IFRS 3 (see 2.3.2 in [iGAAP] chapter A25).

2.7 Financial instruments

IFRS 2 does not apply to share-based payment transactions in which the entity receives or acquires goods or services under a contract within the scope of paragraphs 8 to 10 of IAS 32 Financial Instruments: Presentation or paragraphs 2.4 to 2.7 of IFRS 9(2014) Financial Instruments (or, for entities that have not yet adopted IFRS 9, paragraphs 5 to 7 of IAS 39 Financial Instruments: Recognition and Measurement). [IFRS 2:6]

IAS 32 and IFRS 9 (IAS 39) both state that they should be applied to contracts to buy or sell a non-financial item that can be settled net in cash or by another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments (apart from contracts entered into and continuing to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (the ‘own-use’ exemption)). Such contracts are considered in [iGAAP] chapter B1 (or, for entities that have not yet adopted IFRS 9, [iGAAP] chapter C1). Paragraph IFRS 2:BC28 explains that the IASB concluded that such contracts should remain within the scope of IAS 32 and IFRS 9 (IAS 39) and, therefore, excluded them from the scope of IFRS 2.

**Example 2.7 Interaction with IAS 32 and IFRS 9**

Company C enters into a forward contract to buy 1,000 units of a commodity for consideration of 2,000 of Company C’s ordinary shares. Company C can settle the contract net in cash or another financial instrument, but does not intend to do so because the commodity is being purchased for the purpose of receipt in accordance with Company C’s expected usage requirements; Company C does not have a past practice of settling similar contracts net in cash. Accordingly, the transaction is within the scope of IFRS 2 because it involves the issue of shares in exchange for goods.

However, if Company C had a practice of settling these contracts net, or Company C did not intend to take physical delivery of the commodity, the forward contract would be within the scope of IAS 32 and IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39) and, therefore, IFRS 2 would not apply.
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Example 2.3.6 addresses the accounting for preference shares with a conversion option that are issued as consideration for the purchase of goods.

2.8 Goods or services cannot be specifically identified

IFRS 2 applies to share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received. [IFRS 2:2] Accordingly, the Standard applies to transactions when the identifiable consideration received (or to be received) by the entity, including cash and the fair value of identifiable non-cash consideration, appears to be less than the fair value of the equity instruments granted or the liability incurred.

In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been, or will be, received. In this case IFRS 2 applies. [IFRS 2:2]

If the identifiable consideration received appears to be less than the fair value of the equity instruments granted, or the liability incurred, typically this circumstance indicates that other consideration (i.e. unidentifiable goods or services) has been, or will be, received. [IFRS 2:13A]

The entity measures any identifiable goods and services in accordance with IFRS 2. Any unidentifiable goods or services received are then measured as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services received. The unidentifiable goods or services are measured at grant date although, for cash-settled arrangements, the liability is remeasured at the end of each reporting period until it is settled. [IFRS 2:13A]

IFRS 2 gives the example of a grant of shares to a charitable organisation for nil consideration as an instance when it may be difficult to demonstrate that goods or services have been, or will be, received. It notes that a similar situation might arise in transactions with other parties. [IFRS 2:IG5A]

An illustrative example accompanying IFRS 2 deals with a situation in which an entity grants shares for no consideration to parties who form a particular section of community, as a means of enhancing its corporate image. The example notes that the economic benefits might take a variety of forms such as increasing the entity’s customer base, attracting and retaining employees, and improving its chances of being awarded contracts.

There may be no obvious benefits of this kind in circumstances when shares are required by law to be issued at below their market value. However, IFRS 2 should still be applied and an expense recognised. This might be viewed as ‘the price of staying in business’ or akin to a form of taxation.

For transactions with parties other than employees, IFRS 2 establishes a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. The IASB concluded that goods or services that are unidentifiable cannot be reliably measured and so the rebuttable presumption is relevant only for identifiable goods or services. Therefore, in this case, it is necessary to derive the value of the unidentifiable goods or services received from the value of the equity instruments. [IFRS 2:BC128D]

This approach might be seen to imply that it is always necessary to consider the fair value of the equity instruments granted to see if this is greater than the fair value of the goods or services received. This is not so. IFRS 2:BC128C states that “[t]he Board noted that it is neither necessary nor appropriate to measure the fair value of goods or services as well as the fair value of the share-based payment for every transaction in which the entity receives goods or non-employee services”.

In practice, it will be necessary to consider this issue only in those circumstances when the value of the goods or services received ‘appears to be’ less than the fair value of the equity instruments granted. For example, it would not be necessary to obtain a valuation of unquoted shares that had been issued as consideration for non-employee services unless there were indications that some other non-identifiable goods or services had also been obtained.
When the value of the shares is known because they are quoted in a market and this produces a materially different value from the value attributed to the services in accordance with IFRS 2, an additional expense may need to be recognised for unidentified goods and services. In such situations, all evidence needs to be considered carefully to understand the substance of the transaction and the reason for the apparent discrepancy. This may, in some cases, indicate that additional services were received. In other cases, the services may have been difficult to value and the conflicting evidence may prompt a reconsideration of that value. In rare cases, the arrangements may indeed relate to unidentified goods or services (e.g. because the difference represents a charitable donation).

The phrase 'the fair value of the share-based payment' refers to the value of the particular share-based payment concerned. For example, an entity might be required by legislation to issue some portion of its shares to nationals of a particular country, which may be transferred only to other nationals of that country. Such transfer restrictions may affect the fair value of the shares concerned. They may have a fair value that is less than the fair value of otherwise identical shares that do not carry the transfer restrictions. In such circumstances, if it is the restricted shares that are granted, the phrase 'the fair value of the share-based payment’ in IFRS 2 refers to the fair value of the restricted shares and not to the fair value of the unrestricted shares. [IFRS 2:IG5C]

2.9 Employment taxes on share-based payments
In some jurisdictions, employment taxes may be payable which are determined by reference to the gain made by the employee on the exercise of share options.

When the amount of tax is based on the gain made by the employee (i.e. intrinsic value at exercise date), the following questions arise:

- does the entity have a liability before the employee exercises the options?
- if so, how should that liability be measured at the end of each reporting period?

Such payments of tax are outside the scope of IFRS 2 because they are not payments to the suppliers of goods or services. However, these are similar to the questions addressed in IFRS 2 for cash-settled share-based payments. A liability should, therefore, be recognised at the end of each reporting period for such tax. This is consistent with the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets as well as those of IFRS 2 because the ‘obligating event’ is the granting of the options by the entity rather than the exercise of the options by the employees. The liability could be measured on the same basis as required by IFRS 2, although it is acceptable to use intrinsic value at the end of the reporting period rather than fair value determined using an option pricing model, given that the liability is outside the scope of IFRS 2. Measuring the liability at fair value in accordance with IFRS 2 is nevertheless to be preferred.

Under IFRSs, staff costs generally are within the scope of IAS 19 Employee Benefits, which requires staff costs to be recognised over the period in which services are provided. Therefore, in the absence of any conflicting interpretation by the IFRS Interpretations Committee, the liability could be built up over the vesting period.

3 Classification of share-based payment transactions

3.1 Classification of share-based payment transactions — general
Under IFRS 2, different accounting is required for different types of share-based payment transactions. Three types of transactions are identified in IFRS 2:

[IFRS 2:2]

- equity-settled share-based payment transactions (see section 3.2);
- cash-settled share-based payment transactions (see section 3.3); and
- transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments (see 3.4).
3.2 Equity-settled share-based payment transactions

3.2.1 Equity-settled share-based payment transaction — definition

An equity-settled share-based payment transaction is defined in IFRS 2:Appendix A. The definition is as follows.

[IFRS 2:Appendix A]

“A share-based payment transaction in which the entity

(a) receives goods or services as consideration for its own equity instruments (including shares or share options), or

(b) receives goods or services but has no obligation to settle the transaction with the supplier.”

Accordingly, if a subsidiary receives goods or services but has no obligation to settle the transaction because its parent, or another group entity, is instead obliged to do so, that transaction meets the definition of an equity-settled share-based payment transaction.

3.2.2 Cash payments to employees made by acquirer in a business combination

Some equity-settled share-based payment arrangements include a clause that, in the event of a change in control of the entity, the employees will be required (or may be permitted) to sell their shares or share options to the acquirer on the same terms as are available to other vendors (i.e. at the same price, adjusted, if appropriate, for the option exercise price).

Such a clause does not alter the classification of the arrangement as equity-settled under IFRS 2. The entity does not have any obligation to pay cash if it is acquired. An acquirer may incur such an obligation in the future as a consequence of the acquisition of the entity. However, that obligation would be outside of the scope of IFRS 2 from the acquired entity’s perspective because it does not have the obligation to make the payment.

Therefore, the fact that a potential acquirer may pay cash to the employees at some point in the future does not affect the entity’s assessment that this is an equity-settled arrangement.

3.2.3 Entity agrees to sell shares on behalf of employees

Sometimes employees may not want to become long-term investors in an entity. As a result, they may wish to realise equity-settled awards in cash as soon as possible after the awards vest. To facilitate this realisation process, the entity may agree either to sell the shares in the market on the employee’s behalf or to engage a broker to do so.

If it is clear that the entity does not have an obligation to pay cash until the shares are sold in the market (and, therefore, the entity is not exposed to share price movements), then this agreement may not make an equity-settled share-based payment a cash-settled one if in selling the shares the entity is acting as an agent of the employee. This will also be the case when the entity merely facilitates the sale through a broker and the broker acts as an agent of the employee. Any brokerage costs incurred by the entity represent an employee benefit under IAS 19 and, therefore, should be included within employee expenses.

However, if the entity has created a valid expectation that it will repurchase the shares from the employee on its own account, this will normally make the arrangement cash-settled.

3.3 Cash-settled share-based payment transactions

3.3.1 Cash-settled share-based payment transaction — definition

A cash-settled share-based payment transaction is defined in IFRS 2:Appendix A. The definition is as follows.

[IFRS 2:Appendix A]

“A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.”

Therefore, the definition includes transactions when the transfer of cash or other assets is based on the price (or value) of the equity instruments of another group entity (e.g. a parent).
IFRS 2 includes separate measurement requirements for equity-settled and cash-settled share-based payment transactions, which are discussed in the remainder of this chapter. Business combinations, the contribution of a business on formation of a joint venture, and certain arrangements within the scope of IAS 32 Financial Instruments: Presentation are excluded from the scope of IFRS 2 as discussed at 2.6 and 2.7.

3.3.2 Conflict between IFRS 2 and IAS 32

The liability/equity distinction in IFRS 2 is drawn along different lines from the general requirements of IAS 32 Financial Instruments: Presentation (see [iGAAP] chapter B3 or, for entities that have not yet adopted IFRS 9 Financial Instruments, [iGAAP] chapter C3). This is explained in the following example.

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Example 3.3.2

**Equity-settled or cash-settled?**

Company A issues 1,000 share options to an employee with an exercise price of CU15 per share. After completion of the vesting period, the employee will receive shares with a total value equal to the intrinsic value of the options (referred to below as equity-settled SARs).

The share options should be accounted for as equity-settled because settlement will be by delivery of equity instruments. The number of shares that could be issued under the equity-settled SARs and the value of each share issued are variable. IFRS 2:BC106 and BC108 note that, if the debt/equity requirements of IAS 32 were applied to share-based payment transactions, instruments when the number of shares issued is variable would be considered a liability. They would, therefore, be treated similarly to a cash-settled share-based payment. As a result, IFRS 2:BC110 explains that the debt/equity requirements in IAS 32, whereby some obligations to issue equity instruments are classified as liabilities, should not be applied in the IFRS on share-based payments. IFRS 2:BC107 gives a SAR settled in shares as an example of an instrument that would be accounted for differently between IAS 32 and IFRS 2.

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3.4 Transactions with settlement alternatives

A share-based payment transaction may provide either the entity or the counterparty with a choice as to whether settlement occurs in equity instruments or cash. The basic principles to be applied in such circumstances are as set out below.

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the transaction is, or the components of that transaction are, accounted for:

[IFRS 2:34]

- as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets; or
- as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IFRS 2 contains more detailed requirements concerning how to apply these principles to share-based payment transactions in which the terms of the arrangement:

- provide the counterparty with a choice of settlement (see section 7.2); or
- provide the entity with a choice of settlement (see 7.3).

Contingent cash settlement provisions are considered at 7.4. Circumstances when the terms of settlement are modified are considered at section 5.5.3 (for modification of an arrangement that has been accounted for as an equity-settled share-based payment transaction) and 6.4.2 (for modification of an arrangement that has been accounted for as a cash-settled share-based payment transaction).

3.5 Equity awards settled net of tax

The settlement of employees’ equity-settled awards sometimes results in the employee receiving a reduced number of shares and a payment being made to the tax authority to settle the related tax liability. The value of the shares received is the total value of the award earned reduced by the amount of tax paid by the employer based on the employee’s tax liability on the transaction. The question arises as to whether this type of settlement arrangement results in the award being considered partly cash-settled.
Whether this type of settlement arrangement should be treated as partly cash-settled or entirely equity-settled depends on whether the employer is acting as an agent for the employee in settling the employee’s tax liability. The arrangement should be treated as entirely equity-settled if the employer is considered to be acting as an agent for the employee.

The assessment as to whether the entity is acting as an agent for the employee should be made on the basis of the facts and circumstances of each case. There will be circumstances when it is clear that the entity is acting as an agent (e.g., when the entity offers a broker’s service to sell employees’ shares and passes the cash to the tax authorities, but accepts no liability itself).

In some tax jurisdictions, the tax authority specifies situations in which the entity has a statutory duty to act as agent for its employees and remit tax on behalf of the employees.

This topic has been considered by the IFRS Interpretations Committee but no consensus emerged. The Committee identified a number of issues arising in this context for which the application of the requirements of IFRS 2 caused concern, such as separately classifying components of a single award. The Interpretations Committee has recommended to the IASB that this topic should be included in a future agenda proposal for IFRS 2.

4 Vesting and non-vesting conditions

4.1 Vesting — general

The approach to be adopted in relation to the timing of recognition of share-based payments depends largely on the concept of vesting. IFRS 2 defines ‘vest’ as follows.

[IFRS 2:Appendix A]

“To become an entitlement. Under a share-based payment arrangement, a counterparty’s right to receive cash, other assets, or equity instruments of the entity vests when the counterparty’s entitlement is no longer conditional on the satisfaction of vesting conditions.”

If equity instruments vest immediately, it is generally assumed that the consideration for those equity instruments has been received (see 5.1.1). If equity instruments do not vest immediately, the terms ‘vesting conditions’ and ‘vesting period’, as defined by IFRS 2, are important because they will determine the timing of recognition of share-based payments and will also affect measurement. These, and related, terms are considered in detail in 4.3 to 4.8.

4.2 December 2013 amendments to clarify the definition of a vesting condition

Significant amendments were made to IFRS 2 in December 2013 by Annual Improvements to IFRSs: 2010–2012 Cycle. The amendments were made to clarify the definition of ‘vesting condition’ so as to ensure the consistent classification of conditions attached to share-based payments. Separate definitions for ‘performance condition’ and ‘service condition’ (which were previously part of the definition of vesting condition) were added to the Standard to make the description of each condition clearer and reduce diversity in the application of the guidance. The majority of the clarifications surround the definition of a performance condition (see 4.5). The overall effect of the amendments is likely to be that conditions may be treated as non-vesting conditions that were previously determined to be vesting conditions.

The revised definitions are required to be applied prospectively to share-based payment transactions for which the grant date is on or after 1 July 2014, with earlier application permitted. If the revised definitions are applied for an award made before 1 July 2014, that fact is required to be disclosed. [IFRS 2:63B]

The IASB decided that the December 2013 amendments should be applied prospectively to avoid the use of hindsight in determining the grant date fair value of awards made in previous periods. [IFRS 2:BC370]

Sections 4.3 to 4.8 reflect the revised definitions of ‘vesting condition’ and related terms, and describe the principal effects of the December 2013 amendments. Entities that have not yet adopted the December 2013 amendments should refer to previous editions of this manual for the definitions that apply prior to the amendments.
4.3 Vesting condition — definition
A vesting condition is defined as follows.
[IFRS 2:Appendix A]

“A condition that determines whether the entity receives the services that entitle the counterparty to receive
cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting
condition is either a service condition or a performance condition.”

This definition is clear that vesting conditions are restricted to only service conditions (see 4.4) and performance
conditions (see 4.5). A market condition (see 4.6) is a type of performance condition.

A share-based payment vests when the counterparty’s entitlement to it is no longer conditional on future
service or performance conditions. Therefore, restrictive conditions such as non-compete provisions and transfer
restrictions, which apply after the counterparty has become entitled to the share-based payment, are not vesting
conditions. [IFRS 2:BC171B]

4.4 Service condition — definition
A service condition is defined as follows.
[IFRS 2:Appendix A]

“A vesting condition that requires the counterparty to complete a specified period of service during which
services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during
the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target
to be met.”

The vesting period is defined as follows.
[IFRS 2:Appendix A]

“The period during which all the specified vesting conditions of a share-based payment arrangement are to be
satisfied.”

Prior to the December 2013 amendments, IFRS 2 provided no specific guidance on how to account for a
share-based payment award when the entity terminates an employee’s employment. The December 2013
amendments have expanded the definition of a service condition to clarify that an employee’s failure to
complete a required service period for any reason (which would include termination of employment) is
considered to be a failure to satisfy a service condition. The accounting consequence in such circumstances is
that the compensation expense should be reversed. [IFRS 2:BC365 & BC366]

4.5 Performance condition — definition
A performance condition is defined as follows.
[IFRS 2:Appendix A]

“A vesting condition that requires:
(a) the counterparty to complete a specified period of service (ie a service condition); the service
requirement can be explicit or implicit; and
(b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):
(a) shall not extend beyond the end of the service period; and
(b) may start before the service period on the condition that the commencement date of the performance
target is not substantially before the commencement of the service period.

A performance target is defined by reference to:
(a) the entity’s own operations (or activities) or the operations or activities of another entity in the same
group (ie a non-market condition); or
(b) the price (or value) of its equity instruments or the equity instruments of another entity in the same
group (including shares and share options) (ie a market condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the
entity (or part of the group), such as a division or an individual employee.”
Therefore, a performance condition (which is a vesting condition) must involve both a service condition and a performance target. A performance target with no related service condition is a non-vesting condition (see 4.7).

Examples of performance conditions include the vesting of options based upon:

- the total shareholder return (TSR) of the entity, either in absolute terms or relative to a comparator group or index (market-based);
- meeting a specific target share price (market-based); or
- levels of revenues (non-market-based).

The December 2013 amendments have expanded the definition of a performance condition (previously part of the definition of a vesting condition) considerably. The effect has been to provide clarification on a number of issues, including the following.

- For share-based payment transactions involving entities in the same group, a performance target can be set by reference to the price (or value) of another entity (or entities) within the same group (see IFRS 2:BC337).
- Regarding the duration of the performance target relative to the duration of the related service condition, the IASB has clarified that:

  - the start of the period of achieving the performance target may be before the beginning of the service period, provided that the gap is not significant. The Board decided to allow some flexibility regarding the relative start dates following assertions by respondents to the exposure draft preceding the amendments that it is common for a performance target to start before the service period. For example, a performance target could be set as a measure of growth in earnings per share between the most recently published financial statements on the grant date and the most recently published financial statements before the vesting date. If some flexibility regarding the relative start dates were not allowed, then a relatively minor difference in the way that awards are structured could lead to a different classification of the performance target (i.e. as either a non-vesting condition or a performance (vesting condition), which could lead to difference in accounting; and

  - the period over which the performance target is achieved should not extend beyond the service period. Consequently, the counterparty is required to complete the required period of service and to meet the performance target(s) while the counterparty is rendering the service required. A performance target that extends beyond the service period is a non-vesting condition (see 5.3.15).

- The specified period of service that the counterparty is required to complete may be either implicit or explicit. [IFRS 2:BC346]
- It is not necessary for there to be a demonstrable correlation between an employee’s responsibility and a performance target in order for that target to be a performance condition. The revised definition states explicitly that a performance target may relate to the performance of the entity as a whole or to some part of it, such as a division or an individual employee. [IFRS 2:BC347 – BC352]
- A target based on the performance of a share market index (e.g. a stock exchange index required to reach a specified target) is not a performance condition; it is a non-vesting condition. This is the case even if the entity’s shares form part of the share market index. This conclusion is based on the fact that a share market index not only reflects the performance of the entity but also the performance of other entities outside the group. [IFRS 2:BC353 – BC358]
4.6 Market condition — definition

A market condition is defined as follows.

[IFRS 2:Appendix A]

“A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the entity’s equity instruments (or the equity instruments of another entity in the same group), such as:

(a) attaining a specified share price or a specified amount of intrinsic value of a share option; or
(b) achieving a specified target that is based on the market price (or value) of the entity’s equity instruments (or the equity instruments of another entity in the same group) relative to an index of market prices of equity instruments of other entities.

A market condition requires the counterparty to complete a specified period of service (ie a service condition); the service requirement can be explicit or implicit.”

Similar to the definition of a performance condition (see 4.5), the December 2013 amendments have clarified that, for share-based payment transactions involving entities in the same group, a market condition can be based on the market price of another entity in the same group.

Vesting and non-vesting conditions and their impact on the treatment of equity-settled share-based payment transactions are considered further at section 5.3.

4.7 Non-vesting conditions

IFRS 2 contains no formal definition for a ‘non-vesting condition’ (although implementation guidance on the split between vesting and non-vesting conditions is provided in the flowchart set out in IFRS 2:IG24 — see 5.3.1). In the Basis for Conclusions on IFRS 2, the IASB observes that it can be inferred that a non-vesting condition is any condition that is not a vesting condition. [IFRS 2:BC363 – BC364]

IFRS 2:BC171A notes that “the feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or implicit service requirement and the latter does not”.

The following are examples of non-vesting conditions:

• a requirement to subscribe for shares to become entitled to be granted free ‘matching shares’ in certain types of share schemes;
• the payment of contributions to an SAYE scheme; and
• meeting a specific commodity index target.

Under SAYE share option schemes, employees save a regular amount, usually through deduction from salary, which is applied to cover the exercise price of the options when they are exercised. Employees are free to stop contributing to the scheme and obtain a refund of contributions at any time, but forfeit their entitlement to exercise the options if they do so. IFRS 2 makes clear that the payment of contributions into an SAYE scheme is not a vesting condition; it does not meet the definition of a performance condition because it has no link to service.

Non-vesting conditions are taken into account when estimating the fair value of the equity instruments at grant date. This is the same as the treatment of a market-based vesting condition. For example, on a grant of SAYE options, an estimate should be made of the number of employees who will cease to contribute to the scheme, otherwise than through termination of their employment, before the options vest. The grant date fair value should be reduced accordingly. Failure to meet a non-vesting condition (e.g. by ceasing to contribute to an SAYE scheme) should be accounted for as a cancellation of the options so that the expense will be accelerated.
4.8 Summary of the classification of conditions

IFRS 2:IG4A provides the following flowchart to illustrate the evaluation as to whether a condition is a service or performance condition or a non-vesting condition.

5 Recognition and measurement: equity-settled transactions

5.1 Recognition of equity-settled transactions

5.1.1 Recognition of equity-settled transactions — general

The goods or services received or acquired in an equity-settled share-based payment transaction are recognised as the goods are obtained or the services are received, with a corresponding increase in equity. [IFRS 2:7]

The goods or services received in a share-based payment transaction may qualify for recognition as an asset. If not, they are recognised as an expense. [IFRS 2:8]

Services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service. Goods might be consumed over a period of time or, in the case of inventories, sold at a later date, in which case an expense is recognised when the goods are consumed or sold. However, sometimes it is necessary to recognise an expense before the goods or services are consumed or sold, because they do not qualify for recognition as assets. For example, an entity might acquire goods as part of the research phase of a project to develop a new product. Although those goods have not been consumed, they might not qualify for recognition as assets under the applicable IFRS. [IFRS 2:9]

It will normally be relatively straightforward to ascertain when goods are received, but this is not necessarily so when services are involved. The approach to be adopted in relation to the timing of recognition depends largely on the concept of vesting (see section 4). If equity instruments vest immediately then, in the absence of evidence to the contrary, it is presumed that the consideration for the instruments (e.g. employee services) has been received. The consideration (i.e. an expense or asset, as appropriate) should, therefore, be recognised in full, with a corresponding increase in equity. [IFRS 2:14]

5.1.2 Recognition of an equity-settled transaction subject to a service condition

If the equity instruments granted do not vest until the counterparty completes a specified period of service (i.e. a service condition — see 4.4), it is presumed that the service period equals the vesting period. The services are accounted for as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity. [IFRS 2:15]
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For example, an entity may grant share options which vest only once its employees have completed a specified period of employment — say, three years. In this scenario, the entity will recognise an expense over the three-year vesting period because the consideration for the share options (i.e. the employee service) is received over that period.

5.1.3 Recognition of an equity-settled transaction subject to a performance condition

If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity’s employ until that performance condition is satisfied (i.e. a performance condition — see 4.5), and the length of the vesting period varies depending on when that performance condition is satisfied, the entity presumes that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity estimates the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition (see 4.6), the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the entity revises its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates. [IFRS 2:15(b)]

5.1.4 Adjustments after vesting date

Having recognised the goods or services received in accordance with the requirements of IFRS 2 (and a corresponding increase in equity), no subsequent adjustment should be made to equity after vesting date. For example, the amount recognised for services received from an employee is not subsequently reversed if the vested equity instruments are later forfeited or, in the case of share options, are not exercised. This requirement does not, however, preclude a transfer from one component of equity to another. [IFRS 2:23]

For example, the expense recognised in accordance with IFRS 2 is not reversed if options vest but are not exercised because they are 'out of the money' or simply because the employee elects not to do so.

5.1.5 Presentation of increases in equity arising from equity-settled share-based payment transactions

For equity-settled share-based payment transactions, IFRS 2:7 (see 5.1.1) requires the recognition of a 'corresponding increase in equity' for goods or services received and recognised. There is nothing in IFRSs to require or prohibit the presentation of the credit entry in a separate component of equity. This is true whether the credit entry is in relation to the entity’s own equity instruments or those of its parent, in which case the credit entry is in the nature of a capital contribution by the parent (as described in example 8.3.2).

There is also nothing in IFRSs to prohibit the credit entry being recognised in retained earnings. However, local legal and regulatory requirements may need to be taken into account when determining the most appropriate treatment. In some jurisdictions, these requirements may require the credit entry to be regarded as capital and, consequently, prohibit its inclusion in retained earnings.

The position becomes more complicated when an employee share trust is involved, which is the case with some employee share schemes. For example, it may seem most appropriate to take the IFRS 2 credit entry to the ‘employee share trust reserve’ which represents the deduction within equity for own shares held. However, the IFRS 2 credit entry based on grant date fair value is unlikely to equal the purchase price of the shares in the trust less any exercise price, so a difference will build up. These issues are addressed at 9.5.

5.2 Measurement of cash-settled transactions

5.2.1 Measurement of equity-settled transactions — general

For equity-settled share-based payment transactions, the goods or services received and the corresponding increase in equity are measured directly at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If it is not possible to estimate reliably the fair value of the goods or services received, the fair value of the equity instruments granted is used as a proxy. [IFRS 2:10] A limited exception to this requirement applies in rare circumstances when the entity is unable to estimate reliably the fair value of the equity instruments granted at the measurement date (see 5.4.8).
‘Fair value’ is defined as follows.

[IFRS 2:Appendix A]

“The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction.”

IFRS 2 uses the term ‘fair value’ in a way that differs in some respects from the definition of fair value in IFRS 13 Fair Value Measurement. When applying IFRS 2, an entity should measure fair value in accordance with the guidance in IFRS 2, not IFRS 13. [IFRS 2:6A]

Market conditions (see 4.6) are taken into account when estimating the fair value of the equity instruments granted. All non-vesting conditions (see 4.7) are similarly taken into account. However, non-market vesting conditions are not taken into account for this purpose. This is explained further at section 5.3.

5.2.2 Measurement of transactions with parties other than employees

5.2.2.1 Transactions with parties other than employees — measurement at the fair value of goods or services received

For transactions with parties other than employees, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. This fair value should be measured at the date the entity receives the relevant goods or services. This presumption should be rebutted only in those ‘rare cases’ in which the fair value of the goods or services received cannot be estimated reliably. In such circumstances, the fair value is measured indirectly by reference to the fair value of the equity instrument granted, measured at the date the entity receives the relevant goods or services. [IFRS 2:13]

Example 5.2.2.1
Issue of shares for goods or services from non-employees

Company P issues shares to its external lawyers for services related to a recent lawsuit that Company P defended. The lawyers spent 100 hours working on the case. From other recent invoices from the lawyers, Company P determines that the fair value of the services received is CU300 per hour.

The services received, and the corresponding increase in equity, should be measured directly at the fair value of the services received, i.e. CU30,000 (100 × CU300). Under IFRS 2:13, which introduces a rebuttable presumption that the fair value of goods or services received from parties other than employees can be reliably measured, Company P should not measure the transaction based on the fair value of the shares granted to the lawyers.

5.2.2.2 Transactions with parties other than employees — measurement at the fair value of equity instrument granted

For transactions with parties other than employees, in the exceptional circumstances when the presumption that the fair value of the goods or services received can be estimated reliably is rebutted (e.g. if the entity cannot identify the specific goods or services received — see 2.8), the fair value of the equity instruments granted is used as a proxy.

If the goods or services are received on more than one date, the entity should measure the fair value of the equity instruments granted on each date when goods or services are received. The entity should apply that fair value when measuring the goods or services received on that date. [IFRS 2:IG6]

It is possible to use an approximation in some cases. If an entity received services continuously during a three-month period, and its share price did not change significantly during that period, the entity could use the average share price during the three-month period when estimating the fair value of the equity instruments granted. [IFRS 2:IG7]

5.2.3 Measurement of transactions with employees and others providing similar services

5.2.3.1 Employees and others providing similar services — definition

IFRS 2 defines ‘employees and others providing similar services’ as follows.

[IFRS 2:Appendix A]

*Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those
rendered by employees. For example, the term encompasses all management personnel, i.e. those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors."

Further references to employees in this chapter will include others providing similar services.

The determination as to whether an individual is ‘similar to an employee’ is a matter requiring careful judgement.

The following factors may indicate that the counterparty in a share-based payment transaction is an employee or is providing services similar to an employee.

- The purchasing entity is paying for the right to use certain individuals and not the actual output from the individuals (i.e. the purchasing entity has the risk of downtime).
- The individuals are under the direct supervision of the purchasing entity.
- The contract depends on the services from a specified individual.
- The purchasing entity receives substantially all of the output from the individual for a specified period of time.
- The individuals perform services that are similar to services currently provided by employees.

Factors to indicate that an individual is not an employee or providing services similar to an employee include the following.

- The individual performs services that cannot legally be provided by employees.
- The individual uses technology that is not legally available to the purchasing entity to perform the services.

5.2.3.2 Transactions with employees generally to be measured at the fair value of the equity instruments granted

The IASB has taken the view that the fair value of the equity instruments granted should be used for measuring transactions with employees and others providing similar services. This is because, in such transactions, “typically it is not possible to estimate reliably the fair value of the services received”. The fair value of those equity instruments is measured at grant date. [IFRS 2:11 & 12]

5.2.3.3 Cash received from employees entering a share purchase plan

**Example 5.2.3.3**

**Cash received from employees entering a share purchase plan**

Entity R offers all its employees the opportunity to participate in an employee share purchase plan. The employees have a limited time to decide whether to accept the offer. The plan entitles the employees to purchase a maximum of 100 shares each at a purchase price of CU0.10 per share (the nominal value of a share). The purchase price is lower than the fair value of the shares at the grant date.

The employees are required to pay the purchase price on accepting the offer and receive the shares immediately. However, they must remain employed with Entity R for five years before being permitted to sell the shares. If an employee leaves before the vesting period ends, Entity R will automatically repurchase the shares from the employee at CU0.10 per share. The employees are not entitled to dividends on the shares during the vesting period.

This is an equity-settled share-based payment arrangement because the employees are ultimately only entitled to receive shares. However, the distinctive feature of this share purchase plan is that the shares are delivered immediately on receipt of the cash payment even though they do not vest for five years. In substance, the employees do not receive the shares until they vest unconditionally.

To reflect the prepaid purchase price and the potential that the shares will be repurchased, Entity R should recognise the cash received as a financial liability until the end of the vesting period, at which time it will be reclassified to equity provided that the employee is still employed by Entity R. If the employee leaves Entity R before the end of the vesting period, Entity R repays the original purchase price to the employee and derecognises the financial liability.

Because the financial liability could be repaid at any time within the vesting period, it will be measured at CU0.10 per share. The “prepayment” of the exercise price will be factored into the grant date fair value of the share option.

Entitlement to dividends during the vesting period would be factored into the fair value determination (see 5.4.5.6), but would otherwise not affect the accounting treatment described above. (The appropriate treatment of any dividends paid during the vesting period is discussed in example 5.4.5.6.)
**Example 5.2.3.4**

**Shares to a monetary value**

On 1 January 20X5 (the grant date), an entity grants share awards to each of its employees to the value of CU1,500, conditional on them remaining in employment. If an employee remains employed with the entity until 31 December 20X7, the shares will vest and the employee will receive as many shares as are (on 31 December 20X7) worth CU1,500.

**How should the entity account for this share-based payment?**

The grant is an equity-settled share-based payment because the employees will receive shares. The fair value of the awards should be determined at the grant date (i.e. 1 January 20X5). Therefore, the grant date fair value of the awards is CU1,500. Although the time value of money is ignored for simplicity in this example, it should be considered in the determination of the fair value of the award.

Employment is a service condition which is reflected by adjusting the expense for changes in the number of awards that are expected to vest based on meeting this service condition.

The actual number of shares issued in settlement of the awards will vary according to the share price on the vesting date, but the total value of the awards will not change. Therefore, the expense should not be adjusted for changes in the number of shares that will be issued as a result of changes in the market value of the shares.

Therefore, the entity will recognise CU1,500 as an expense over the vesting period, subject to the service condition (i.e. employment), regardless of how many shares are actually issued on the vesting date.

This approach is illustrated below.

At 1 January 20X5, the market price per share is CU5. At 31 December 20X7, it is CU10. At 31 December 20X5 and 20X6, the entity expects that 95 per cent of the employees will remain employed until 31 December 20X7. Ultimately, 96 per cent of the employees remain in service at 31 December 20X7.

At the grant date, the fair value of the awards issued per employee is CU1,500.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation of expense: grant date fair value of awards issued × proportion expected to vest</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(CU1,500 × 100 employees) × 95% expected to vest × 1/3 years</td>
<td>47,500</td>
<td>47,500</td>
</tr>
<tr>
<td>2</td>
<td>(CU1,500 × 100 employees) × 95% expected to vest × 2/3 years</td>
<td>47,500</td>
<td>95,000</td>
</tr>
<tr>
<td>3</td>
<td>(CU1,500 × 100 employees) × 96% actually vested × 3/3 years</td>
<td>49,000</td>
<td>144,000</td>
</tr>
</tbody>
</table>

5.2.3.5 Reload features

Some share options have a ‘reload feature’. This entitles the employee to automatic grants of additional share options whenever he/she exercises previously granted share options and pays the exercise price in the entity’s shares rather than in cash. Typically, the employee is granted a new share option, called a reload option, for each share surrendered when exercising the previous share option. The exercise price of the reload option is usually set at the market price of the shares on the date the reload option is granted. [IFRS 2:BC188]

A ‘reload feature’ is defined in IFRS 2 as follows.

[IFRS 2:Appendix A]

“A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity’s shares, rather than cash, to satisfy the exercise price.”

A ‘reload option’ is defined as follows.

[IFRS 2:Appendix A]

“A new share option granted when a share is used to satisfy the exercise price of a previous share option.”

IFRS 2 requires that for options with a reload feature, the feature should not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a reload option should be accounted for as a new option grant, if and when a reload option is subsequently granted. [IFRS 2:22]

As discussed in IFRS 2:BC189 to BC192, it may theoretically be preferable to take account of reload features when measuring the fair value of options granted. The exposure draft that preceded IFRS 2 proposed this treatment ‘when practicable’. However, in the light of comments received, the IASB decided to require the treatment set out above in all cases.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

Example 5.2.3.5
Award with reload feature

Company M issues 100 share options to one of its directors. The total exercise price for the options is CU100. However, there is a reload feature under which the director can surrender shares to the total value of CU100 instead of paying the exercise price in cash and become entitled to a number of new share options. In this example, that number is equal to the number of shares surrendered.

If the market value of the shares on exercise is CU10, the director will surrender 10 shares worth CU100 in total to cover the exercise price on 100 options. He will then be granted 10 new options. These new options represent a new grant and are accounted for in the usual way in accordance with IFRS 2 (i.e. an expense is recognised over the applicable vesting period based on the grant date fair value of the new options).

5.2.3.6 Share price denominated in a foreign currency

IFRS 2 does not make reference to share-based payment transactions in which the share price is denominated in a foreign currency. An appropriate treatment for such transactions can, however, be derived from the general principles of IAS 21 The Effects of Changes in Foreign Exchange Rates as discussed in example 5.2.3.6.

Example 5.2.3.6
Equity-settled share-based payment transaction with share price and option exercise price denominated in a foreign currency

Company E is a UK entity with Sterling as its functional currency. Company E is registered on the New York Stock Exchange with a current market price of US$15 per share. Company E issues 100 options to its employees with an exercise price of US$15 per share and a vesting period of three years. At the date of issue of the options, the fair value of each option is determined to be US$15 and the exchange rate is US$1.5/£1.

The share options can only be equity-settled.

Given that the share price is quoted in a currency other than the functional currency of the entity, how should these arrangements be accounted for?

As discussed in example 3.3.2, the debt/equity requirements of IAS 32 Financial Instruments: Presentation (which would require a contract to issue shares for a fixed amount of foreign currency cash to be classified as a liability) do not apply to share-based payments. Because the options will be settled in Company E’s shares, they should be accounted for as equity-settled share-based payments by expensing the grant date fair value in functional currency terms (£10 per option, £1,000 in total in this example) over the vesting period. Changes in the exchange rate over the life of the options will not change the amount expensed.

This issue is considered at 6.2.2 in relation to cash-settled share-based payment transactions.

5.2.3.7 Number of shares to be issued determined by reference to the relative fair value of shares of another group entity

Example 5.2.3.7
Number of shares to be issued determined by reference to the relative fair value of shares of another group entity

Entity A owns 100 per cent of Entity B.

On 1 January 20X5 (the grant date), Entity B grants share options to each of its employees, conditional on them remaining in employment until 31 December 20X7.

The share-based payment arrangement specifies that each employee of Entity B will receive as many of Entity A’s shares as are, on 31 December 20X7, of the same value as 1,000 shares of Entity B.

The fair value of both Entity A and Entity B shares can be reliably obtained on 31 December 20X7.

The grant is an equity-settled share-based payment because the employees will receive shares. The fair value of the awards should be determined as of the grant date (i.e. 1 January 20X5).

The actual number of Entity A’s shares issued in settlement of the awards will vary according to the relative fair values of Entity A’s and Entity B’s shares on the vesting date, but there is no target that the fair value of Entity B’s shares needs to meet for vesting to occur. The fair values are only used as a converter to define the number of Entity A’s shares to be issued; they do not constitute a vesting condition.

The expense measured at the grant date will not be adjusted for changes in the number of shares of Entity A that will be issued as a result of changes in the fair value of the shares in Entity B.

Employment is a service condition that is reflected by adjusting the expense for changes in the number of awards that are expected to vest based on meeting this service condition.
5.3 Impact of vesting and non-vesting conditions on equity-settled transactions

5.3.1 Impact of vesting and non-vesting conditions — general

As discussed in section 4, the concepts of vesting and non-vesting conditions are significant both for recognising and for measuring equity-settled share-based payment transactions.

IFRS 2:IG24 provides the following table which categorises, with examples, the various conditions that determine whether a counterparty receives an equity instrument granted and the accounting treatment of share-based payments with those conditions under IFRS 2.

<table>
<thead>
<tr>
<th>Example conditions</th>
<th>VESTING CONDITIONS</th>
<th>NON-VESTING CONDITIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Service conditions</td>
<td>Performance conditions that are market conditions</td>
</tr>
<tr>
<td>Requirement to remain in service for three years</td>
<td>Target based on the market price of the entity’s equity instruments</td>
<td>Target based on a successful initial public offering with a specified service requirement</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Include in grant date fair value?</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Accounting treatment if the condition is not met after the grant date and during the vesting period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest.</td>
</tr>
</tbody>
</table>

^a In the calculation of the fair value of the share-based payment, the probability of continuation of the plan by the entity is assumed to be 100 per cent.

The treatment of vesting, non-vesting and performance conditions is summarised in the following diagram and is more fully described below.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

Conditions for Receipt of Equity Instruments

Non-vesting and market related vesting conditions (e.g. target share price)

- **DO** reflect in fair value at grant date
- **DO NOT** re-estimate number of shares expected to vest
- Charge continues irrespective of whether conditions are met

Service and non-market vesting conditions (e.g. stay employed for 3 years)

- **DO NOT** reflect in fair value at grant date
- **DO** re-estimate number of shares expected to vest ("true up")
- Charge is reversed if conditions are not met

IFRS 2 distinguishes between market conditions (see 4.6) and conditions other than market conditions (referred to generally as ‘non-market conditions’).

Market conditions, such as a target share price upon which vesting is conditional, are taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity recognises the goods or services received from a counterparty who satisfies all other vesting conditions (e.g. service conditions) irrespective of whether that market condition is satisfied. [IFRS 2:21]

Similarly, all non-vesting conditions are taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (e.g. services received from an employee who remains in service for the specified period of service) are recognised, irrespective of whether those non-vesting conditions are satisfied. [IFRS 2:21A]

Vesting conditions other than market conditions are not taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, those non-market vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction so that, ultimately, the amount recognised for goods or services received is based on the number of equity instruments that eventually vest. Therefore, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of a failure to satisfy non-market vesting conditions. For example, this will be the case when an employee fails to complete a specified period of service. [IFRS 2:19]

To apply this requirement for non-market vesting conditions, an amount is recognised for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest. That estimate is revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the estimate is revised to equal the number of equity instruments that ultimately vest. [IFRS 2:20]

This approach, which is generally referred to as the ‘modified grant date method’, was adopted by the IASB for two primary reasons: measurement practicalities and US GAAP convergence.

Valuation models used to determine the fair value of share-based payments could be modified to incorporate non-market conditions. However, the inclusion of these conditions would increase the difficulty and reduce the reliability of the fair value measurement. Therefore, non-market conditions are not included in the grant date fair value calculation due to the practical difficulties of measuring these conditions as noted in IFRS 2:BC184.
The operation of these requirements in practice is illustrated by the examples set out in the following sections.

5.3.2 Non-market vesting condition

5.3.3 Vesting period varies with a non-market condition

5.3.4 Number of options vesting is dependent on a non-market performance condition

5.3.5 Exercise price dependent on a non-market condition

5.3.6 A market condition and a non-market condition

5.3.7 A market condition when the vesting period varies

5.3.8 Contingent issue of shares for goods or services from non-employees

5.3.9 Equity instruments vesting in instalments

5.3.10 Distinguishing market and non-market vesting conditions

5.3.11 Good leavers and bad leavers

5.3.12 Matching share awards

5.3.13 Allocation of expense when there are multiple vesting conditions

5.3.14 Effect of planned restructuring events in estimating the number of awards expected to vest

5.3.15 Conditions relating to completion of an initial public offering (IPO)

5.3.16 Pro rata vesting for good leavers

5.3.2 Non-market vesting condition

The following example, which is taken from the implementation guidance accompanying IFRS 2, illustrates the basic approach to be adopted in relation to a non-market vesting condition.

### Example 5.3.2A Non-market vesting condition

[Guidance on implementing IFRS 2: IG Example 1A]

#### Background

An entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share option is CU15.

On the basis of a weighted average probability, the entity estimates that 20 per cent of employees will leave during the three-year period and therefore forfeit their rights to the share options.

#### Application of requirements

**Scenario 1**

If everything turns out exactly as expected, the entity recognises the following amounts during the vesting period, for services received as consideration for the share options.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000 options × 80% × CU15 × 1/3 years</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>2</td>
<td>(50,000 options × 80% × CU15 × 2/3 years) – CU200,000</td>
<td>200,000</td>
<td>400,000</td>
</tr>
<tr>
<td>3</td>
<td>(50,000 options × 80% × CU15 × 3/3 years) – CU400,000</td>
<td>200,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>
Example 5.3.2A (continued)

Non-market vesting condition

Scenario 2
During year 1, 20 employees leave. The entity revises its estimate of total employee departures over the three-year period from 20 per cent (100 employees) to 15 per cent (75 employees). During year 2, a further 22 employees leave. The entity revises its estimate of total employee departures over the three-year period from 15 per cent to 12 per cent (60 employees). During year 3, 15 employees leave. Hence, a total of 57 employees forfeited their rights to the share options during the three-year period, and a total of 44,300 share options (443 employees × 100 options per employee) vested at the end of year 3.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000 options × 85% × CU15 × 1/3 years</td>
<td>212,500</td>
<td>212,500</td>
</tr>
<tr>
<td>2</td>
<td>(50,000 options × 88% × CU15 × 2/3 years) – CU212,500</td>
<td>227,500</td>
<td>440,000</td>
</tr>
<tr>
<td>3</td>
<td>(44,300 options × CU15) – CU440,000</td>
<td>224,500</td>
<td>664,500</td>
</tr>
</tbody>
</table>

The following example illustrates the use of probabilities when assessing non-market vesting conditions.

Example 5.3.2B

Use of probabilities to assess non-market vesting conditions

Background
Company A has issued 10 options to 10 employees (i.e. 100 options in total). The options will vest at the end of Year 2 of an employee’s continued employment (i.e. the ‘service condition’) and provided Company A has met a specified level of earnings-per-share (EPS) growth compared with the EPS for Year 0. However, the number of options that will vest depends on the extent of the EPS growth. Provided that an employee remains in employment, the options will vest according to the following EPS growth percentages at the end of Year 2:

- less than 4 per cent — none of the options will vest;
- between 4 per cent and 10 per cent — 50 per cent of the options will vest; and
- more than 10 per cent — all options will vest.

Therefore, if all employees remain in employment, the number of options expected eventually to vest can only be 0, 50 or 100.

Application of requirements

Scenario 1
All employees are expected to remain in employment until the end of Year 2.

The target EPS growth vesting condition is a non-market-based vesting condition. During the vesting period, an entity is required to recognise an expense (or asset, if the employee costs are capitalised as part of the cost of another asset) by determining the total number of equity instruments that are expected to vest eventually as a result of the fulfilment of non-market-based conditions (IFRS 2:19). An entity should only use probabilities when determining whether a non-market-based condition will be met — the amount recognised in accordance with IFRS 2 reflects the most likely outcome, not a weighted average of outcomes. For example, if an entity believes that there is a 90 per cent chance that a performance target will be met, the accounting for this transaction during the vesting period should reflect the target being met. The entity would recognise 100 per cent of the total expense for the reporting period (as long as all other vesting conditions are met), not 90 per cent of the total expense for the reporting period.

At the end of Year 1, Company A should estimate the most probable EPS growth figure for the end of Year 2 (using, for example, budget information or historical EPS growth) and should use this estimate to determine the number of options that will vest.

At each future reporting date, Company A should reassess expected EPS growth and ‘true up’ the expense accordingly. This requirement may result in greater volatility in the amount of expense recognised from year to year.
Example 5.3.2B (continued)

Use of probabilities to assess non-market vesting conditions

Scenario 2
Only eight employees are expected to remain until the end of Year 2.

If only 80 per cent of the employees are expected to remain employed by the entity at the end of two years, the number of options expected to vest would need to be adjusted to incorporate the impact of the service condition (e.g. staff turnover rate should be analysed). Therefore, the actual number of options expected to vest, after the impact of the service condition and the number of employees expected to remain with the entity are taken into account, can only be one of the following:

- 0 (i.e. no options are expected to vest);
- 40 (50 per cent of 80 per cent of 100 — i.e. 50 per cent of the options are expected to vest); or
- 80 (100 per cent of 80 per cent of 100 — i.e. all options are expected to vest).

Many of the examples in the implementation guidance accompanying IFRS 2 employ percentages for determining the number of employees expected to meet a service condition. These percentages are used to estimate the number of equity instruments that will actually vest, not the probability that the employee will meet the service condition. That is, an entity expects that 80 per cent of its employees will meet the service condition, not that there is an 80 per cent chance of the service condition being met.

5.3.3 Vesting period varies with a non-market condition

The length of the vesting period might vary depending on when a performance condition is met. If an employee is granted share options that are conditional on the achievement of a performance condition and on remaining in employment until that performance condition is satisfied, it is presumed that the services to be rendered by the employee will be received in the future, over the expected vesting period. When this is the case, the length of the estimated vesting period at grant date is estimated based on the most likely outcome of the performance condition. [IFRS 2:15] If the performance condition is a market condition, the estimated length of the vesting period should be consistent with the assumptions used in estimating the fair value of the options granted and should not subsequently be revised. If the performance condition is a non-market condition, the initial estimate of the length of the vesting period should be revised if subsequent information indicates that the length of the vesting period differs from the previous estimate.

The following example, taken from the implementation guidance accompanying IFRS 2, illustrates the circumstances when the vesting period varies according to the achievement of a non-market condition (a specified increase in earnings).

Example 5.3.3
Grant with a performance condition, in which the length of the vesting period varies

[Guidance on implementing IFRS 2:IG Example 2]

Background
At the beginning of year 1, the entity grants 100 shares each to 500 employees, conditional upon the employees’ remaining in the entity’s employ during the vesting period. The shares will vest at the end of year 1 if the entity’s earnings increase by more than 18 per cent; at the end of year 2 if the entity’s earnings increase by more than an average of 13 per cent per year over the two-year period; and at the end of year 3 if the entity’s earnings increase by more than an average of 10 per cent per year over the three-year period. The shares have a fair value of CU30 per share at the start of year 1, which equals the share price at grant date. No dividends are expected to be paid over the three-year period.

By the end of year 1, the entity’s earnings have increased by 14 per cent, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that 440 employees will vest in 100 shares each at the end of year 2.

By the end of year 2, the entity’s earnings have increased by only 10 per cent and therefore the shares do not vest at the end of year 2. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity’s earnings will increase by at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of year 3, 23 employees have left and the entity’s earnings had increased by 8 per cent, resulting in an average increase of 10.67 per cent per year. Therefore, 419 employees received 100 shares at the end of year 3.
Example 5.3.3 (continued)
Grant with a performance condition, in which the length of the vesting period varies

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>440 employees × 100 shares × CU30 × 1/2</td>
<td>660,000</td>
<td>660,000</td>
</tr>
<tr>
<td>2</td>
<td>(417 employees × 100 shares × CU30 × 2/3) – CU660,000</td>
<td>174,000</td>
<td>834,000</td>
</tr>
<tr>
<td>3</td>
<td>(419 employees × 100 shares × CU30 × 3/3) – CU834,000</td>
<td>423,000</td>
<td>1,257,000</td>
</tr>
</tbody>
</table>

Granter share options contingent on an Initial Public Offering (IPO) of an entity is another example of an award with a variable vesting period depending on a non-market vesting condition. However, no expense will be recognised unless and until the IPO is probable. This may not be the case on grant date. Therefore, in practice, the expense may sometimes be recognised over a relatively short period between the IPO becoming probable and taking place. As explained at 5.3.15, an IPO may be a non-vesting condition if the exercise of the options is not linked to service continuing until the IPO.

5.3.4 Number of options vesting is dependent on a non-market performance condition

A similar approach will be adopted when the number of equity instruments that might vest with each employee varies. This is illustrated in the following example which is taken from the implementation guidance accompanying IFRS 2.

Example 5.3.4
Grant with a performance condition, in which the number of equity instruments varies

[Guidance on implementing IFRS 2: IG Example 3]

Background

At the beginning of year 1, Entity A grants share options to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity’s employ, and provided that the volume of sales of a particular product increases by at least an average of 5 per cent per year. If the volume of sales of the product increases by an average of between 5 per cent and 10 per cent per year, each employee will receive 100 share options. If the volume of sales increases by an average of between 10 per cent and 15 per cent per year, each employee will receive 200 share options. If the volume of sales increases by an average of 15 per cent or more, each employee will receive 300 share options.

On grant date, Entity A estimates that the share options have a fair value of CU20 per option. Entity A also estimates that the volume of sales of the product will increase by an average of between 10 per cent and 15 per cent per year, and therefore expects that, for each employee who remains in service until the end of year 3, 200 share options will vest. The entity also estimates, on the basis of a weighted average probability, that 20 per cent of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the entity still expects a total of 20 employees will leave by the end of year 3. Hence, the entity expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12 per cent and the entity expects this rate of increase to continue over the next 2 years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The entity now expects only three more employees will leave during year 3, and therefore expects a total of 15 employees will have left during the three-year period, and hence 85 employees are expected to remain. Product sales have increased by 18 per cent, resulting in an average of 15 per cent over the two years to date. The entity now expects that sales will average 15 per cent or more over the three-year period, and hence expects each sales employee to receive 300 share options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The entity’s sales have increased by an average of 16 per cent over the three years. Therefore, each of the 86 employees receives 300 share options.
Example 5.3.4 (continued)
Grant with a performance condition, in which the number of equity instruments varies

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period CU</th>
<th>Cumulative remuneration expense CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>80 employees × 200 options × CU20 × 1/3</td>
<td>106,667</td>
<td>106,667</td>
</tr>
<tr>
<td>2</td>
<td>(85 employees × 300 options × CU20 × 2/3) – CU106,667</td>
<td>233,333</td>
<td>340,000</td>
</tr>
<tr>
<td>3</td>
<td>(86 employees × 300 options × CU20 × 3/3) – CU340,000</td>
<td>176,000</td>
<td>516,000</td>
</tr>
</tbody>
</table>

5.3.5 Exercise price dependent on a non-market condition
The exercise price might vary depending on whether non-market vesting conditions are satisfied. This is illustrated in the following example taken from the implementation guidance accompanying IFRS 2.

Example 5.3.5
Grant with a performance condition, in which the exercise price varies

[Guidance on implementing IFRS 2:IG Example 4]

Background
At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive’s remaining in the entity’s employ until the end of year 3. The exercise price is CU40. However, the exercise price drops to CU30 if the entity’s earnings increase by at least an average of 10 per cent per year over the three-year period.

On grant date, the entity estimates that the fair value of the share options, with an exercise price of CU30, is CU16 per option. If the exercise price is CU40, the entity estimates that the share options have a fair value of CU12 per option.

During year 1, the entity’s earnings increased by 12 per cent, and the entity expects that earnings will continue to increase at this rate over the next two years. The entity therefore expects that the earnings target will be achieved, and hence the share options will have an exercise price of CU30.

During year 2, the entity’s earnings increased by 13 per cent, and the entity continues to expect that the earnings target will be achieved.

During year 3, the entity’s earnings increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years’ service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested share options have an exercise price of CU40.

Application of requirements
Because the exercise price varies depending on the outcome of a performance condition that is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be CU40 and the possibility that the exercise price might be CU30) is not taken into account when estimating the fair value of the share options at grant date. Instead, the entity estimates the fair value of the share options at grant date under each scenario (i.e. exercise price of CU40 and exercise price of CU30) and ultimately revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period CU</th>
<th>Cumulative remuneration expense CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000 options × CU16 × 1/3</td>
<td>53,333</td>
<td>53,333</td>
</tr>
<tr>
<td>2</td>
<td>(10,000 options × CU16 × 2/3) – CU53,333</td>
<td>53,334</td>
<td>106,667</td>
</tr>
<tr>
<td>3</td>
<td>(10,000 options × CU12 × 3/3) – CU106,667</td>
<td>13,333</td>
<td>120,000</td>
</tr>
</tbody>
</table>

5.3.6 A market condition and a non-market condition
The following example, taken from the implementation guidance accompanying IFRS 2, illustrates the operation of the requirements of IFRS 2 for a grant of options with a market condition (a specified increase in share price) and a non-market service condition (continuing employment).
Example 5.3.6A  
Grant with a market condition

[Guidance on implementing IFRS 2:IG Example 5]

Background

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity’s employ until the end of year 3. However, the share options cannot be exercised unless the share price has increased from Cu50 at the beginning of year 1 to above Cu65 at the end of year 3. If the share price is above Cu65 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e. by the end of year 10.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price will exceed Cu65 at the end of year 3 (and hence the share options become exercisable) and the possibility that the share price will not exceed Cu65 at the end of year 3 (and hence the options will be forfeited). It estimates the fair value of the share options with this market condition to be Cu24 per option.

Application of requirements

Because paragraph 21 of IFRS 2 requires the entity to recognise the services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date.

Therefore, if the entity expects the executive to complete the three-year service period, and the executive does so, the entity recognises the following amounts in years 1, 2 and 3:

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000 options × Cu24 × 1/3</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>2</td>
<td>(10,000 options × Cu24 × 2/3) – Cu80,000</td>
<td>80,000</td>
<td>160,000</td>
</tr>
<tr>
<td>3</td>
<td>(10,000 options × Cu24) – Cu160,000</td>
<td>80,000</td>
<td>240,000</td>
</tr>
</tbody>
</table>

As noted above, these amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2 (or year 3), the amount recognised during year 1 (and year 2) would be reversed in year 2 (or year 3). This is because the service condition, in contrast to the market condition, was not taken into account when estimating the fair value of the share options at grant date. Instead, the service condition is taken into account by adjusting the transaction amount to be based on the number of equity instruments that ultimately vest, in accordance with paragraphs 19 and 20 of the IFRS.

Another example in which share options are granted with both market conditions and non-market conditions is set out below.

Example 5.3.6B  
Share option grant with both market and non-market performance conditions

Company H issued 100 share options to certain of its employees that will vest if accumulated revenues for five years reach Cu1 billion and its share price exceeds Cu50 on the fifth anniversary of the grant date. The employees will have to be employed with Company H at the end of the five-year vesting period to receive the options. The share options will expire if any of these conditions has not been met at the end of the five-year vesting period.

IFRS 2:21 states that the grant date fair value of a share-based payment with market-based performance conditions that has met all its other vesting conditions should be recognised, irrespective of whether that market condition is achieved. Company H determines the grant date fair value of the share-based payment excluding the non-market-based performance factor (accumulated revenues), but including the market-based performance factor (share price).

Assuming Company H determines that the fair value of the share-based payment (after taking into consideration the probability that the share price target of Cu50 will be met) at the date of grant is Cu20 per option, the cumulative expense recognised over the expected vesting period in the following scenarios would be:

- if all vesting conditions are met, Cu2,000 [100 options × Cu20];
- if all vesting conditions are met, except that the market-based performance condition of share price exceeding Cu50 is not achieved, Cu2,000 [100 options × Cu20];
- if all vesting conditions are met, except that the non-market-based performance condition of accumulated revenues reaching Cu1 billion is not achieved, nil expense; and
- if all vesting conditions are met, except that employees who received half of the options leave Company H’s employment prior to the vesting date, Cu1,000 [50 options × Cu20].

Therefore, when there are both market and non-market conditions that have to be met, an entity will still need to estimate whether non-market conditions will be satisfied even if ultimately no share options vest due to market conditions.
5.3.7 A market condition when the vesting period varies

The effect of a vesting condition may be to change the length of the vesting period. In this case, IFRS 2:15 requires the entity to presume that the services to be rendered by the employees as consideration for the equity instruments granted will be received in the future, over the expected vesting period. Hence, the entity will have to estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period must be consistent with the assumptions used in estimating the fair value of the share options granted and is not subsequently revised.

The following example, taken from the implementation guidance accompanying IFRS 2, illustrates the application of IFRS 2 when the vesting period varies with a market condition (a specified increase in the share price).

### Example 5.3.7
Grant with a market condition, in which the length of the vesting period varies

[Guidance on implementing IFRS 2:IG Example 6]

**Background**

At the beginning of year 1, an entity grants 10,000 share options with a ten-year life to each of ten senior executives. The share options will vest and become exercisable immediately if and when the entity’s share price increases from CU50 to CU70, provided that the executive remains in service until the share price target is achieved.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The entity estimates that the fair value of the share options at grant date is CU25 per option. From the option pricing model, the entity determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the entity estimates that the expected vesting period is five years. The entity also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 share options (10,000 share options × 8 executives) will vest at the end of year 5.

Throughout years 1–4, the entity continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

**Application of requirements**

Paragraph 15 of the IFRS requires the entity to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the entity not to revise that estimate. Therefore, the entity recognises the services received from the executives over years 1–5. Hence, the transaction amount is ultimately based on 70,000 share options (10,000 share options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years. Therefore, the entity recognises the following amounts in years 1–5:

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period CU</th>
<th>Cumulative remuneration expense CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>80,000 options × CU25 × 1/5</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>2</td>
<td>(80,000 options × CU25 × 2/5) – CU400,000</td>
<td>400,000 – 400,000 = 0</td>
<td>800,000</td>
</tr>
<tr>
<td>3</td>
<td>(80,000 options × CU25 × 3/5) – CU800,000</td>
<td>400,000 – 800,000 = -400,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>4</td>
<td>(80,000 options × CU25 × 4/5) – CU1,200,000</td>
<td>400,000 – 1,200,000 = -800,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td>5</td>
<td>(70,000 options × CU25) – CU1,600,000</td>
<td>150,000 – 1,600,000 = -1,450,000</td>
<td>1,750,000</td>
</tr>
</tbody>
</table>
5.3.8 Contingent issue of shares for goods or services from non-employees

**Example 5.3.8**
*Contingent issue of shares for goods or services from non-employees*

Company G enters into an agreement with lawyers currently assisting in its defence of a lawsuit. If Company G is successful in winning the case, it will issue 100 of its own shares to the lawyers. If Company G is not successful, it will issue 20 of its own shares to the lawyers.

Company G expenses the amount it expects to pay to the lawyers over the service period (being the variable period to settlement of the lawsuit). At the end of each reporting period, Company G should make its best estimate as to whether it will win the case, as well as the most likely outcome of the period over which the case will be settled. This estimate should be revised at the end of each reporting period as long as the case is not settled.

The total expense recognised up to the date of settlement should equal the fair value of services received. This value should be calculated directly (taking into account the differential between the value of services received in winning and in losing the case — one being five times the other in this example based upon the number of shares to be delivered), unless a reliable estimate cannot be made on this basis, in which case the value should be determined indirectly by reference to the fair value of the equity instruments granted, measured at the date the entity receives the services.

5.3.9 Equity instruments vesting in instalments

**Example 5.3.9**
*Equity instruments vesting in instalments (graded vesting)*

Company A grants its employees 1,000 share options each with a fair value of CU10. The options vest pro rata over the service period (one-fourth each year). Under IFRS 2:IG11, entities are required to treat each instalment as a separate share option grant because each instalment has a different vesting period and, therefore, the grant date fair value of each instalment is likely to be different. This is because the length of the vesting period will affect, for example, the likely timing of cash flows arising from the exercise of the options.

The following table summarises how the total fair value of CU10,000 [1,000 × CU10] should be allocated to each of the four years in the vesting period. (Note that, for simplicity, it is assumed that the grant date fair value is CU10 for each tranche. In practice, as explained above, the grant date fair value might be slightly different for each tranche.)

<table>
<thead>
<tr>
<th>Award</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1 [(10,000/4) × 1/1]</td>
<td>2,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tranche 2 [(10,000/4) × 1/2]</td>
<td>1,250</td>
<td>1,250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tranche 3 [(10,000/4) × 1/3]</td>
<td>833</td>
<td>833</td>
<td>834</td>
<td></td>
</tr>
<tr>
<td>Tranche 4 [(10,000/4) × 1/4]</td>
<td>625</td>
<td>625</td>
<td>625</td>
<td>625</td>
</tr>
<tr>
<td>Total expense</td>
<td>5,208</td>
<td>2,708</td>
<td>1,459</td>
<td>625</td>
</tr>
</tbody>
</table>

5.3.10 Distinguishing market and non-market vesting conditions

For the majority of vesting conditions, it is straightforward to determine whether they should be viewed as market or non-market conditions. However, it is not always so straightforward to make this distinction as illustrated in the following examples.

**Example 5.3.10A**
*Market and non-market vesting conditions (index)*

Company A issues share options to certain of its employees that vest if, and when, Company A’s share price growth (as a percentage) exceeds the average share price growth of Company A’s 10 most significant competitors. Share price growth is calculated based on share prices only and does not factor in dividends or other factors.

IFRS 2:Appendix A defines one form of a market condition as a “condition upon which the exercise price, vesting, or exercisability of an equity instrument depends that is related to . . . achieving a specified target that is based on the market price of the entity’s equity instruments . . . relative to an index of market prices of equity instruments of other entities”. IFRS 2 does not provide guidance on what constitutes an index.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

Example 5.3.10A (continued)
Market and non-market vesting conditions (index)

While the term ‘index’ would appear to require a comparison of more than one entity, there clearly is no requirement that the index be a published, standard index such as the S&P 500 or FTSE 100. The following criteria should be considered in determining whether an index exists:

- the fair value at the date of grant can be reliably determined by reference to the index;
- the share prices of the entities in the index are readily available in an active market such that accurate and reliable measurements of fair value can be determined at a specific point in time; and
- a consistent and reasonable formula is used to determine the effects of the entities’ performance on the performance of the index.

If these criteria are met, Company A would have a strong case for demonstrating that the vesting condition is a market condition.

This example refers to circumstances in which the performance of an entity's shares is judged by reference to a market index. Note that, as discussed at 4.5, a condition based solely on the performance of a share index is not a performance condition.

Example 5.3.10B
Ranking of share price within a population

Company A issues share options to certain employees that vest if Company A's share price growth (as a percentage) ranks in the top quartile of the largest 100 entities in its market. Share price growth is calculated based on share price only and does not take account of dividends or other factors.

Should this vesting condition be considered a market condition?

It depends. The ranking within an index or group of entities may be representative of an index if it meets the criteria described in example 5.3.10A — notably that the vesting condition be measured via a consistent formula based on the prices of shares in an active market. In such cases, a vesting condition based on a ranking should be considered a market condition.

Example 5.3.10C
Total shareholders’ return as a market condition

Company A issues share options to certain employees, the vesting of which is subject to a Total Shareholders’ Return (TSR) condition. TSR is the internal rate of return on the entity’s shares calculated by assuming that:

- someone bought the share at the start of the performance period;
- any dividends received on the share had been used to buy more shares (‘dividend shares’) when received; and
- the shares (plus dividend shares) were sold at the end of the performance period.

For example, if no dividends were paid and the share price increased from CU100 to CU107 after one year, the TSR would be 7 per cent.

Company A’s TSR condition works by comparing the entity’s TSR with that of an index of the 100 largest entities in its market. For example, if Company A’s TSR were to be placed in the top 30th percentile, then 90 per cent of the award would vest.

The criteria for an index described in example 5.3.10A are met.

A TSR calculation includes not only changes in the entity’s share price, but the effects of dividends. Nevertheless, a TSR condition should be considered a market condition because movements in the share price are the predominant factor in its calculation.

5.3.11 Good leavers and bad leavers

Vesting conditions may distinguish between ‘good leavers’ and ‘bad leavers’. In practice, a good leaver is often defined in the terms of a share-based arrangement as an employee who leaves the entity due to injury, disability, death, redundancy or on reaching normal retirement age (see example 5.3.11). A bad leaver is usually defined as any other leaver (e.g. due to resignation).

For example, an entity may grant options with a specified period of service as a vesting condition. A good leaver will be entitled to exercise all or some of the options when leaving the entity during the specified period of service. A bad leaver loses any entitlement to the award when he/she leaves during the vesting period.
Such arrangements represent share-based payment arrangements with a variable vesting period for good leavers (see 5.3.3). When calculating the IFRS 2 expense, the entity estimates how many good and bad leavers it expects to have. If the estimate of good leavers is material, a separate estimate should be made of the vesting period(s) for good leavers and that vesting period should be reassessed at the end of each reporting period. When accounting for all other employees (i.e. non-leavers and bad leavers), the estimate of bad leavers is used to true up the IFRS 2 expense for those failing to meet the service condition. Once the shares have vested, there is no further true up for leavers, regardless of whether they are good leavers or bad leavers. Example 5.3.16 illustrates the accounting for pro rata vesting of shares for good leavers.

However, this guidance applies only if good and bad leavers are defined in the terms and conditions of the award. In other cases (i.e. when management or a remuneration committee determines whether an employee is a good or a bad leaver only at the time when the employee leaves employment), the particular arrangements should be considered carefully. The exercise of discretion by management may be a modification of the award and should be accounted for as such or it may affect the determination of grant date (see example 5.4.1.4).

Example 5.3.11
Awards exercisable on retirement

Company A grants an award that vests in five years if the employees stay in employment until the end of that period. If an employee leaves earlier because of reaching the retirement age of 60, that employee will still be entitled to receive the full award at his or her retirement date.

Under this arrangement, the vesting period for those employees who, at the grant date, are more than 55 years old is shorter than the general vesting period of five years. Company A will need to determine how many employees have shorter vesting periods and recognise the grant date fair value of these awards over the applicable vesting periods. If the award is granted to an employee aged 60 or over, the award would in effect vest immediately and should be recognised as an expense in full at the grant date.

The grant date fair value of these awards may also be affected because a shorter vesting period affects the life of the options as an input to the option pricing model.

This applies even when some of the employees decide to stay and work beyond their retirement age because the employees could leave at any time after reaching the age of 60 without forfeiting the right to the award.

5.3.12 Matching share awards

Matching share awards take various forms but generally involve an arrangement under which an employee is given shares in the entity to ‘match’ those for which he/she subscribes. Often this is linked to a bonus payment. For example, if an employee elects to take the bonus in the form of shares to the value of the bonus, the entity makes a matching share award. The award typically has a vesting condition relating to continuing employment and/or a non-vesting condition relating to holding the purchased shares for a prescribed period.

The determination of the vesting period for a matching share award is not always straightforward. Arrangements vary with regard to whether the employee has discretion to take the bonus in cash or shares and whether the entity has discretion to provide the matching shares. When there is no discretion, the start of the vesting period for the matching share award will generally be the date when the bonus arrangements are established. However, in other cases it may be a later date. The facts and circumstances of each case should be considered carefully.

Accounting for a bonus which will be settled in a variable number of shares to the value of the bonus is considered at 5.2.3.4.

The appropriate measurement date for matching share awards is considered at 5.4.1.6.
5.3.13 Allocation of expense when there are multiple vesting conditions

**Example 5.3.13**

**Allocation of expense when there are multiple vesting conditions**

Entity A enters into a share-based payment arrangement with certain of its employees, which contains a three-year service condition beginning on 1 January 20X1 and ending on 31 December 20X3. In addition, there is a one-year non-market performance condition assessed during the period 1 January 20X1 to 31 December 20X1.

**How should Entity A recognise the share-based payment expense given that there are multiple vesting conditions with different reference periods?**

Entity A should allocate the expense using a straight-line method over the service period of three years, unless there is compelling evidence that a different expense recognition pattern is appropriate.

IFRS 2:15 requires that if the equity instruments do not vest until the counterparty completes a specified period of service, an entity should presume that the services to be rendered by the counterparty will be received in the future, during the vesting period. However, the Standard is silent regarding which pattern of expense allocation should be used if there are multiple vesting conditions with different reference periods.

In the circumstances described, there is no evidence that employee services provided in the different periods are explicitly different. Therefore, allocation of the share-based payment expense on a straight-line basis is the most appropriate method.

5.3.14 Effect of planned restructuring event in estimating the number of awards expected to vest

**Example 5.3.14**

**Effect of planned restructuring event in estimating the number of awards expected to vest**

An entity intends to restructure some of its operations. At the end of the reporting period, the costs associated with the restructuring plan do not meet the criteria for recognition of a provision under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. However, the restructuring plan has been approved by the entity’s board of directors and will be announced shortly after the end of the reporting period. The entity considers that it is probable that the restructuring will take place. As part of the restructuring plan, the entity expects to terminate the employment of some employees who hold unvested share-based payment awards accounted for under IFRS 2. The terminations are expected to occur before the vesting date of the share-based payment awards and would result in forfeiture based on the existing terms of the share-based payment arrangement. However, the entity intends to change the terms of the arrangement to accelerate vesting of the awards held by employees terminated as a result of the restructuring plan.

**At the end of the reporting period, how should the entity estimate the number of awards expected to vest?**

Under IFRS 2:20, an entity recognises an expense based on the best available estimate of the number of awards expected to vest. The entity should revise this estimate if the number of instruments expected to vest changes. In the circumstances described, it is considered probable that the restructuring will take place. Therefore, at the end of the reporting period, the entity should reduce the number of awards expected to vest to reflect the forfeiture that will result when the employment of the employees is terminated under the planned restructuring. That is, the entity should reverse the expense previously recognised for the effect of awards that are no longer expected to vest because of the planned restructuring, under the terms of the arrangement in effect at the end of the reporting period.

Separately, the impact of changes to the terms of the share-based payment arrangement should only be reflected in the determination of the IFRS 2 expense on modification of the awards. Therefore, only when the terms of the arrangement have been modified (i.e. in the next reporting period) will the entity apply the requirements of IFRS 2:27 and consider these revised terms in assessing the number of awards expected to vest in accordance with IFRS 2:843(c).

5.3.15 Conditions relating to completion of an initial public offering (IPO)

When determining the appropriate treatment of a condition related to the successful completion of an IPO, it is necessary to consider whether there is a related service condition.

One of the examples of a vesting condition in the table below IFRS 2:IG24 (see 5.3.1) is the successful completion of an IPO together with a specified service requirement (i.e. an employee is required to be employed at the time an IPO is successfully completed). It is also clear that the successful completion of an IPO without any related service condition is a non-vesting condition.

If the service period is shorter than the period to the IPO, the IPO should be treated as a non-vesting condition (as clarified by the IASB in the December 2013 amendments to IFRS 2 — see 4.5). This would be the case if there is a service condition for a limited period (e.g. two years) and the employees are then free to leave while retaining their right to exercise the options at a later date if the IPO is achieved. In this case, any expense recognised for the options granted to employees who leave before meeting the two-year service condition will be reversed. There will be no reversal, if the IPO does not occur, in relation to the employees who are still employed at the end of the two-year service period. However, as noted above, the grant date fair value will have been adjusted to take account of the probability that the IPO will not occur.
Examples 5.3.15A to 15C illustrate the appropriate accounting for share-based payment conditions involving the completion of an IPO.

**Example 5.3.15A**

**IPO and a service condition when IPO determines vesting period**

An entity grants 100 share options each to 10 of its employees. The grant is conditional on a successful IPO within the next four years, and employees working for the entity over the period until the IPO. Therefore, the vesting period is dependent on the timing of the IPO. The fair value of each share option at grant date is CU60.

At the end of Year 1, no employees have left, but the entity expects two to leave by the end of the service period. The entity believes that it is not probable that there will be a successful IPO within the next three years.

At the end of Year 2, one employee has left, and the entity expects one more employee to leave during the next year. The entity now believes that it is probable that there will be a successful IPO before the end of Year 3.

The IPO is completed successfully six months after the beginning of Year 3. Prior to the completion of the IPO, one further employee has left and the entity expects another two to leave in the final year.

During Year 4, another two employees leave as expected.

The IPO condition is a non-market performance condition because it is not related to the entity’s share price and it must be met within a specified period during which the employees must remain in employment with the entity.

IFRS 2:19 requires that vesting conditions, other than market conditions, are not taken into account when estimating the fair value of the share options at the measurement date. Instead, vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount.

Therefore, the determination of grant date fair value excludes the probability of a successful IPO within the service period.

**Year 1**

The entity believes that it is not probable that there will be a successful IPO within the service period; therefore, the number of equity instruments expected to vest is zero. As a result, no accounting entries are recognised.

**Year 2**

Because the entity believes that it is probable that there will be a successful IPO before the end of Year 3 and eight employees are expected to be employed until the completion of the IPO, a share-based payment expense is recognised over the estimated vesting period of three years. Because no amounts were recognised in Year 1, the expense in Year 2 is recognised as follows.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Share-based payment</td>
<td>Cr Equity</td>
</tr>
<tr>
<td>(CU60 × 100 × 8/3) × 2</td>
<td>32,000</td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense.*

**Year 3**

Because the IPO is completed successfully six months after the beginning of Year 3 and eight employees remained employed at the time of the IPO, the final vesting period is two and a half years. Therefore, the remainder of the share-based payment expense is recognised as follows.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Share-based payment</td>
<td>Cr Equity</td>
</tr>
<tr>
<td>(CU60 × 100 × 8) – CU32,000</td>
<td>16,000</td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense.*

**Year 4**

Because the IPO is completed successfully six months after the beginning of Year 3 and the share options are vested in full at that point, no further share-based payment expense is recognised in Year 4, regardless of whether any more employees leave.

In practice, the determination as to whether it is probable that an IPO will occur is difficult because it is dependent on factors outside the entity’s control. Often it will not be possible to conclude that an IPO is probable until plans are well advanced.

Note that, in the circumstances described above, the completion of the IPO determines the required service period and so the vesting period over which the expense is spread is changed as the expectation of occurrence and timing of the IPO changes. Example 5.3.15B addresses the accounting if the timing of the IPO does not alter the vesting period of the share-based payments.
Example 5.3.15B
IPO and a service condition when vesting period is fixed

An entity grants 100 share options each to 10 of its employees. The grant is conditional on employees working for the entity over the next four years, and a successful IPO within that service period. Therefore, the vesting period is four years. The fair value of each share option at grant date is CU60.

At the end of Year 1, no employees have left, but the entity expects two to leave by the end of the service period. The entity believes that it is not probable that there will be a successful IPO within the next three years.

At the end of Year 2, one employee has left, and the entity expects one more employee to leave during the next year. The entity now believes that it is probable that there will be a successful IPO before the end of Year 3.

The IPO is completed successfully six months after the beginning of Year 3. Prior to completion of the IPO, another employee has left and the entity expects another two to leave in the final year.

During Year 4 another two employees leave as expected.

The IPO condition is a non-market performance condition because it is not related to the entity’s share price and it must be met within a specified period during which the employees must remain in employment with the entity.

IFRS 2:19 requires that vesting conditions, other than market conditions, are not taken into account when estimating the fair value of the share options at the measurement date. Instead, vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount.

Therefore, the determination of grant date fair value excludes the probability of a successful IPO within the service period.

Year 1
The entity believes that it is not probable that there will be a successful IPO within the service period; therefore, the number of equity instruments expected to vest is zero. As a result, no accounting entries are recognised.

Year 2
Because the entity believes that it is probable that there will be a successful IPO before the end of Year 3 (and eight employees are expected to remain in employment to the end of Year 4), a share-based payment expense is recognised. Because no amounts were recognised in Year 1, the expense in Year 2 is recognised as follows.

\[
\begin{align*}
\text{Dr Share-based payment expense} & \quad \text{CU} 24,000 \\
& \quad (\text{CU60} \times 100 \times 8/4) \times 2 \\
\text{Cr Equity} & \quad 24,000
\end{align*}
\]

To recognise the share-based payment expense.

Year 3
Because the IPO has been completed successfully six months after the beginning of Year 3 (and six employees are expected to remain in employment to the end of Year 4), a share-based payment expense is recognised as follows.

\[
\begin{align*}
\text{Dr Share-based payment expense} & \quad \text{CU} 3,000 \\
& \quad (\text{CU60} \times 100 \times 6/4 \times 3) – \text{CU24,000} \\
\text{Cr Equity} & \quad 3,000
\end{align*}
\]

To recognise the share-based payment expense.

Year 4
As expected, another two employees have left; therefore, the remainder of the share-based payment expense is recognised as follows.

\[
\begin{align*}
\text{Dr Share-based payment expense} & \quad \text{CU} 9,000 \\
& \quad (\text{CU60} \times 100 \times 6) – \text{CU27,000} \\
\text{Cr Equity} & \quad 9,000
\end{align*}
\]

To recognise the share-based payment expense.

In practice, the determination as to whether it is probable that an IPO will occur is difficult because it is dependent on factors outside the entity’s control. Often it will not be possible to conclude that an IPO is probable until plans are well advanced.

Note that, in the circumstances described above, the completion of the IPO did not alter the required service period of four years and so the vesting period over which the expense is spread was not changed. Example 5.3.15A addresses the accounting if the timing of the IPO determines the vesting period of the share-based payments.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

Example 5.3.15C
Share-based payment conditions — IPO with no service period

An entity grants 100 share options each to 10 of its employees. The grant is conditional on the completion of a successful IPO within five years. There is no service condition attached to the awards and employees that leave the employment of the entity prior to the successful completion of the IPO will continue to be entitled to the reward if the IPO occurs within five years.

The successful IPO is a non-vesting condition because the vesting of the share options is not dependent on the entity receiving the services that entitle the employees to the reward. IFRS 2:21A requires all non-vesting conditions to be taken into account when determining the grant date fair value of the equity instruments granted. The grant date fair value of the options should, therefore, reflect the probability of a successful IPO.

Assume that on grant date the entity estimates that the share options have a fair value of CU30 per option. Because there is no service period attached to the awards, the expense should be recognised immediately:

\[
\begin{array}{c|c}
\text{Dr} & \text{Share-based payment expense} \\
& \text{CU} \\
& [\text{CU30} \times 10 \times 100] \\
& \text{30,000} \\
\text{Cr} & \text{Equity} \\
& \text{30,000} \\
\end{array}
\]

To recognise the share-based payment expense.

The above entries are not reversed if the IPO is unsuccessful.

5.3.16 Pro rata vesting for good leavers

Example 5.3.16
Pro rata vesting for good leavers

Entity A grants each of its employees 100 shares conditional solely on the employee remaining in employment with Entity A for three years. However, if an employee leaves Entity A's employment at any time during the three-year period for one of a number of reasons specified in the scheme (including, for example, termination by Entity A without cause, and invalidity), he/she will be entitled to a pro rata allocation of the 100 shares based on the number of days of service completed. (Employees entitled to such allocations are defined in the scheme as ‘good leavers’.)

How should Entity A recognise the share-based payment expense for the arrangement described?

In the circumstances described, the most appropriate reflection of the service charge is achieved by allocating the share-based payment expense on a straight-line basis up to the date of vesting (i.e. the end of the three-year period).

As discussed at 5.3.11, arrangements of this nature represent share-based payment arrangements with a variable vesting period for good leavers (i.e. the general vesting period is three years but it will be less if the employee is a good leaver within three years). A good leaver’s entitlement to receive a pro rata number of shares when he or she leaves Entity A’s employment within the three-year period means that the number of shares receivable upon vesting is also variable.

IFRS 2:15 requires that an entity should account for services as they are rendered by the counterparty during the vesting period. The application of this principle to grants with a variable vesting period and a variable number of equity instruments receivable is illustrated in example 5.3.3 and example 5.3.4, respectively. In both examples, the variability is addressed by making an estimate of the vesting period or number of equity instruments and revising that estimate at the end of each reporting period until vesting occurs.

In the circumstances described, the interaction between the vesting period and the number of equity instruments receivable means that a straight-line allocation of the expense for 100 shares over three years will reflect both of the sources of variability for good leavers. This is because after, say, 18 months, the cumulative expense for 100 shares and a vesting period of three years will be the same as for 50 shares and a vesting period of 18 months. As discussed at 5.3.11, the entity’s total cumulative expense will be reduced due to the estimated number of bad leavers.

This example may be distinguished from a graded vesting scheme (see example 5.3.9 under which awards vest in separate tranches. In contrast, here, the award vests at only one date (the earlier of three years from the grant date and the date of leaving as a good leaver).

5.4 Determining the fair value of equity instruments granted

5.4.1 Measurement date

5.4.1.1 Measurement date — definition

When transactions are measured by reference to the fair value of the equity instruments granted, that fair value should be determined at the ‘measurement date’ which is defined in IFRS 2 as follows.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

5.4.1.2 Grant date — definition
This definition uses the term ‘grant date’ which is in turn defined as follows.

5.4.1.3 Determination of the grant date for a share-based bonus plan

Example 5.4.1.3
Determination of the grant date for a share-based bonus plan

On 1 January 20X1, Company A enters into an agreement with each of its executives whereby Company A will issue shares to each executive. The number of shares to be issued will vary in line with growth in revenue and profits for the year ended 31 December 20X1. Depending on audited revenue and profit growth for that year (which will be known at 31 March 20X2), Company A will issue between nil and 100 restricted shares to each employee.

The restricted shares will vest if the executive remains in Company A’s employment at the end of a further three years. Therefore, the earliest an executive will be able to sell his or her restricted shares is at the end of 20X4. The board of directors has already approved the formula and no further approvals are needed.

At what date should the fair value of the shares issued be measured — 1 January 20X1 or 31 March 20X2?

IFRS 2:11 requires that the fair value of the equity instruments should be measured at the grant date, which is defined in IFRS 2: Appendix A as “the date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.”

5.4.1.4 Grant date — requirement for agreement to a shared understanding of the terms and conditions
Two key factors that need to be considered when deciding on the grant date are:

• both parties need to ‘agree’ to a share-based payment; and
• both parties must have a shared understanding of the terms and conditions.

The word ‘agree’ is used in its usual sense and means that there must be both an offer and acceptance of that offer. The date of grant is when the other party accepts an offer and not when the offer is made. In some instances the agreement might be implicit (i.e. not by signing a formal contract) and this is the case for many share-based payment arrangements with employees. In these cases, the employees’ agreement is evidenced by their commencing to render services. [IFRS 2:IG2]

For both parties to have agreed to the share-based payment arrangement, they must have a shared understanding of the terms and conditions of the arrangement. If some of the terms and conditions of the arrangement are agreed on one date, with the remainder of the terms and conditions agreed on a later date, then grant date is on that later date, when all of the terms and conditions have been agreed. For example, consider the situation when an entity agrees to issue share options to an employee, but the exercise price of the options will be set by a remuneration committee that meets in three months’ time. The grant date is when the exercise price is set by the remuneration committee. [IFRS 2:IG3]
The scenario described in the previous paragraph differs from that described in example 5.4.1.3. In example 5.4.1.3, the number of restricted shares to be issued, although not known, is the subject of an agreed formula which considers revenue and profit growth. In the circumstances described in the previous paragraph, the exercise price is not agreed until it is set by the remuneration committee because until then it remains subject to the committee’s discretion.

**Example 5.4.1.4
Performance target at the discretion of the remuneration committee**

Company P granted share options to its employees. The share options vest over a three-year period assuming that a specified performance target is achieved. However, under the terms of the grant, the remuneration committee has the power to vary the performance target at any time until vesting.

The terms of the agreement should be reviewed carefully to understand the limits of the remuneration committee’s power. When the committee has wide discretion to vary the performance condition and is expected to use this discretion in practice, it is likely that the grant date of the options will be when they vest (i.e. when the committee exercises its discretion and the performance target is fixed). This is because there is no shared understanding of the terms of the award until that date (see below for further consideration).

However, in other cases, it will be apparent that the power to vary the performance target is intended to be used only in very rare and unusual circumstances. In such cases, it may be reasonable to assume that this term has little substance and should be ignored when accounting for the arrangement. In the event that the power is used at a later date, the amendment to the performance target should be accounted for as a modification (see section 5.5).

When the committee’s discretion is substantive, so that the grant date is not considered to occur until the options vest, this means that the grant date occurs after the employees to whom the equity instruments are granted have begun rendering services. However, IFRS 2:13 requires the entity to recognise the services when received. The guidance in IFRS 2:IG4 states that “the entity should estimate the grant date fair value of the equity instruments (e.g. by estimating the fair value of the equity instruments at the end of the reporting period)” for the purpose of recognising the services received during the period between the date of commencement of service and the grant date. Once the grant date occurs (in the example above, assuming the committee’s discretion is substantive, when the options vest), the entity revises the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments.

### 5.4.1.5 Grant date — requirement for employee acceptance

Share-based payment arrangements take various forms. Some arrangements require explicit employee acceptance (often for legal or tax reasons). Others permit implicit acceptance evidenced by the employee rendering service.

Entities must carefully consider all the details of a share-based payment arrangement in assessing whether a requirement for explicit employee acceptance affects the determination of the grant date. Relevant considerations include, but are not limited to, whether the terms of the arrangement:

- require an employee’s explicit agreement (e.g. by requiring the employee to sign the arrangement), in which case the grant date would normally be the date the employee accepts the offer by signing. However, if the offer requires shareholders’ approval, the grant date would be the later of the date the shareholders approve the arrangement and the date the employee agrees to the arrangement in accordance with IFRS 2:IG4; or

- do not require an employee’s explicit agreement, in which case the grant date would normally be the date the employee starts rendering services. However, if shareholders’ approval is required, the grant date cannot be before the shareholders approve the arrangement.

Sometimes there is a time lapse between the date when the shareholders approve the plan and when the approval of the plan is communicated to the employee. Normally the communication process is an administrative process and, consequently, the communication process does not defer the grant date.
The entity should also consider whether the requirement for explicit acceptance by the employee is a substantive feature of the arrangement. In making this assessment, the entity should consider whether, for example:

- the employee is required to accept the offer explicitly because acceptance of the awards triggers another event (e.g. the employee’s liability to tax arising from the award), or whether acceptance is implicit by virtue of the employee providing services; or
- the employee has a choice between accepting the share-based payment award or taking the compensation in an alternative form (e.g. free membership of insurance scheme offered by the employer).

If explicit acceptance by the employee is judged not to be a substantive feature, the grant date should not be delayed until the acceptance documents have been received.

The following example illustrates the application of these principles.

**Example 5.4.1.5**

**Effect of employee acceptance conditions on grant date**

In Country B, an individual is taxed in the period that share-based payments are received. As a result, prior to issuing share-based payments to its employees, Company X first issues an offer letter to each employee detailing the amount of shares or share options and the exercise price. Each employee has 30 days in which to return the offer letter to accept the options.

What is the grant date — the date of offer or the date of acceptance?

In many cases, the determination as to whether the requirement for rejection or acceptance is explicit or implicit requires careful analysis of the facts and circumstances. In the circumstances described, the requirement to accept is explicit and has substance, given that the employee will be taxed immediately on the options received. While the employee understands all of the terms and conditions, the employer does not (until acceptance) have a full understanding of how many share options will be issued. Therefore, due to the explicit acceptance requirement, grant date would be the date of acceptance.

The date of grant determines the date the options should be measured, but does not affect the recognition period of the expense; that is, the option should be recognised as an expense over the service period. If the service period begins prior to the grant date (e.g. from the offer date), Company X should begin expensing the share-based payment at the date of offer at an amount that will approximate to the fair value of the share-based payment to be determined at grant date. If the period between the offer date and the grant date crosses the reporting date, the fair value should be remeasured at the reporting date. Once an employee accepts, that date would be the grant date and the fair value would be determined at that date.

5.4.1.6 Measurement date — matching share awards

Matching share awards take various forms but generally involve an arrangement under which an employee is given shares in the entity to ‘match’ those for which the employee subscribes. Often this is linked to a bonus payment. For example, if an employee elects to take the bonus in the form of shares to the value of the bonus, the entity makes a matching share award. The award typically has a vesting condition relating to continuing employment and/or a non-vesting condition relating to holding the purchased shares for a prescribed period.

The determination of the measurement date for a matching share award is not always straightforward. Arrangements vary with regard to whether the employee has discretion to take the bonus in cash or shares and whether the entity has discretion to provide the matching shares. The measurement date is the grant date, which is when the entity and the employee have a shared understanding of the terms and conditions of the arrangement. When there is no discretion, the measurement date for the matching share award will generally be the date when the bonus arrangements are established. However, in other cases it may be a later date. The facts and circumstances of each case should be considered carefully.

Accounting for a bonus which will be settled in a variable number of shares to the value of the bonus is considered at 5.2.3.4.

The appropriate vesting period for matching share awards is considered at 5.3.12.
5.4.2 Measuring fair value by reference to the fair value of goods or services — volume rebates

Example 5.4.2
Measuring fair value by reference to the fair value of goods or services — volume rebates

Company A purchases 1,000 computers in return for 5,000 of Company A’s ordinary shares, trading at CU100 each. The seller generally sells the same computers individually for CU700 each. Company A currently trades several thousand shares a day, such that 5,000 shares would be readily convertible to cash by the seller.

How should the fair value of the computers received be determined?

When determining fair value by reference to the value of the goods or services, care should be taken to ensure that volume rebates or other discounts are considered. When the value of the goods or services received does not appear to be commensurate with the value of the equity instruments issued, the difference may be due to volume rebates. If this is the case, the amount recognised should be the fair value net of any volume rebates.

In the circumstances described, the difference between CU500,000 (5,000 × CU100) (the market value of the shares issued by Company A) and CU700,000 (1,000 × CU700) (the fair value of 1,000 computers purchased individually) may relate to a volume rebate that should be considered in the valuation. If this is the case, CU500,000 is the appropriate measure for the computers.

5.4.3 Measuring fair value by reference to the fair value of equity instruments

When share-based payment transactions are measured by reference to the fair value of the equity instruments granted, ideally that fair value should be determined by reference to market prices. For example, in the case of an issuance of shares that must be forfeited if the employee leaves service during a three-year period, the share-based payment will be measured at the fair value of the shares at the date of grant. A share price or valuation of the entity at the date of grant would be sufficient to determine the fair value of those shares and it would not be necessary to recalculate this value unless the grant was modified.

When market prices do not exist for share options, the fair value should be determined by applying a valuation technique, usually in the form of an option pricing model. [IFRS 2:B4]

IFRS 2 does not prescribe the use of a specific valuation methodology. The overriding principle implicit in the guidance in IFRS 2:B5 is that, in the selection of the appropriate option pricing model, an entity considers factors that knowledgeable and willing market participants would consider. Generally, this will be an issue requiring careful consideration by preparers, possibly requiring the involvement of valuation experts.

It may be acceptable, and even necessary, to use different models for different schemes to reflect their particular features. It may also sometimes be appropriate to use different models for different grants under the same scheme (e.g. to change to a more complex model as amounts become more material). However, other than in the case of material error, the grant date fair value should not be adjusted, once it has been determined using a particular model, even if that model is no longer used for new grants.

Appendix B to IFRS 2 discusses measurement of the fair value of shares and share options granted, focusing on specific terms and conditions that are common features of a grant of shares or share options to employees. Examples of the types of decisions related to measurement that entities are required to make include the following.

<table>
<thead>
<tr>
<th>Items to determine</th>
<th>Accounting decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pricing model</td>
<td>Black-Scholes, binomial, Monte Carlo etc.</td>
</tr>
<tr>
<td>Expected life assumption/employee behaviour</td>
<td>For variable exercise dates, assumptions are needed as to when employees are likely to exercise their options (e.g. in a financially optimal manner; when the option is in the money at a certain time, e.g. vesting date; when the share price hits a specified share price (‘barrier’); or based on historical behaviour).</td>
</tr>
<tr>
<td>Current share price</td>
<td>Share price can be determined on the basis of closing price on grant date or the average price on grant date.</td>
</tr>
<tr>
<td>Expected volatility</td>
<td>There are various methods to calculate this amount (e.g. based on historical experience, implied volatility of traded options, volatility of comparator entities, or industry index).</td>
</tr>
</tbody>
</table>
### Items to determine

<table>
<thead>
<tr>
<th>Items to determine</th>
<th>Accounting decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected dividends</td>
<td>This should be the expected future dividends over the expected life of the award. This should be in line with the entity’s policy, although this may be derived from historical experience or experience of competitors.</td>
</tr>
<tr>
<td>Risk-free interest rate</td>
<td>This should generally be the implied yield available at the date of grant on zero-coupon government issues of the country in whose currency the exercise price is expressed and of duration that is similar to the expected life of the award.</td>
</tr>
</tbody>
</table>

These items are addressed in more detail in section 5.4.4.

The fair value of cash-settled share-based payments, such as share appreciation rights (SARs), should be measured by using a model similar to one used for share options. That is, future share price increases and other variables have a similar effect on the fair value of many forms of cash-settled share-based payment transactions.

### 5.4.4 Valuation models

#### 5.4.4.1 Widely accepted valuation models

Three widely accepted valuation models are generally used to value equity options: the Black-Scholes model, the binomial model and Monte Carlo model.

These three models are compared and contrasted in 5.4.4.2 to 5.4.4.4.

#### 5.4.4.2 Black-Scholes

Application of the Black-Scholes model (sometimes referred to as the Black-Scholes-Merton formula) is a straightforward calculation, which requires only the six minimum inputs noted in 5.4.5.

The Black-Scholes approach requires a single expected life assumption as to when the option is likely to be exercised, does not allow for variable exercise dates and is not able to factor in any market conditions.

On the issue of expected early exercise, IFRS 2:B5 states that “many employee options have long lives, are usually exercisable during the period between vesting date and the end of the options’ life, and are often exercised early. These factors should be considered when estimating the grant date fair value of the options. For many entities, this might preclude the use of the Black-Scholes-Merton formula, which does not allow for the possibility of exercise before the end of the option’s life and may not adequately reflect the effects of expected early exercise”.

IFRS 2:B17, however, notes that this will not always be the case, stating that “the means by which the effects of expected early exercise are taken into account depends upon the type of option pricing model applied. For example, expected early exercise could be taken into account by using an estimate of the option’s expected life . . . as an input into an option pricing model (e.g. the Black-Scholes-Merton formula). Alternatively, expected early exercise could be modelled in a binomial or similar option pricing model that uses contractual life as an input”.

#### 5.4.4.3 Binomial model

The binomial model is more complex to apply than the Black-Scholes model, but allows more factors to be taken into account (i.e. variable exercise dates and some market-based vesting conditions).

The binomial model breaks down the time to expiration into potentially a large number of time intervals or steps. A tree of share prices is initially produced working forward from the present time to expiration of the option. At each step it is assumed that the share price will move up or down by an amount calculated using the volatility assumption and the length of each time interval. The probabilities of upward and downward movements are calculated using risk-neutral probabilities derived from the size of the upward and downward steps and the risk-free rate of return. This produces a binomial distribution, or tree, of underlying share prices. The tree represents all possible paths that the share price could take during the life of the option. The effect of dividends on the share price is adjusted for in the binomial tree as they are expected to be paid during the contractual life. At the end of the tree — that is, the expiration of the option — all the terminal option payoffs for each of the final possible share prices are known as they simply equal their intrinsic values.
Next, the ‘option values’ at each step of the tree are calculated working back from expiration to the present. The option values at each step are used to derive the option values at the preceding step of the tree using a risk-neutral valuation. This risk-neutral valuation uses the risk-free rate of interest as a discount factor and risk-neutral probabilities of the share price moving up or down. At any point during the option’s life at which exercise would be permitted, the higher of the intrinsic value (i.e. the value of the option if it were to be exercised) and the ‘option value’ (i.e. the value of the option if it were to be held) is taken (because a rational investor would exercise when exercising an option would give a higher value than holding on to it). In this way, the binomial model takes into account variable exercise dates. Certain adjustments to option values as a result of market-based vesting features can also be worked into the calculations at the required point in time. At the start of the tree, the option’s fair value is obtained.

5.4.4.4 Monte Carlo model

A Monte Carlo model works by simulating a large number of projected random outcomes for how the share price may move in future. The relevant share price may be that of the entity and, if applicable, those of comparator entities, e.g. when there are market-based performance conditions based on relative total shareholder return.

On the basis of each simulated share price (or set of comparator entity share prices), the proportion of awards that would vest and the resultant pay-off is determined. This is then discounted back to the valuation date at the risk-free interest rate. The procedure is then repeated a large number of times to determine the expected (average) value of the award at the valuation date.

5.4.5 Basic factors affecting the valuation of share-based payments

5.4.5.1 Basic inputs required to be considered by valuation models

Most employee share-based payments granted will not have an equivalent instrument traded in an active market and, therefore, when the determination of their fair values is required by IFRS 2, valuation models will need to be applied. IFRS 2 requires, at a minimum, that all valuation models consider the following six basic inputs:

[IFRS 2:B6]

- the exercise price of the option (see 5.4.5.2);
- the current price of the underlying shares (see 5.4.5.3);
- the expected life of the option (see 5.4.5.4);
- the expected volatility of the share price (see 5.4.5.5);
- the dividends expected on the shares (see 5.4.5.6); and
- the risk-free interest rate for the life of the option (see 5.4.5.7).

These variables have been widely accepted as required inputs into valuations. Therefore, it is useful first to review these basic inputs. Other factors affecting the valuation of share-based payments are addressed in section 5.4.6.

For some of the inputs listed above, it is likely that there will be a range of reasonable expectations, e.g. for exercise behaviour of employees. If this is the case, the fair value should be calculated by weighting each amount within the range of probabilities of occurrence. [IFRS 2:B12]

5.4.5.2 Exercise price

IFRS 2 does not provide guidance on the determination of the exercise price. The exercise price should be determined from the agreement.

It is possible for the exercise price to be variable. For example, an exercise price dependent on a non-market vesting condition is considered at 5.3.5.

5.4.5.3 Current share price

IFRS 2 does not provide guidance on the determination of the current share price.
The current share price should be determined in accordance with an entity’s accounting policy. That policy may dictate the use of closing price or average price at the grant date. Whichever method is chosen, it should be used consistently between periods and among plans.

5.4.5.4 Expected life

There are several factors that affect the expected life of a typical non-traded share option given to employees, such as vesting features and various behavioural considerations. These factors and others are discussed in greater detail in section 5.4.6.

Some ways that the expected life of a share option may be determined are:

- by creating a binomial lattice that includes all the appropriate factors — the lattice outcomes will determine when the exercise date is most likely to occur; or
- by taking factors, such as those listed below, employee risk aversion and behaviour into consideration and estimating an expected life that is then used in, for example, a Black-Scholes model.

Factors to consider in estimating the expected exercise date of a share option include:

[IFRS 2:B18]

- the length of the vesting period, because share options typically cannot be exercised before they vest;
- historical experience related to actual lives of share options;
- the price of underlying shares (employees may tend to exercise options when the share price reaches a specified level above the exercise price);
- the expected volatility of the underlying shares (employees tend to exercise options earlier on highly volatile shares); and
- the employee’s level within the organisation.

IFRS 2 suggests that different groups of employees may have homogeneous exercise behaviours and, therefore, determining the expected life for each homogeneous group may be more accurate than an expected life for all recipients of an option grant. [IFRS 2:B20] That is, one share option granted to the Chief Executive Officer may have a different value from one share option granted to a factory worker at the same time with the same term. For example, the Chief Executive Officer might have a greater understanding of when it is optimal to exercise the award and might have less restrictive cash flow constraints compared to the average worker. If the Black-Scholes model is used, IFRS 2 requires the use of the expected life of the option. Alternatively, exercise behaviours can be modelled into a binomial or similar option pricing model that uses contractual life.

5.4.5.5 Expected volatility

Volatility is a measure of the amount by which a share price is expected to fluctuate during a period. [IFRS 2:B22] Many of the concerns about determining the fair value of non-traded employee share options relate to determining the estimate of expected volatility over the term of the option.

Volatility may be measured by reference to the implied volatility in traded options. However, the trading of such options is quite thin and the terms tend to be much shorter than the terms of most employee share options. There is also empirical evidence that options with the same term but different strike prices have different implied volatility. This is a factor that cannot be included in the Black-Scholes model, which assumes a constant volatility.

Historical volatility is often used as a rebuttable presumption for long-term options because there is evidence that volatilities are mean-reverting. Therefore, using the long-term average historical volatility for long-term options would be sufficient if there were no reasons to assume that historical volatility would not generally be representative of future volatility. Some have suggested a blended approach utilising both implied volatility and historical volatility.

The historical volatility may be problematic for newly listed and unlisted entities. If a newly listed entity does not have sufficient historical information, it should nevertheless compute historical volatility for the longest period for which trading activity is available. It can also consider the historical volatility of similar entities following a comparable period in their lives. [IFRS 2:B26]
The unlisted entity will not have historical information to consider when estimating expected volatility. Instead, it should consider other factors, including historical or implied volatility of similar listed entities. [IFRS 2:B27 & B29]

Many factors should be considered when estimating expected volatility. For example, the estimate of volatility might first focus on implied volatilities for the terms that were available in the market and compare the implied volatility to the long-term average historical volatility for reasonableness.

In addition to implied and historical volatility, IFRS 2 suggests the following factors to be considered in estimating expected volatility:

[IFRS 2:B25]

- the length of time an entity’s shares have been publicly traded;
- appropriate and regular intervals for price observations; and
- other factors indicating that expected future volatility might differ from past volatility (e.g. extraordinary volatility in historical share prices).

5.4.5.6 Expected dividends

Whether expected dividends should be included in the measurement of share-based payments depends on whether the holder is entitled to dividends or dividend equivalents. For example, if employees are granted options and are entitled to dividends on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividends will be paid on the underlying shares. That is to say, the input to the option pricing model for expected dividends should be zero. [IFRS 2:B31 & B32] If the holder of the option or share is entitled to dividends between the grant date and the exercise date, expected dividends should not be included in the fair value measurement. [IFRS 2:B33]

If the employees are not entitled to dividends or dividend equivalents during the vesting period (or, in the case of options, before exercise), the grant date valuation of the rights to shares or options should take expected dividends into account. That is to say, when the fair value of an option is estimated, expected dividends should be included in the application of the option pricing model. When the fair value of a share grant is estimated, that valuation should be reduced by the present value of dividends expected to be paid during the vesting period. [IFRS 2:B34]

IFRS 2 notes that assumptions about expected dividends should generally be based on publicly available information. An entity that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. However, a newly formed entity with no history of paying dividends might expect to begin paying dividends during the expected lives of its employee share options. Those entities could use an average of their past dividend yield (zero) and the mean dividend yield of an appropriately comparable peer group. [IFRS 2:B36]

Option pricing models usually require expected dividend yield as input into the models. However, the models can be modified to use an expected dividend amount rather than a yield. If an entity uses the amount, it should consider its historical patterns of increases in dividends. For example, if an entity’s policy has generally been to increase dividends by 3 per cent per year, its estimated option value should not assume a fixed dividend amount throughout the option’s life unless there is evidence to support this. [IFRS 2:B35]

**Example 5.4.5.6 Accounting for dividends paid on share options**

Company B purchases its own shares in the market and holds them in an employee share trust (over which Company B has control) for use in settlement of an award of options to its employees. Under the terms of the award, if an employee leaves Company B within three years of the grant, the employee forfeits the share options. After three years of service, the options vest and an employee is eligible to receive shares on payment of a predetermined exercise price.

Consider the following three scenarios.

**Scenario A:** employees are not entitled to dividends on the shares declared prior to vesting.

**Scenario B:** employees are entitled to dividends in cash on the shares and any dividends declared are paid to the employees. The exercise price is unaffected by these dividends and, if the shares are forfeited, the employees retain the dividends declared and paid up to that date.

**Scenario C:** employees are notionally entitled to dividends, but the dividends are automatically applied to reduce the exercise price. If the shares are forfeited, the employee loses the right to dividends accrued and applied to reduce the exercise price.

- How should dividends declared and paid on the shares be treated in measuring the share options?
- How should dividends be accounted for in Company B’s financial statements when declared?
Example 5.4.5.6 (continued)

Accounting for dividends paid on share options

IFRS 2:B32 and B34 clarify that when dividends are paid to the option holders before the exercise of the options, the value of those options is greater than the value of options for which there is no dividend entitlement prior to exercise.

Scenario A: employees not entitled to dividends declared prior to vesting

When no dividend accrues to employees, the fair value of the share options at grant date should be reduced by the present value of dividends expected to be paid during the vesting period (for example, by including the expected dividend yield in a Black-Scholes calculation).

When the share-based payment related to these options is recognised, provided that they are classified as equity-settled share-based payments, the appropriate journal entry for the shares expected to vest is as follows.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Share-based payment expense</td>
<td>XXX</td>
</tr>
<tr>
<td>Cr Equity</td>
<td>XXX</td>
</tr>
</tbody>
</table>

To recognise the share-based payment expense.

Dividends accrued on the shares held by the employee share trust are eliminated from the aggregate of dividends paid and proposed by Company B (see section 9.2).

Scenario B: dividends declared are paid to employees

When dividends are paid to the option holders before the exercise date of the options, the share options should be valued as if no dividends will be paid on the underlying shares during the vesting period (for example, by including an expected dividend yield of zero per cent in a Black-Scholes calculation). As a result, the grant date valuation is not reduced by the present value of the dividends expected to be paid during the vesting period.

The accounting for any dividends paid on the underlying shares will depend on whether the underlying shares are expected to vest. Provided that the share-based payment is equity-settled:

- for awards that are expected to vest, IFRS 2 treats the employees as holders of equity share options. Therefore, any dividends paid on these share options are recognised directly in equity. This is consistent with the principles of paragraph 35 of IAS 32 Financial Instruments: Presentation which states that “[d]istributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit”. In addition, expensing the dividends through profit or loss as additional compensation when paid would result in double counting of an expense that has already been reflected in the grant date fair value of the award recognised under IFRS 2; and
- for awards that are not expected to vest (due to employees expected to leave during the three-year service period), employees are not treated as holders of equity share options. Any cash paid as ‘dividends’ on those share options represents employee remuneration in accordance with IAS 19 Employee Benefits and should, therefore, be recognised as an expense. The expense is measured at the amount of cash paid on these shares. Expensing these dividends through profit or loss does not result in double counting because no cumulative expense will be recognised under IFRS 2 for awards not expected to vest due to non-fulfilment of a service condition.

The appropriate journal entries are as follows.

Share-based payment expense related to the share options that are expected to vest (provided that they are considered to be an equity-settled share-based payment).

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Share-based payment expense</td>
<td>XXX</td>
</tr>
<tr>
<td>Cr Equity</td>
<td>XXX</td>
</tr>
</tbody>
</table>

To recognise the share-based payment expense.

Dividends paid on share options that are expected to vest.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Equity/retained earnings</td>
<td>XXX</td>
</tr>
<tr>
<td>Cr Cash</td>
<td>XXX</td>
</tr>
</tbody>
</table>

To recognise the dividends paid on share options that are expected to vest.

Dividends paid on share options that are NOT expected to vest.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Employee expense</td>
<td>XXX</td>
</tr>
<tr>
<td>Cr Cash</td>
<td>XXX</td>
</tr>
</tbody>
</table>

To recognise the dividends paid on share options that are not expected to vest.
Example 5.4.5.6 (continued)
Accounting for dividends paid on share options

If the assessment of the number of shares expected to vest changes, there will need to be an adjustment to reverse or increase the share-based payment expense as appropriate, together with an adjustment to increase or decrease the amount of dividend considered an additional employee expense.

Scenario C: dividends reduce exercise price, lost if shares forfeited

When dividends are automatically applied to reduce the exercise price, the input for dividends into the valuation of the option is the same as in Scenario B, as indicated in IFRS 2:B32.

When the share-based payment expense related to these options is recognised, provided that they are considered to be an equity-settled share-based payment, the appropriate journal entry is as follows.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based payment expense</td>
<td>Equity</td>
</tr>
</tbody>
</table>

To recognise the share-based payment expense.

When the dividends are declared, the entity may make a transfer from retained earnings to another component of equity for the amount of the dividends because this represents a part of the exercise price ‘paid’ by the employee. This is relevant only if the credit to equity under IFRS 2 is made to a separate reserve (see 5.1.5).

5.4.5.7 Risk-free interest rate

The risk-free interest rate affects the price of an option in a less intuitive way than expected volatility or expected dividends. As interest rates increase, the value of a call option also increases. This is because the present value of the exercise price will decrease.

IFRS 2 states that the risk-free interest rate should be the implied yield available at the date of grant on zero-coupon government issues in whose currency the exercise price is expressed, with a remaining term equal to the expected life of the option being valued. It may be necessary to use an appropriate substitute in some circumstances. [IFRS 2:B37]

5.4.6 Other factors affecting the valuation of share-based payments

5.4.6.1 Impact of variables that are not factored into the Black-Scholes model

There are certain variables that affect the value of many employee share options that are not factored into the standardised Black-Scholes model. The inability to incorporate these factors directly into the Black-Scholes model limits its usefulness in estimating the fair value of the options. While the approach in IFRS 2 attempts to ‘fix’ this fault through adjustments to the inputs to the Black-Scholes calculation (e.g. expected life versus contractual life), many believe these adjustments are not enough. Sections 5.4.6.2 to 5.4.6.8 discuss in more detail some of these additional assumptions. However, depending upon materiality levels, the additional benefits derived from a model that involves these assumptions may not be worth the costs of preparing that model.

5.4.6.2 Performance conditions

As further explained in section 5.3, IFRS 2 requires that market-based performance related vesting features be included in the determination of the fair value at the date of grant. Additionally, IFRS 2 requires the entity to estimate the vesting period at the date of grant and recognise the related expense over that period. There is no subsequent adjustment to the vesting period when the vesting period depends on a performance condition that is market-based.

Under IFRS 2, a non-market-based performance condition should not be included in the determination of the fair value at the grant date. For grants with such vesting conditions, at the end of each reporting period, the cumulative expense should equal that proportion of the charge that would have been expensed based on the multiple of the latest estimate of the number of awards that will meet that condition and the fair value of each award, i.e. it should be trued up at the end of each reporting period.

5.4.6.3 Non-vesting conditions

As further explained in section 5.3, non-vesting conditions are factored into the fair value calculation.
5.4.6.4 Non-transferability

Many believe non-transferability after the vesting period does not have a material impact on the valuation of an option from the perspective of the issuer. However, because the shareholding is typically a disproportionate part of an employee’s wealth, it may have a significant impact on their behaviour and, therefore, the expected life of the option. Several valuation experts have stated that the inability to transfer an employee share option does not violate option pricing model assumptions because there is no assumption about the transferability of the option in the calculation.

When estimating the fair value of an employee share option at the grant date, IFRS 2 requires the use of expected life to exercise instead of the option’s contractual life to expiration to take into account the option’s non-transferability. However, valuation experts agree that the use of an average expected life to exercise is not a theoretically accurate way to capture the option’s non-transferability. They argue that looking only at the average expected life of the share option distribution could not capture information about that distribution. Therefore, some believe employee behaviours that result in early exercise should be explicitly modelled using a more dynamic option pricing model — such as the binomial model.

Furthermore, many valuation experts now believe that no discount is warranted for non-transferability during the vesting period. If the premise of fair value, as discussed above, is to estimate the amount that a hypothetical market participant would pay for such an option, then the estimate should incorporate employee characteristics only to the extent that they would affect the amount and timing of cash flows of the option. The only alternatives facing the employee during the vesting period are to vest or not to vest — and those two alternatives are addressed under the modified grant date approach in IFRS 2.

IFRS 2:B3 indicates that post-vesting transfer restrictions should be taken into account when estimating the fair value of the shares granted, but only to the extent that the post-vesting transfer restrictions affect the price that a knowledgeable willing market participant would pay for those shares. If the shares are actively traded in a deep and liquid market, postvesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

Example 5.4.6.4
Effect of post-vesting transfer restrictions when measuring fair value of equity instruments

Company A operates a share purchase plan for its employees. Company A’s shares are listed and are actively traded. There are no vesting conditions; therefore, the shares vest immediately on grant date.

The plan stipulates post-vesting transfer restrictions such that employees cannot sell their shares until the end of a five-year period beginning on the grant date. The sale of those shares is legally prohibited before the end of the five-year period. Consequently, employees are required to pay the subscription price on the grant date, but they are unable to take advantage of market fluctuations during the following five years. The shares are held in a trust until the transfer restrictions expire. Dividends distributed during the restriction period are held by the trust.

In order to measure the effect of the post-vesting transfer restrictions, Company A considers a methodology that combines bank borrowings as if to acquire unrestricted shares on the market (the same number as granted in the plan) at the beginning of the five-year period and a forward to sell shares kept in the trust at the end of the five-year period. The fair value determined by such a methodology depends mainly on the interest rate applied to the borrowings. Typically, a financial markets participant (such as a bank) would be able to borrow money at a low rate such that the fair value would be less than the fair value determined on the basis of an interest rate applicable to an individual employee who does not have ready access to financial markets.

IFRS 2:Appendix A defines fair value as the “amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction”. Based on this definition, under Company A’s valuation methodology, the interest rate applied to the borrowings should be the rate applicable to the instrument. Therefore, an employee’s ability to source such borrowings is not considered.
5.4.6.5 Stated exercise restrictions

Stated exercise restrictions (e.g. restrictions on exercise or sale of shares by employees) will affect the value both directly and through their impact on the behaviour of holders. The easiest way to see this is to note that employees may find themselves holding a large proportion of their wealth in the form of shares whereas, in the absence of such restrictions, they would hold a more diversified portfolio. This, in turn, will affect their behaviour and, generally (but not invariably) will cause them to exercise as early as possible so as to be out of the restricted period as fast as possible. A history of exercising options as early as possible demonstrates that the value given by the employer is less than the amount attributable to the full term of the option.

The effects of exercise restrictions will be similar to the effects of nontransferability features as discussed above. Therefore, stated exercise restrictions should be evaluated when estimating the fair value of employee share options based on their effect on the expected future cash flows from the options.

5.4.6.6 Behavioural considerations

There are many factors that affect the value of share options through their impact on employee behaviour. Behavioural considerations are critical and should be included in the valuation of share options. This is a familiar consideration in the financial markets. The entire mortgage market, for example, revolves around estimation of the behavioural influences on prepayments.

IFRS 2 requires behavioural considerations to be included in the model through an adjustment to the expected life of the option. Many believe, however, that this will generally be inadequate since the life of the option will depend on the returns for both the entity and for the market and the mechanism for this dependency will be determined by the group characteristics noted, such as risk aversion, diversification, and tax considerations. For example, as individuals grow wealthier in a rising market, the costs of poor diversification may decline and that will reduce occurrences of early exercise of the share options.

5.4.6.7 Long-term nature of employee share options

The long-term nature of employee share option grants is significant and will clearly affect valuation. The Black-Scholes model uses one set of assumptions at grant date that do not change during the expected life of the options, while a binomial model can use varying assumptions at grant date depending on expected changes to the inputs during the expected life. A typical employee share option can have a contractual life of 10 years. Therefore, the use of static model inputs is not grounded in reality. Because changes in those factors over time can have a significant impact on option value, failure to model such changes over the term of the option can result in overstating or understating the fair value of an option.

Based on the results of research and discussions with valuation experts, fair value for an employee share option should incorporate at the measurement date volatility factors for discrete time periods over the term of the option, interest and dividend rates and exercise patterns over the term of the option, to correspond with historical evidence and/or current expectations, to the extent material. It is to be expected that applying a more dynamic option pricing model with changing inputs will be more difficult and, therefore, a cost benefit analysis (taking into consideration materiality) should be completed.

5.4.6.8 Effects of options granted on the capital structure of an entity

Typically, the shares underlying traded options are acquired from existing shareholders and, therefore, have no dilutive effect. [IFRS 2:838]

Capital structure effects of non-traded options, such as dilution, can be significant and are generally anticipated by the market at the date of grant. Nevertheless, except in most unusual cases, they should have no impact on the individual employee's decision. The market's anticipation will depend, among other matters, on whether the process of share returns is the same or is altered by the dilution and the cash infusion. In many situations, the number of employee share options issued relative to the number of shares outstanding is not significant and, therefore, the effect of dilution on share price can be ignored.

IFRS 2 suggests that the issuer should consider whether the possible dilutive effect of the future exercise of options granted has an effect on the fair value of those options at grant date by an adjustment to option pricing models and factor it into the valuation. [IFRS 2:841]
5.4.7 Example of employee share purchase plan

The following example is taken from the implementation guidance accompanying IFRS 2 and illustrates some issues about the valuation of equity instruments.

Example 5.4.7

[Guidance on implementing IFRS 2:IG Example 11]

Employee share purchase plan

Background

An entity offers all its 1,000 employees the opportunity to participate in an employee share purchase plan. The employees have two weeks to decide whether to accept the offer. Under the terms of the plan, the employees are entitled to purchase a maximum of 100 shares each. The purchase price will be 20 per cent less than the market price of the entity’s shares at the date the offer is accepted and the purchase price must be paid immediately upon acceptance of the offer. All shares purchased must be held in trust for the employees, and cannot be sold for five years. The employee is not permitted to withdraw from the plan during that period. For example, if the employee ceases employment during the five-year period, the shares must nevertheless remain in the plan until the end of the five-year period. Any dividends paid during the five-year period will be held in trust for the employees until the end of the five-year period.

In total, 800 employees accept the offer and each employee purchases, on average, 80 shares, i.e. the employees purchase a total of 64,000 shares. The weighted-average market price of the shares at the purchase date is CU30 per share, and the weighted-average purchase price is CU24 per share.

Application of requirements

For transactions with employees, IFRS 2 requires the transaction amount to be measured by reference to the fair value of the equity instruments granted (IFRS 2:11). To apply this requirement, it is necessary first to determine the type of equity instrument granted to the employees. Although the plan is described as an employee share purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, share option plans. For example, an ESPP might include a ‘lookback feature’, whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the entity’s share price at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan. Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph B3 of IFRS 2 states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the postvesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the entity should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm’s length transaction between knowledgeable, willing parties. Suppose that, in this example, the entity estimates that the fair value of each restricted share is CU28. In this case, the fair value of the equity instruments granted is CU4 per share (being the fair value of the restricted share of CU28 less the purchase price of CU24). Because 64,000 shares were purchased, the total fair value of the equity instruments granted is CU256,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 14 of IFRS 2, the entity should recognise an expense of CU256,000 immediately.

However, in some cases, the expense relating to an ESPP might not be material. IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors states that the accounting policies in IFRSs need not be applied when the effect of applying them is immaterial (IAS 8, paragraph 8). IAS 8 also states that an omission or misstatement of an item is material if it could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor (IAS 8:5). Therefore, in this example, the entity should consider whether the expense of CU256,000 is material.

It is unusual that the example in the implementation guidance accompanying IFRS 2 explicitly refers to the possibility that the charge might not be material. This might equally be true of most other requirements of this or other Standards. Caution should be exercised in deciding that a charge otherwise required by IFRS 2 is not material. IAS 8 provides guidance on the meaning of ‘material’ in the context of errors.
5.4.8 Measurement of equity instruments when fair value is not reliably measurable

IFRS 2 provides an exemption from fair value when the fair value of the equity instruments issued cannot be reliably measured. In these rare cases, the grant is initially measured at its intrinsic value and adjusted at the end of each reporting period for any change in intrinsic value until the options are either exercised, forfeited or lapse.

IFRS 2 defines ‘intrinsic value’ as follows.

\[ \text{IFRS 2:Appendix A} \]

"The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares."

For example, a share option with an exercise price of CU15 on a share with a fair value of CU20 has an intrinsic value of CU5.

In the rare cases in which fair value is not reliably measurable, the equity instruments granted are measured at their intrinsic value, initially at the date when the entity obtains the goods or the counterparty renders the services. The instrument is subsequently remeasured at intrinsic value at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, are forfeited (e.g. upon cessation of employment) or lapse (e.g. at the end of the option’s life). [IFRS 2:24(a)]

When this approach is used, the goods or services received should be recognised based on the number of equity instruments that ultimately vest or, when applicable, are ultimately exercised. This means that in the case of share options, the goods or services received are recognised during the vesting period in accordance IFRS 2:14 and 15 (see section 5.1) except that the requirements of IFRS 2:15(b) concerning market conditions do not apply. The amount recognised for goods or services received during the vesting period is based on the number of share options expected to vest. That estimate is revised if subsequent information indicates that the number of options expected to vest differs from previous estimates. On vesting date, the estimate is revised to equal the number of equity instruments that ultimately vested. After vesting date, the amount recognised for goods or services received is reversed if the options are later forfeited, or lapse at the end of the option’s life. [IFRS 2:24(b)]

If the intrinsic value approach is used, it is not necessary to apply IFRS 2:26 to 29, which deal with modifications to the terms and conditions on which equity instruments were granted, including cancellation and settlement (see section 5.5). This is because any modifications to the terms and conditions on which the equity instruments were granted will be taken into account when applying the intrinsic value method described above. [IFRS 2:25]

However, if an equity instrument to which the intrinsic value method has been applied is settled and the settlement occurs during the vesting period, the settlement is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised for services received over the remainder of the vesting period is, therefore, recognised immediately. In this case, any payment made on settlement is accounted for as the repurchase of equity instruments (i.e. as a deduction from equity) except to the extent that the payment exceeds the intrinsic value of the equity instruments measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2:25]

The application of the intrinsic value method is illustrated in the following example which is taken from the implementation guidance accompanying IFRS 2.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs  
A Roadmap to Accounting for Share-Based Payment Awards

Example 5.4.8  
Grant of share options that is accounted for by applying the intrinsic value method

[Guidance on implementing IFRS 2:IG Example 10]

Background
At the beginning of year 1, an entity grants 1,000 share options to 50 employees. The share options will vest at the end of year 3, provided the employees remain in service until then. The share options have a life of 10 years. The exercise price is CU60 and the entity’s share price is also CU60 at the date of grant.

At the date of grant, the entity concludes that it cannot estimate reliably the fair value of the share options granted.

At the end of year 1, three employees have ceased employment and the entity estimates that a further seven employees will leave during years 2 and 3. Hence, the entity estimates that 80 per cent of the share options will vest.

Two employees leave during year 2, and the entity revises its estimate of the number of share options that it expects will vest to 86 per cent.

Two employees leave during year 3. Hence, 43,000 share options vested at the end of year 3.

The entity’s share price during years 1–10, and the number of share options exercised during years 4–10, are set out below. Share options that were exercised during a particular year were all exercised at the end of that year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Share price at year-end</th>
<th>Number of share options exercised at year-end</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>63</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>65</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>75</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>88</td>
<td>6,000</td>
</tr>
<tr>
<td>5</td>
<td>100</td>
<td>8,000</td>
</tr>
<tr>
<td>6</td>
<td>90</td>
<td>5,000</td>
</tr>
<tr>
<td>7</td>
<td>96</td>
<td>9,000</td>
</tr>
<tr>
<td>8</td>
<td>105</td>
<td>8,000</td>
</tr>
<tr>
<td>9</td>
<td>108</td>
<td>5,000</td>
</tr>
<tr>
<td>10</td>
<td>115</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Application of requirements
In accordance with paragraph 24 of the IFRS, the entity recognises the following

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Expense for period</th>
<th>Cumulative expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000 options × 80% × (CU63 – CU60) × 1/3 years</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>2</td>
<td>50,000 options × 86% × (CU65 – CU60) × 2/3 years – CU40,000</td>
<td>103,333</td>
<td>143,333</td>
</tr>
<tr>
<td>3</td>
<td>43,000 options × (CU75 – CU60) – CU143,333</td>
<td>501,667</td>
<td>645,000</td>
</tr>
<tr>
<td>4</td>
<td>37,000 outstanding options × (CU88 – CU75) + 6,000 exercised options × (CU88 – CU75)</td>
<td>559,000</td>
<td>1,204,000</td>
</tr>
<tr>
<td>5</td>
<td>29,000 outstanding options × (CU100 – CU88) + 8,000 exercised options × (CU100 – CU88)</td>
<td>444,000</td>
<td>1,648,000</td>
</tr>
<tr>
<td>6</td>
<td>24,000 outstanding options × (CU90 – CU100) + 5,000 exercised options × (CU90 – CU100)</td>
<td>(290,000)</td>
<td>1,358,000</td>
</tr>
<tr>
<td>7</td>
<td>15,000 outstanding options × (CU96 – CU90) + 9,000 exercised options × (CU96 – CU90)</td>
<td>144,000</td>
<td>1,502,000</td>
</tr>
<tr>
<td>8</td>
<td>7,000 outstanding options × (CU105 – CU96) + 8,000 exercised options × (CU105 – CU96)</td>
<td>135,000</td>
<td>1,637,000</td>
</tr>
<tr>
<td>9</td>
<td>2,000 outstanding options × (CU108 – CU105) + 5,000 exercised options × (CU108 – CU105)</td>
<td>21,000</td>
<td>1,658,000</td>
</tr>
<tr>
<td>10</td>
<td>2,000 exercised options × (CU115 – CU108)</td>
<td>14,000</td>
<td>1,672,000</td>
</tr>
</tbody>
</table>
5.5 Modifications to equity-settled transactions (including cancellations and settlements)

5.5.1 Modifications — general

An entity may decide to modify the terms of an existing equity instrument granted in a share-based payment transaction. For example, if there is a decline in the entity's share price an employer may decide to reduce the exercise price of options previously issued to employees, thus increasing their fair value. IFRS 2's requirements in this area are expressed in the context of transactions with employees. However, the requirements also apply to share-based payment transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted. In this case, any references to grant date are instead used to refer to the date the entity obtains the goods or the counterparty renders service. [IFRS 2:26]

As a minimum, the services received are measured at the grant date fair value, unless the instruments do not vest because of a failure to satisfy a non-market vesting condition that was specified at grant date. This applies irrespective of any modifications to the terms and conditions on which the instruments were granted (including cancellation or settlement). In addition, the effects of modifications that increase the total fair value of the share-based payment arrangement, or are otherwise beneficial to the employee, are recognised. [IFRS 2:27]

Therefore, a modification that results in a decrease in the fair value of equity instruments does not result in a reduction in the expense recognised in future periods. However, the effects of modifications that increase fair value are recognised. Appendix B of IFRS 2 provides guidance on how this requirement should be implemented. This guidance, which forms an integral part of the Standard, is summarised below.

The transition provisions of IFRS 2 (and, for first-time adopters, the provisions of IFRS 1) do not require the Standard to be applied to awards granted before 7 November 2002. IFRS 2 does not address the modification of such awards. For such modifications, it will be necessary to recognise any incremental fair value as a result of the modification. However, this should not require the recognition of an expense for the original grant date fair value because this is not required under the transition provisions of IFRS 2 or IFRS 1.

5.5.1.2 Modification increases the fair value of the equity instruments granted

The fair value of the equity instruments granted may be increased, for example by reducing the exercise price of share options. When this happens, the incremental fair value is measured by comparing the fair value of the instrument immediately before and immediately after the modification. This incremental fair value is then included in the measurement of the amount recognised for services received.

If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest. The amount based on the grant date fair value of the original equity instruments continues to be recognised over the remainder of the original vesting period.

If the modification occurs after vesting date, the incremental fair value granted is recognised immediately. If the employee is required to complete an additional period of service before becoming unconditionally entitled to the modified equity instruments, the incremental fair value granted will be recognised over the vesting period. [IFRS 2:B43(a)]

The following example, which is taken from the implementation guidance accompanying IFRS 2, illustrates the approach that should be adopted for a simple option repricing.

**Example 5.5.1.2**
**Grant of share options that are subsequently repriced**

[Guidance on implementing IFRS 2:IG Example 7]

**Background**

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15. On the basis of a weighted average probability, the entity estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.
Example 5.5.1.2 (continued)
Grant of share options that are subsequently repriced

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the entity’s share price has dropped, and the entity reprices its share options, and that the repriced share options vest at the end of year 3. The entity estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of year 3.

The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (ie before taking into account the repricing) is CU5 and that the fair value of each repriced share option is CU8.

Application of requirements

Paragraph 27 of the IFRS requires the entity to recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. If the modification increases the fair value of the equity instruments granted (eg by reducing the exercise price), measured immediately before and after the modification, paragraph B43(a) of Appendix B requires the entity to include the incremental fair value granted (ie the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the equity instruments granted. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

The incremental value is CU3 per share option (CU8 – CU5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of CU15.

The amounts recognised in years 1–3 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Remuneration expense for period</th>
<th>Cumulative remuneration expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(500 – 110) employees × 100 options × CU15 × 1/3</td>
<td>195,000</td>
<td>195,000</td>
</tr>
<tr>
<td>2</td>
<td>(500 – 105) employees × 100 options × (CU15 × 2/3 + CU3 × 1/2) – CU195,000</td>
<td>259,250</td>
<td>454,250</td>
</tr>
<tr>
<td>3</td>
<td>(500 – 103) employees × 100 options × (CU15 + CU3) – CU454,250</td>
<td>260,350</td>
<td>714,600</td>
</tr>
</tbody>
</table>

5.5.1.3 Modification increases the number of equity instruments granted

If the modification increases the number of equity instruments granted, the fair value of the additional equity instruments granted, measured at the date of the modification, is included in the measurement of the amount recognised for services received, consistent with the requirements in 5.5.1.2.

For example, if the modification occurs during the vesting period, the fair value of the additional equity instruments granted is included in the amount recognised for services received over the period from the modification date until the date when the additional equity instruments vest. This is in addition to the amount based on the grant date fair value of the equity instruments originally granted which is recognised over the remainder of the original vesting period. [IFRS 2:B43(b)]

The additional equity instruments granted as a result of the modification are, therefore, accounted for in the same way as a new grant of equity instruments on the date of the modification. The related expense is recognised over the remainder of the vesting period, in addition to the expense on the original grant.
Example 5.5.1.3
Modification increases the number of equity instruments granted

On 1 January 20X1, Company A puts in place a share-based payment arrangement under which employees will receive 10,000 shares in Company A free of charge if they stay in employment for three years. At 1 January 20X1 (the grant date), Company A’s share price is CU6.

During the first half of 20X1, Company A’s share price falls significantly. On 1 July 20X1, Company A modifies the scheme so that participating employees who are still employed at 31 December 20X3 will receive twice as many shares (i.e. 20,000 shares rather than 10,000 shares). On 1 July 20X1, Company A’s share price is CU2.50.

At 31 December 20X1, Company A expects that shares will vest for 90 per cent of the employees (i.e. 18,000 shares are expected to vest).

Company A does not anticipate paying any dividends before 31 December 20X3 and, accordingly, the fair value of each equity instrument is determined to be Company A’s share price at the grant date.

At the end of 20X1, Company A is 1/3 (12 out of 36 months) of the way through the vesting period for the original grant, and 1/5 (6 out of 30 months) of the way through the vesting period for the additional grant. Therefore, the expense for 20X1 is calculated as follows.

\[
(10,000 \times CU6 \times 1/3 \times 90\%) + (10,000 \times CU2.50 \times 1/5 \times 90\%) = CU22,500.
\]

5.5.1.4 Vesting conditions modified in a manner that is beneficial to the employee

The vesting conditions may be modified in a way that is beneficial to the employee. For example, the vesting period may be reduced or a performance condition might be eliminated or made less demanding. When the modification affects a market condition it is accounted for as described at 5.5.1.2. In all other cases, the modified vesting conditions are taken into account when applying the requirements of IFRS 2:19 to 21 (see 5.3.1).

[IFRS 2:B43(c)]

The following example illustrates a modification that is beneficial to the employee as a result of the removal of a market condition.

Example 5.5.1.4A
Removal of a market condition (1)

Company A issues 100 options each to 100 employees. The options vest if:

(a) the employees remain in employment for three years; and
(b) the share price increases to CU9 by the end of the three-year vesting period.

The share price at grant date is CU5 and the fair value of each option is CU3. It is expected that 90 of the employees will remain in Company A’s employment for the three years.

In Year 1, the expense recognised is as follows.

\[
\begin{align*}
\text{Dr Profit or loss} & \quad (100 \times CU3 \times 90 \text{ employees} \times 1/3) \\
\text{Cr Equity} & \quad 9,000
\end{align*}
\]

To recognise the share-based payment expense.

At the beginning of Year 2, the market-based vesting condition (share price target) is removed. At this date, the fair value of each option with the share price target is CU2 and the fair value of each option without the share price target is CU3.50. Thus, an incremental fair value of CU1.50 per option is given to the employees. It is now expected that 92 employees will remain in Company A’s employment until the end of Year 3.

In Year 2, the expense recognised is as follows.

In respect of the original scheme

\[
\begin{align*}
\text{Dr Profit or loss} & \quad [(100 \times CU3 \times 92 \text{ employees} \times 2/3) – CU9,000] \\
\text{Cr Equity} & \quad 9,400
\end{align*}
\]

To recognise the share-based payment expense relating to original scheme.
Example 5.5.1.4A (continued)
Removal of a market condition (1)

In respect of the modification

\[\text{Dr Profit or loss} \times [100 \text{ options} \times \text{CU}1.50 \times 92 \text{ employees} \times \frac{1}{2}] = 6,900 \text{ CU} \]

\[\text{Cr Equity} \times 6,900 \text{ CU} \]

To recognise the share-based payment expense relating to modification.

At the end of Year 3, 88 employees are still in employment. The expense recognised is as follows.

In respect of the original scheme

\[\text{Dr Profit or loss} \times [(100 \text{ options} \times \text{CU}3 \times 88 \text{ employees}) - \text{CU}9,000 - \text{CU}9,400] = 8,000 \text{ CU} \]

\[\text{Cr Equity} \times 8,000 \text{ CU} \]

To recognise the share-based payment expense relating to original scheme.

In respect of the modification

\[\text{Dr Profit or loss} \times [(100 \text{ options} \times \text{CU}1.50 \times 88 \text{ employees}) - \text{CU}6,900] = 6,300 \text{ CU} \]

\[\text{Cr Equity} \times 6,300 \text{ CU} \]

To recognise the share-based payment expense relating to modification.

The following example illustrates a modification that is beneficial to the employee as a result of the removal of a non-market condition. The removal of a non-market performance condition will increase the likelihood of the instruments vesting. Overall, this will only be reflected by an increased expense in profit or loss if, and to the extent that, more instruments ultimately vest as a result of the modification.

Example 5.5.1.4B
Removal of a non-market condition (1)

Company A issues 100 options each to 100 employees. The options vest if:

(a) the employees remain in employment for three years; and
(b) earnings per share (EPS) for Year 3 is at least CU1.

The fair value of each option is CU3. It is expected that 90 of the employees will remain in Company A’s employment for the three years. At the beginning of Year 1, it is expected that the EPS condition will be met.

In Year 1, the expense recognised is as follows.

\[\text{Dr Profit or loss} \times [100 \text{ options} \times \text{CU}3 \times 90 \text{ employees} \times \frac{1}{3}] = 9,000 \text{ CU} \]

\[\text{Cr Equity} \times 9,000 \text{ CU} \]

To recognise the share-based payment expense.

In Year 2, because it is no longer expected that the EPS condition will be met, the expense previously recognised is reversed.

\[\text{Dr Equity} \times 9,000 \text{ CU} \]

\[\text{Cr Profit or loss} \times 9,000 \text{ CU} \]

To recognise the reversal of the share-based payment expense.

In Year 3, the EPS condition is removed. At the end of Year 3, 88 employees are still in employment. The expense recognised is as follows (reflecting the options vesting in the absence of the now removed EPS condition).

\[\text{Dr Profit or loss} \times [(100 \text{ options} \times \text{CU}3 \times 88 \text{ employees}) - \text{nil}] = 26,400 \text{ CU} \]

\[\text{Cr Equity} \times 26,400 \text{ CU} \]

To recognise the share-based payment expense.
The effect of modifications which replace a market condition with a non-market condition is considered at 5.5.1.7. The effect of a modification which replaces a non-market condition with a market condition is considered at 5.5.1.8.

5.5.1.5 Terms or conditions modified in a manner that is not beneficial to the employee

The terms and conditions of the equity instruments granted may be varied in a manner that reduces the total fair value of the share-based payment arrangement, or is otherwise not beneficial to the employee. In this case, the entity continues to account for the services received as if the modification had not occurred (other than for a cancellation of some or all of the equity instruments granted which is considered at 5.5.2). [IFRS 2:B44]

This situation is unlikely to be common in practice because it is difficult to see why employees would consent to their agreed benefits being made less attractive. However, if this requirement did not exist it would be possible for management to reduce or eliminate the expense for ‘out of the money’ options because the employees might accept that they would receive no benefit anyway.

If the modification reduces the fair value of the equity instruments granted, measured immediately before and after the modification, the decrease in fair value is not taken into account. The amount recognised for services received continues to be measured based on the grant date fair value of the instrument originally granted. [IFRS 2:B44(a)]

If the modification reduces the number of equity instruments granted to an employee, the reduction is accounted for as a cancellation of that portion of the grant (see 5.5.2). [IFRS 2:B44(b)]

If the vesting conditions are modified in a manner that is not beneficial to the employee (e.g. by increasing the vesting period), the modified vesting conditions are not taken into account when applying the requirements of IFRS 2:19 to 21 (see 5.3). [IFRS 2:B44(c)]

The following example, taken from the implementation guidance accompanying IFRS 2, illustrates the application of this requirement.

**Example 5.5.1.5
Grant of share options with a vesting condition that is subsequently modified**

[Guidance on implementing IFRS 2:IG Example 8]

**Background**

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, conditional upon the employee’s remaining in the entity’s employ for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is CU15 per option at the date of grant.

During year 2, the entity increases the sales target to 100,000 units. By the end of year 3, the entity has sold 55,000 units, and the share options are forfeited. Twelve members of the sales team have remained in service for the three-year period.

**Application of requirements**

Paragraph 20 of the IFRS requires, for a performance condition that is not a market condition, the entity to recognise the services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vested. However, paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received, measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Furthermore, paragraph B44(c) of Appendix B specifies that, if the entity modifies the vesting conditions in a manner that is not beneficial to the employee, the entity does not take the modified vesting conditions into account when applying the requirements of paragraphs 19–21 of the IFRS.

Therefore, because the modification to the performance condition made it less likely that the share options will vest, which was not beneficial to the employee, the entity takes no account of the modified performance condition when recognising the services received. Instead, it continues to recognise the services received over the three-year period based on the original vesting conditions. Hence, the entity ultimately recognises cumulative remuneration expense of CU180,000 over the three-year period (12 employees × 1,000 options × CU15).
Example 5.5.1.5 (continued)
Grant of share options with a vesting condition that is subsequently modified

The same result would have occurred if, instead of modifying the performance target, the entity had increased the number of years of service required for the share options to vest from three years to ten years. Because such a modification would make it less likely that the options will vest, which would not be beneficial to the employees, the entity would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service over the original three-year vesting period.

5.5.1.6 Adjustments to preserve the rights of holders

Share options or other share-based payment arrangements may change in the case of capital changes such as bonus issues, rights issues and demergers in order to preserve the rights of the holders. For example, in the event of a one-for-one bonus issue, the number of shares in issue will double and the share price will fall by half. Therefore, to avoid the option holders being disadvantaged, it would be usual for the exercise price to be halved and the number of options to be doubled.

Such an adjustment would not result in an additional expense due to modification under IFRS 2 in the following circumstances.

- Preservation of rights in the case of a capital change is part of the scheme rules at inception. If this is the case, the adjustment is made in accordance with the original terms of the grant and there has, therefore, been no modification to the terms and conditions of the grant. This may be the case even if there is no explicit requirement in the written rules of the scheme to make the adjustment. It is important to consider whether such a requirement was implicit in the agreement and, therefore, the entity has merely acted in accordance with the original grant. For example, in some jurisdictions it may be the norm for such adjustments to be made, in which case a court might conclude that there was an implicit contract term in the absence of any evidence to the contrary.

- The option holders are treated in their capacity as equity holders, not as providers of goods or services. This is the case if an equivalent adjustment is made to all other equity or compound instruments (e.g. any convertible bonds) that would otherwise be affected at the time of the capital change and, as stated in IFRS 2:4, means that the adjustment is not subject to the requirements of IFRS 2.

If neither of these circumstances applies, or if other amendments to the terms are made that confer any additional benefit on the employees, the adjustment will be a modification and it will be necessary to compare the fair value of the rights immediately before and after the adjustment.

5.5.1.7 Replacement of a market condition with a non-market condition

The following example is similar to example 5.5.1.4A in that a market condition has been removed, but in this case it has been replaced with a non-market condition. There will usually be an incremental fair value because an equity instrument with no market conditions attached will be more valuable than the same equity instrument with a market condition attached. However, whether that incremental fair value is charged as an expense will depend on whether the replacement non-market condition is met.

Example 5.5.1.7
Replacement of a market condition with a non-market condition

Company A issues 100 options each to 100 employees. The options vest if:

(a) the employees remain in employment for three years; and

(b) the share price increases to CU9 by the end of the three-year vesting period.

The share price at grant date is CU5 and the fair value of each option is CU3. It is expected that 90 of the employees will remain in Company A’s employment for the three years.

At the beginning of Year 2, the market-based vesting condition (share price target) is removed and replaced with an earnings per share (EPS) condition such that, for the options to vest, EPS for Year 3 must be at least CU1.

At this date, the fair value of each option with the share price target is CU2 and the fair value of each option without the share price target is CU3.50. Therefore, an incremental fair value of CU1.50 per option is being given to the employees. It is now expected that 92 employees will remain in Company A’s employment until the end of Year 3, and that the EPS target will be met.

At the end of Year 3, 88 employees are still in employment.
Example 5.5.1.7 (continued)
Replacement of a market condition with a non-market condition

Scenario A: the EPS target is met
In Year 1, the expense recognised is as follows.

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU3} \times 90 \\
& \text{employees} \times 1/3\} \\
& \text{CU} 9,000 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 9,000
\end{array}
\]

To recognise the share-based payment expense.

In Year 2, the expense recognised is as follows.

In respect of the original scheme

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU3} \times 92 \\
& \text{employees} \times 2/3 \} - \text{CU9,000}\} \\
& \text{CU} 9,400 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 9,400
\end{array}
\]

To recognise the share-based payment expense in respect of original scheme.

In respect of the modification

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU1.50} \times 92 \\
& \text{employees} \times 1/2\} \\
& \text{CU} 6,900 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 6,900
\end{array}
\]

To recognise the share-based payment expense in respect of modification.

In Year 3, the expense recognised is as follows.

In respect of the original scheme

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU3} \times 88 \} - \\
& \text{CU9,000} \} - \text{CU9,400}\} \\
& \text{CU} 8,000 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 8,000
\end{array}
\]

To recognise the share-based payment expense in respect of original scheme.

In respect of the modification

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU1.50} \times 88 \} - \text{CU6,900}\} \\
& \text{CU} 6,300 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 6,300
\end{array}
\]

To recognise the share-based payment expense in respect of modification.

Scenario B: the EPS target is not met
In the event that the EPS target is not met, the incremental expense in respect of the modification is reversed because the non-market condition has not been met. However, in accordance with IFRS 2:B42, Company A continues to recognise the expense in respect of the original scheme because, although the options have failed to vest, this was not because of failure to satisfy a vesting condition specified at the grant date.

Therefore, the expense recognised in Year 3 would be as follows.

In respect of the original scheme

\[
\begin{array}{lr}
\text{Dr} & \text{Profit or loss \{100 options} \times \text{CU3} \times 88 \} - \\
& \text{CU9,000} \} - \text{CU9,400}\} \\
& \text{CU} 8,000 \\
\text{Cr} & \text{Equity} \\
& \text{CU} 8,000
\end{array}
\]

To recognise the share-based payment expense in respect of original scheme.
Example 5.5.1.7 (continued)
Replacement of a market condition with a non-market condition

In respect of the modification (reversal of expense previously recognised)

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Equity</td>
<td>6,900</td>
<td></td>
</tr>
<tr>
<td>Cr Profit or loss</td>
<td>6,900</td>
<td></td>
</tr>
</tbody>
</table>

*To reverse the share-based payment expense in respect of modification.*

It is possible that the modification might be structured with the intention that the fair value to the employee is the same before and after the modification. For example, this might be the case if the probability of the replacement non-market condition being met is the same as the probability of the original market condition being met. However, as illustrated in example 5.5.1.7, such a modification may result in an additional expense in accordance with the requirements of IFRS 2. This is a consequence of the different manner in which IFRS 2 treats market and non-market conditions.

5.5.1.8 Replacement of a non-market condition with a market condition

The following example is similar to example 5.5.1.4B in that a non-market condition has been removed but in this case it has been replaced with a market condition.

Example 5.5.1.8
Replacement of a non-market condition with a market condition

Company A issues 100 options each to 100 employees. The options vest if:

(a) the employees remain in employment for three years; and
(b) earnings per share (EPS) for Year 3 is at least CU1.

The fair value of each option at grant date is CU3. It is expected that 90 of the employees will remain in Company A’s employment for the three years. At the start of Year 1, it is expected that the EPS condition will be met.

In Year 1, the expense recognised is as follows.

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Profit or loss [100 options × CU3 × 90 employees × 1/3]</td>
<td>9,000</td>
<td></td>
</tr>
<tr>
<td>Cr Equity</td>
<td>9,000</td>
<td></td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense.*

At the beginning of Year 2, the EPS condition is removed and replaced with a market-based performance condition such that the share price must reach CU9 by the end of the vesting period. It is expected that 92 employees will remain in Company A’s employment for the three years.

At the date of the modification, the fair value of the option with the share price target is CU2 and the fair value of the option without the share price target is CU3.50. Value to the employees is decreased but, under IFRS 2:B44, this decrease is not accounted for.

The original grant date fair value must continue to be recognised as an expense except to the extent that the shares do not vest because a service or nonmarket performance condition that was present at grant date is not met. The only such condition that continues to exist once the EPS condition is removed is the employment condition.

In Year 2, the expense recognised is as follows.

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Profit or loss [(100 options × CU3 × 92 employees × 2/3) − CU9,000]</td>
<td>9,400</td>
<td></td>
</tr>
<tr>
<td>Cr Equity</td>
<td>9,400</td>
<td></td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense.*
Example 5.5.1.8 (continued)
Replacement of a non-market condition with a market condition

At the end of Year 3, 88 employees are still in employment and the share price target is not met, so the expense recognised is as follows.

<table>
<thead>
<tr>
<th>Dr Profit or loss</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>(100 options × CU3 × 88 employees) – CU9,000 – CU9,400</td>
<td>8,000</td>
</tr>
</tbody>
</table>

Cr Equity 8,000

To recognise the share-based payment expense.

The share-based payment expense is not reversed even though the options do not vest as a result of the market-based performance condition (the share price target). This is the case even though the effect of the market-based performance condition (i.e. reduction in fair value of the options) was not reflected in the measurement of the compensation expense as a result of IFRS 2:B44.

Replacement of a non-market performance condition with a market-based performance condition will, therefore, result in the need to recognise an expense equal to the original grant date fair value irrespective of whether the replacement market-based performance condition is met. In particular, replacement of a non-market performance condition that is not ultimately met with a market condition that is also not ultimately met will result in the need to recognise an expense that would not otherwise have been recognised. This is a consequence of the different manner in which market and non-market performance conditions are treated under IFRS 2.

5.5.1.9 Several modifications in one

IFRS 2:27 requires an entity to recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee in addition to the amount recognised for service received measured at the grant date fair value.

In determining the fair value of modifications, IFRS 2:B42 – B44 provide the following guidance.

Modifications beneficial to employees:

- for those that increase the fair value of the equity instruments granted or modify a market condition, the incremental fair value granted (difference between fair value measured immediately before and after the modification) is included in the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest; and
- for those that modify the vesting conditions (other than market conditions), an adjustment is made for the number of awards expected to vest.

Modifications not beneficial to employees:

- for those that reduce the fair value of the equity instruments granted or modify a market condition, an entity continues to recognise the amount for services received based on the grant date fair value; and
- for those that modify the vesting conditions (other than market conditions), the modified vesting conditions are not taken into account and the grant date fair value is recognised over the original vesting period.

IFRS 2 does not explicitly address when several modifications to a share-based payment arrangement are made at one time. However, the application of the principles set out in IFRS 2:B42 to B44 in such cases is illustrated in example 5.5.1.9A to 5.5.1.9C.
Example 5.5.1.9A
Modification by reducing both the exercise price and the vesting period

Company A awards share options to its 10 employees, which vest if the employee remains in employment for four years. The fair value of the award is CU100 (i.e. CU10 per employee). It is expected that eight employees will remain in employment until the end of Year 4.

In Year 1, the following entry is recorded.

CU
Dr Profit or loss \([CU10 \times 8 \text{ employees} \times 1/4]\) 20
Cr Equity 20
To recognise the share-based payment expense.

At the beginning of the second year, Company A modifies share options by (1) reducing the exercise price, and (2) reducing the vesting period to three years.

The reduction of the exercise price increases the fair value of the award. Assume that, as a result of this modification, the fair value of the awards at the date of the modification has been increased by CU16 (i.e. CU1.6 per employee). This additional value is recognised over the period to the revised vesting date (i.e. in Years 2 and 3).

As required by IFRS 2:B43(c), a reduction in the vesting period is beneficial to the employees. The reduction in service period may affect the number of share options expected to vest and, therefore, the cumulative expense that will be recognised over the revised vesting period.

Assume that, after the modifications, it is expected that all 10 employees will complete the vesting period and the total expense recognised over three years will be CU116 (i.e. value of CU11.6 for 10 employees). At the end of Year 3, all 10 employees remain in employment.

In Year 2, the following entry is recorded.

CU
Dr Profit or loss \([CU10 \times 10 \text{ employees}] \times 2/3 – CU20 + (CU1.6 \times 10 \text{ employees}) \times 1/2\) 55
Cr Equity 55
To recognise the share-based payment expense.

In Year 3, the following entry is recorded.

CU
Dr Profit or loss \([CU10 \times 10 \text{ employees}] + (CU1.6 \times 10 \text{ employees}) – CU20 – CU55\) 41
Cr Equity 41
To recognise the share-based payment expense.

Example 5.5.1.9B
Modification by reducing the exercise price and increasing the vesting period

Company A awards share options to its 10 employees, which vest if the employee remains in employment for four years. The fair value of the award is CU100 (i.e. CU10 per employee). It is expected that eight employees will remain in employment until the end of year 4.

In each of Years 1 and 2, the following entry is recorded.

CU
Dr Profit or loss \([CU10 \times 8 \text{ employees} \times 1/4]\) 20
Cr Equity 20
To recognise the share-based payment expense.

After two years, Company A modifies share options by (1) reducing the exercise price, and (2) increasing the vesting period to five years. The reduction of the exercise price increases the fair value of the award. Assume that, as a result of this modification, the fair value of the awards has been increased by CU16 (i.e. CU1.6 per employee). This additional value is recognised over the period to the revised vesting date.

As confirmed by IFRS 2:B44(c), an increase in the vesting period is not beneficial to the employees. Accordingly, the grant date fair value (i.e. the fair value measured based on the original terms of the award) is recognised over the original vesting period of four years.
Example 5.5.1.9B (continued)
Modification by reducing the exercise price and increasing the vesting period

At the date of modification, it is estimated that eight employees will remain in employment until the end of Year 4 and that only five employees will stay until the end of Year 5.

- The grant date fair value is recognised over the original vesting period of four years [IFRS 2:B44(c)] for eight employees [IFRS 2:B42].
- The modification relating to the reduction of the exercise price vests over the remaining three years of the new vesting period of five years [IFRS 2:B43(a)] for five employees.

In Year 3, the following entry is recorded.

\[ \text{Dr Profit or loss } \left( \text{CU10 } \times 8 \text{ employees } \times \frac{3}{4} - \text{CU40} \right) + \left( \text{CU1.60 } \times 5 \text{ employees } \times \frac{1}{3} \right) \]
\[ \text{Cr Equity } 22.67 \]
To recognise the share-based payment expense.

In Year 4, the following entry is recorded.

\[ \text{Dr Profit or loss } \left( \text{CU10 } \times 7 \text{ employees } \times \frac{4}{4} - \text{CU60} \right) + \left( \text{CU1.60 } \times 5 \text{ employees } \times \frac{1}{3} \right) \]
\[ \text{Cr Equity } 12.67 \]
To recognise the share-based payment expense.

By the end of Year 5, as expected, only five employees remain.

In Year 5, the following entry is recorded.

\[ \text{Dr Profit or loss } \left( \text{CU1.60 } \times 5 \text{ employees } \times \frac{1}{3} \right) \]
\[ \text{Cr Equity } 2.66 \]
To recognise the share-based payment expense.

The total expense over five years is CU78 (i.e. the grant date fair value of CU10 for seven employees and additional CU1.6 for five employees).

Example 5.5.1.9C
Modification by reducing the exercise price and decreasing the number of shares granted (without modification affecting the vesting period)

Company A awards 1,000 share options to one employee, which vest if the employee remains in employment for two years. The fair value of the award is CU10,000 (i.e. CU10 per share option).

In Year 1, the following entry is recorded.

\[ \text{Dr Profit or loss } \left( \text{CU10 } \times 1,000 \text{ share options } \times \frac{1}{2} \right) \]
\[ \text{Cr Equity } 5,000 \]
To recognise the share-based payment expense.

At the beginning of the second year, Company A modifies the share option award by (1) reducing the number of granted share options from 1,000 to 800, and (2) reducing the exercise price of the share option.

The appropriate accounting depends on whether the effects of the modifications increase the total fair value of the award.

IFRS 2:B42 requires an entity to “recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee”. Because, in this example, the modifications are linked, they will be considered as one modification to determine this impact (i.e. the modification in total is either beneficial or not beneficial to the counterparty). The incremental value is calculated as the change in the ‘total fair value’ before and after the modification.

Assume that the fair value of a share option before and after the reduction in exercise price is CU7 and CU11.

The total change in the fair value of the grant is, therefore, CU1,800 [(800 × CU11) – (1,000 × CU7)].
**Example 5.5.1.9C (continued)**

Modification by reducing the exercise price and decreasing the number of shares granted (without modification affecting the vesting period)

In Year 2, the following entry is recorded.

| Dr | Profit or loss [(CU10 \times 1,000 share options \times 1/2) – CU5,000 + (800 \times CU11) – (1,000 \times CU7)] | CU |
| Cr | Equity | 6,800 |

**To recognise the share-based payment expense.**

The total expense over two years is CU11,800 (CU10,000 + CU1,800).

### 5.5.2 Cancellations and settlements

An entity may cancel or settle a grant of equity instruments during the vesting period. IFRS 2 includes requirements that deal with such situations. This does not cover those cases when a grant is forfeited when the vesting conditions are not satisfied which are dealt with in accordance with IFRS 2’s requirements for vesting conditions (see section 5.3).

IFRS 2:28 refers to circumstances when “a grant of equity instruments is cancelled or settled during the vesting period”. Therefore, all cancellations must be dealt with in accordance with IFRS 2:28 irrespective of whether it is the entity or the counterparty that cancels the arrangements.

Similarly, if an entity or counterparty can choose whether to meet a non-vesting condition, the entity treats the failure to meet that non-vesting condition during the vesting period as a cancellation, irrespective of whether the entity or the counterparty fails to meet the non-vesting condition. [IFRS 2:28A]

A practical example of this is when an employee stops making payments into an SAYE option scheme and, therefore, forfeits his or her entitlement under the scheme. The failure to make contributions is a failure to meet a non-vesting condition and is, therefore, accounted for as a cancellation.

The cancellation or settlement of an equity instrument is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised for services received over the remainder of the vesting period is, therefore, recognised immediately. [IFRS 2:28(a)]

Any payment made to the employee on cancellation or settlement is accounted for as a repurchase of an equity interest (i.e. as a deduction from equity) except to the extent that the payment exceeds the fair value of the equity instrument granted, measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2:28(b)]

If the share-based payment arrangement included liability components, the fair value of the liability at the date of cancellation or settlement should be remeasured. Any payment made to settle the liability component is accounted for as an extinguishment of the liability. [IFRS 2:28(a)] requires that an “entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period” (emphasis added). The Standard does not specify whether the amount that ‘would have been’ recognised refers to the compensation expense that would have been recognised if all of the awards outstanding at the settlement date had vested, or whether it should take into account the entity’s estimate of the number of awards that would have vested if the settlement had not occurred.

In the absence of clear guidance on the issue, an entity may adopt either alternative as an accounting policy choice. The accounting policy adopted should be disclosed and applied consistently.
Regardless of the treatment adopted as an accounting policy, entities will need to consider whether additional compensation expense should be recognised under IFRS 2.28(b) by comparing the settlement payment to the fair value of the amounts measured at the settlement date. Although not explicitly stated in IFRS 2.28(b), the settlement payment should be compared to the settlement date fair value of the number of awards used to determine ‘the amount that would have been recognised over the remaining vesting period’ (i.e. in a manner consistent with the choice of accounting policy described above). Example 5.5.2A illustrates the alternative accounting policies.

**Example 5.5.2A**

**Meaning of ‘would have been’ as used in IFRS 2.28**

At the beginning of 20X0, Entity A granted 100 equity-settled share-based awards to each of 120 employees. The number of awards depends on whether specified profit thresholds are met at the end of the second year. The awards vest if the employees remain in Entity A’s employment for two years. At the grant date, Entity A estimates that 80 employees will complete the required two year service period and that 90 per cent of the awards held by those employees will vest (based on the profits estimated for Years 1 and 2 at the grant date); therefore, 7,200 awards (i.e. 90 awards for 80 employees) are expected to vest.

At the beginning of 20X1, Entity A settles all 12,000 awards in cash (all employees remained in Entity A's employment at that date).

At the date of settlement, consistent with estimates made at the grant date, Entity A estimates that if the awards had remained in place until the contractual vesting date, 80 employees would have completed the required two-year service period and 90 per cent of the awards held by those employees would have vested.

The fair value of each award on the grant date was CU10 and on the settlement date was CU6.

**How should Entity A determine the amount that ‘would have been’ recognised over the remaining vesting period as required by IFRS 2.28(a)?**

The various alternatives for Entity A as explained above are illustrated below.

**Scenario 1: settlement amount for each award outstanding is lower than the fair value of the award at the settlement date**

Assume that Entity A settles each award for cash of CU5.

**Accounting policy to recognise expense that would have been recognised if all of the awards outstanding at the settlement date had vested**

- Compensation expense recognised in 20X0 is CU36,000 \((7,200 \times \text{CU}10)/2\).
- Compensation expense recognised upon settlement under IFRS 2.28(a) is CU84,000 \((12,000 \times \text{CU}10) – \text{CU}36,000\) (compensation expense recognised in prior period).
- Additional compensation expense recognised upon settlement under IFRS 2.28(b) is nil because the payment made on settlement (CU5 \(\times 12,000\)) is lower than the fair value of the awards measured at the settlement date (CU6 \(\times 12,000\)).
- Total compensation expense is CU120,000.

**Accounting policy to recognise expense taking into account the estimate of the number of awards that would have vested had settlement not occurred**

- Compensation expense recognised in 20X0 is CU36,000 \((7,200 \times \text{CU}10)/2\).
- Compensation expense recognised upon settlement under IFRS 2.28(a) is CU36,000 \((7,200 \times \text{CU}10) – \text{CU}36,000\) (compensation expense recognised in prior period).
- Additional compensation expense recognised upon settlement under IFRS 2.28(b) is CU16,800, representing the excess of the payment made on settlement (CU5 \(\times 12,000\)) over the fair value of the awards measured at the settlement date (CU6 \(\times 7,200\)).
- Total compensation expense is CU88,800.

**Scenario 2: settlement amount for each award outstanding is greater than the fair value of the award at the settlement date**

Assume that Entity A settles each award for cash of CU7.
Example 5.5.2A (continued)
Meaning of ‘would have been’ as used in IFRS 2:28

Accounting policy to recognise expense that would have been recognised if all of the awards outstanding at the settlement date had vested

- Compensation expense recognised in 20X0 is CU36,000 \([7,200 \times CU10]/2\).
- Compensation expense recognised upon settlement under IFRS 2:28(a) is CU84,000 \([(12,000 \times CU10) – CU36,000 \text{ compensation expense recognised in prior period}]\).
- Additional compensation expense recognised upon settlement under IFRS 2:28(b) is CU12,000, representing the excess of the payment made on settlement (CU7 \times 12,000) over the fair value of the awards measured at the settlement date (CU6 \times 12,000).
- Total compensation expense is CU132,000.

Accounting policy to recognise expense taking into account the estimate of the number of awards that would have vested had settlement not occurred

- Compensation expense recognised in 20X0 is CU36,000 \([7,200 \times CU10]/2\).
- Compensation expense recognised upon settlement under IFRS 2:28(a) is CU36,000 \([(7,200 \times CU10) – CU36,000 \text{ compensation expense recognised in prior period}]\).
- Additional compensation expense recognised upon settlement under IFRS 2:28(b) is CU40,800, representing the excess of the payment made on settlement (CU7 \times 12,000) over the fair value of the awards measured at the settlement date (CU6 \times 7,200).
- Total compensation expense is CU112,800.

IFRS 2 also deals with the situation when new equity instruments may be granted to an employee in connection with the cancellation of existing equity instruments. If new equity instruments are granted and they are identified, on the date when they are granted, as replacement equity instruments for the cancelled equity instruments, this is accounted for as a modification of the original equity instruments (see 5.5.1). The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee that is accounted for as deduction from equity in accordance with IFRS 2:28(b). [IFRS 2:28(c)]

If the entity does not identify new equity instruments granted as replacement equity instruments for those cancelled, the new equity instruments are accounted for as a new grant.

IFRS 2 appears to imply a free choice as to whether an entity decides to identify replacement instruments. As illustrated in example 5.5.2B, it will often be attractive to identify the new options as replacements because this will avoid accelerating the expense recognised for the original options. However, it would not give a fair presentation to characterise equity instruments as replacements when they were clearly unrelated to the cancelled instruments.

The determination as to whether the issue of new options is a replacement of cancelled options requires careful assessment of the facts and circumstances surrounding such transactions. IFRS 2 does not provide specific guidance in this area. Factors that may indicate that a new issue of options is a replacement of cancelled options include:

- the new share options are with the same participants as the cancelled options;
- the new share options are issued at a fair value that is broadly consistent with the fair value of the cancelled options determined either at their original grant date (indicating a repricing) or the cancellation date (indicating a replacement);
- the transactions to issue and cancel the options are part of the same arrangement;
- the cancellation of the options would not have occurred unless the new options were issued; and
- the cancellation of the options does not make commercial sense without the issue of the new options (and vice versa).

If vested equity instruments are repurchased from employees, the payment made is accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the repurchased instruments, measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2:29]
These requirements are illustrated by the following example.

**Example 5.5.2B**

**Replacement of share options**

Company O issued options with a four-year vesting period to employees in 20X3. The options had an exercise price of CU10 per share and the aggregate fair value of the options determined at the grant date was CU100,000. In 20X5, Company O cancelled those options and issued new options with an exercise price of CU3 per share.

The aggregate fair value of the new share options at the grant date is CU75,000, while the aggregate fair value of the cancelled options at that date is CU20,000.

**If the new issue of options is considered a replacement of the cancelled options**

Company O accounts for the transaction in the same way as for a modification. Therefore, Company O will continue to expense the portion of the CU100,000 not yet recognised over the original vesting period. Additionally, Company O will expense the incremental fair value of the new instruments over the old instruments determined at the date of modification (in this example, CU55,000 [CU75,000 – CU20,000]) over the remaining vesting period. Therefore, a total of CU155,000 is expensed related to these options.

**If the new issue of options is not considered a replacement of the cancelled share options**

The remaining portion of the original fair value of CU100,000 is expensed immediately and the fair value of the new issue is recognised over its vesting period. Therefore, a total of CU175,000 is expensed related to these options, much of the expense in earlier periods.

The following example considers the situation when the replacement options are issued by a different entity in a group.

**Example 5.5.2C**

**Issue of new options as a replacement of cancelled options**

Company S is a publicly listed subsidiary of Company P which is also publicly listed. Company P decides to de-list Company S by purchasing all of its outstanding shares from existing shareholders at an amount determined to be fair value. As part of the transaction, all outstanding share options in Company S are cancelled. In return, Company P issues share options in Company P to the same employees of Company S whose share options in Company S were cancelled. The fair value of the new share options determined at the grant date approximates the fair value of the replaced options determined at the cancellation date. In addition, the vesting terms and option lives of the new share options are adjusted to ensure consistency with the cancelled options.

In the circumstances described, even though the share options are in a different entity that has a different risk profile from Company S, the intention is to replace value held by the employees. Therefore, the transaction should be considered a replacement of equity instruments and accounted for in accordance with IFRS 2:28(c).

The following example considers the settlement in cash of a fully vested equity-settled share-based payment.

**Example 5.5.2D**

**Settlement in cash of a fully vested equity-settled share-based payment**

On 1 January 20X5, Company A issued 100 share options with an exercise price of CU15 per option to certain of its employees. The options vest if the employees remain employed by Company A for four years. The share options can only be settled by delivery of Company A’s equity instruments and, therefore, they are classified as equity-settled share-based payments. At the grant date, the fair value of the instruments was determined to be CU5 per option.

As at 31 December 20X8, Company A had recognised a cumulative expense of CU500 [(CU5 × 100) × 4/4 years] because all options had vested. On that date, Company A decided to settle the fully vested equity-settled share-based payments in cash to the value of the share options (rather than settling by delivery of equity instruments). The fair value of the share options as at 31 December 20X8 is CU2,400. Therefore, Company A will pay the employees CU2,400 in cash.

In accordance with IFRS 2:29, a cash payment made to settle a fully vested equity-settled share-based payment should be accounted for as a repurchase of equity instruments. Accordingly, the payment made to the employees is accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the instruments repurchased, measured at the repurchase date. Any such excess should be recognised as an additional remuneration expense.

Therefore, the cash settlement of CU2,400 is accounted for as a reduction in equity. If the payment made to the employees had been greater than CU2,400 (the fair value of the original awards at settlement date), Company A would have recognised the excess in profit or loss as an additional remuneration expense.
5.5.3 Changes to method of settlement of equity-settled transactions

5.5.3.1 Addition of a cash alternative

An entity may decide, during the vesting period for an equity-settled transaction, to add an employee option to choose a cash alternative. From the date of such a modification, the transaction should be accounted for as a compound instrument as outlined at section 7.2. This approach is illustrated in the example 5.5.3.1A which is taken from the implementation guidance accompanying IFRS 2.

Example 5.5.3.1A
Grant of shares, with a cash alternative subsequently added

[Guidance on implementing IFRS 2:IG Example 9]

Background
At the beginning of year 1, the entity grants 10,000 shares with a fair value of CU33 per share to a senior executive, conditional upon the completion of three years’ service. By the end of year 2, the share price has dropped to CU25 per share. At that date, the entity adds a cash alternative to the grant, whereby the executive can choose whether to receive 10,000 shares or cash equal to the value of 10,000 shares on vesting date. The share price is CU22 on vesting date.

Application of requirements
Paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Therefore, the entity recognises the services received over the three-year period, based on the grant date fair value of the shares.

Furthermore, the addition of the cash alternative at the end of year 2 creates an obligation to settle in cash. In accordance with the requirements for cash-settled share-based payment transactions (paragraphs 30–33 of the IFRS), the entity recognises the liability to settle in cash at the modification date, based on the fair value of the shares at the modification date and the extent to which the specified services have been received. Furthermore, the entity remeasures the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period. Therefore, the entity recognises the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Expense CU</th>
<th>Equity CU</th>
<th>Liability CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Remuneration expense for year:</td>
<td>110,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10,000 shares × CU33 × 1/3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Remuneration expense for year:</td>
<td>110,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(10,000 shares × CU33 × 2/3) – CU110,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reclassify equity to liabilities:</td>
<td>(166,667)</td>
<td>166,667</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10,000 shares × CU25 × 2/3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Remuneration expense for year:</td>
<td>110,000*</td>
<td>26,667</td>
<td>83,333</td>
</tr>
<tr>
<td></td>
<td>(10,000 shares × CU33 × 3/3) – CU220,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Adjust liability to closing fair value:</td>
<td>(30,000)</td>
<td>(30,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(CU166,667 + CU83,333) – (CU22 × 10,000 shares)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>300,000</td>
<td>80,000</td>
<td>220,000</td>
</tr>
</tbody>
</table>

* Allocated between liabilities and equity, to bring in the final third of the liability based on the fair value of the shares as at the date of the modification.

Example 5.5.3.1B is based on similar facts to example 5.5.3.1A but assumes that the share price has increased rather than decreased by the end of Year 2.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

Example 5.5.3.1B
Equity-settled share-based payment when a cash alternative is subsequently offered

At the beginning of Year 1, an entity grants 10,000 shares with a fair value of CU33 per share to a senior executive, conditional on the completion of three years of service. By the end of Year 2, the share price has increased to CU50 per share. At that date, the entity adds a cash alternative to the grant, whereby the executive can choose whether to receive 10,000 shares, or take the cash equivalent to the value of the 10,000 shares on the vesting date. This cash alternative has the same value as the shares. The share price decreased to CU45 at the end of Year 3.

IFRS 2:27 requires an entity to “recognise, as a minimum, services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date”. In addition, the entity must recognise in profit or loss the effects of modifications that increase the total fair value of the share-based payment arrangement.

Because the modification to the share-based payment to add a cash alternative does not increase the total fair value of the share-based payment arrangement at the date of the modification, the entity continues to recognise an IFRS 2 expense for the services received during the three-year period, based on the grant date fair value of the shares.

However, the addition of the cash alternative at the end of Year 2 creates an obligation to settle in cash. In accordance with the requirements for cash-settled share-based payment transactions (IFRS 2:30 to 33), the entity recognises the liability to settle in cash at the modification date. In a manner consistent with example 5.5.3.1A, the liability is measured at the value of the shares on the date of modification, pro-rated for the effect of the service condition. This effect of the modification is recognised in equity and not in profit or loss. Thereafter, the cost of the original equity grant is recognised in profit or loss, along with the remeasurement in the liability value to CU450,000 at the end of the year. The remaining unvested portion of the fair value of the liability at the modification date, which is CU166,667 [(10,000 shares x CU50 x 3/3) - CU333,333], is recognised in equity.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Expense</th>
<th>Equity</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Remuneration expense for year: 10,000 shares x CU33 x 1/3</td>
<td>110,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Remuneration expense for year: (10,000 shares x CU33 x 2/3) – CU110,000</td>
<td>110,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reclassify equity to liabilities: 10,000 shares x CU50 x 2/3</td>
<td>(333,333)</td>
<td>333,333</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Remuneration expense for year: (10,000 shares x CU33 x 3/3) – CU220,000</td>
<td>110,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Final third of liability at modification value: (10,000 shares x CU50 x 3/3) – CU333,333</td>
<td>(166,667)</td>
<td>166,667</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Remeasurement of liability: (10,000 shares x CU45 x3/3) – CU500,000</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>280,000</td>
<td>(170,000)</td>
<td>450,000</td>
</tr>
</tbody>
</table>

In the entry in Year 2, therefore, the value of the cash modification is recognised in equity and not in profit or loss. In Year 3, the cost of the original equity grant is recognised in profit or loss, along with the remeasurement in the liability value to CU450,000 at the end of the year. The remaining unvested portion of the fair value of the liability at the modification date, which is CU166,667 [(10,000 shares x CU50 x 3/3) - CU333,333], is recognised in equity.

5.5.3.2 Change from equity-settled to cash-settled

The following example considers a change in the terms whereby options that were originally to be equity-settled will be cash-settled.

Example 5.5.3.2
Modification from an equity-settled to a cash-settled share-based payment arrangement during the vesting period

On 1 January 20X3, Company A issued 100 share options to certain employees, with a strike price of CU15 per option. The options vest if the employees remain in Company A’s employment after four years. The share options can only be settled by delivery of Company A’s equity instruments and, therefore, they are classified as equity-settled share-based payments. Company A determined the fair value of the instruments to be CU5 per option.

At 31 December 20X4, Company A had recognised a cumulative expense of CU250 [(CU5 x 100) x 2/4 years], because it expected all of the options to vest. On 1 January 20X5, Company A modified the options so that they could only be settled in cash. Therefore, upon settlement, Company A will pay the employees in cash the amount equal to the intrinsic value on the settlement date. On the date of modification, the fair value of each share option is determined to be CU8.
Modification from an equity-settled to a cash-settled share-based payment arrangement during the vesting period

IFRS 2:B43, which contains guidance on the application of IFRS 2:27, states, in part, that “if the modification increases the fair value of the equity instruments granted . . . measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the equity instruments granted”. IFRS 2:B43 further clarifies that the “incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification”.

Therefore, the fair value of the share options is reclassified from equity to liability to the extent to which specified services have been received, i.e. CU400 (CU800 × 2/4) as follows.

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Equity</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Cr Liability</td>
<td></td>
<td>400</td>
</tr>
</tbody>
</table>

To recognise the reclassification from equity to liability.

This results in a cumulative debit within equity of CU150, comprising the debit of CU400 arising on the modification less the credit of CU250 which arose under the equity-settled arrangements prior to the modification date (IFRS 2:BC267 and BC268).

6 Recognition and measurement: cash-settled transactions

6.1 Recognition of cash-settled transactions — general

As indicated in 2.2.1, IFRS 2 applies to transactions in which the entity acquires goods or services by incurring a liability to transfer cash or other assets for amounts based on the price (or value) of the shares or other equity instruments of the entity or of another group entity.

The most common examples of such arrangements are cash-settled Share Appreciation Rights (SARs) which are also sometimes referred to as ‘phantom option schemes’ (see 2.2.2).

For cash-settled share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability. Until the liability is settled, the liability is remeasured at fair value at the end of each reporting period (and at the settlement date). Any changes in fair value are recognised in profit or loss for the period. [IFRS 2:30]

IFRS 2 uses the term ‘fair value’ in a way that differs in some respects from the definition of fair value in IFRS 13 Fair Value Measurement. When applying IFRS 2, an entity should measure fair value in accordance with the guidance in IFRS 2, not IFRS 13. [IFRS 2:6A]

The effect of vesting conditions on the fair value measurement is discussed at 6.3.

For cash-settled share-based payment transactions, under IFRS 2:30, the goods or services acquired and the liability incurred are measured at the fair value of the liability. Until the liability is settled, the liability is remeasured at fair value at the end of each reporting period (and at the settlement date) and any changes in fair value are recognised in profit or loss for the period.

However, if the amount recognised for the goods or services received was capitalised as part of the carrying amount of an asset recognised in the entity’s statement of financial position, the carrying amount of that asset can be adjusted for the effects of the liability remeasurement during the period that is the shorter of:

- the period during which costs are eligible for capitalisation in accordance with whichever Standard is applicable to the asset in question (e.g. IAS 2 for inventories, IAS 16 for property, plant and equipment etc.); and
- the vesting period.

Subsequent to the capitalisation period, the carrying amount of that asset is not adjusted for any further remeasurement of the liability and any subsequent changes in the fair value of the liability are recognised in profit or loss.
The services received and the liability to pay for those services are recognised as the employees render service. For example, some SARs vest immediately and the employees are not, therefore, required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, it should be presumed that the services rendered by the employees in exchange for the SARs have been received. In this case, the expense for the services received and the liability to pay for them should be recognised immediately. But if the rights do not vest until the employees have completed a specified period of service, the services received and the liability to pay for them should be recognised as the employees render service during the period. [IFRS 2:32]

6.1.2 Presentation of liability

The following example considers the presentation and disclosure of the liability for cash-settled SARs.

<table>
<thead>
<tr>
<th>Example 6.1.2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Presentation of SARs in the statement of financial position</strong></td>
</tr>
</tbody>
</table>

Company C issues 12 cash-settled share appreciation rights (SARs) to certain of its employees. The SARs vest over a three-year period. At the end of the vesting period, Company C expects that three of the SARs will be exercised within one year and the remaining nine SARs will be exercised after one year.

Company C should consider whether the liability should be presented separately in the statement of financial position, and whether it should be presented as current or non-current.

IFRS 2 does not require separate presentation of the carrying amount of liabilities relating to share-based payments in the statement of financial position, but requires this information to be disclosed in the financial statements. Liabilities arising from share-based payments are financial liabilities, although they are excluded from the scope of IAS 32 Financial Instruments: Presentation and IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement).

Therefore, an entity should consider whether share-based payment liabilities should be grouped with other financial liabilities in the statement of financial position. Paragraph 29 of IAS 1 Presentation of Financial Statements requires each material class of similar items to be presented separately in the financial statements. Items of a dissimilar nature or function are presented separately unless they are immaterial. IAS 1:30 explains that if a line item is not individually material, it is aggregated with other items either on the face of the financial statements or in the notes. Share-based payment liabilities are likely to be different from other financial liabilities in nature and function.

IAS 1:60 requires separate presentation in the statement of financial position for current and non-current liabilities. In the circumstances described, because all of the SARs can be exercised within the next year, these liabilities should be presented as current liabilities in Year 3. If Company C determines that presentation on a liquidity basis is more relevant, the current portion of the liability should be disclosed in accordance with IAS 1:61.

6.2 Measurement of cash-settled transactions

6.2.1 Measurement of cash-settled transactions — general

The liability is measured, initially and at the end of each reporting period until settled, at the fair value of the SARs by applying an option pricing model, taking into account the terms and conditions upon which the rights were granted and the extent to which the employees have rendered service to date. The use of option pricing models is considered in section 5.4.4.

A simpler approach would have been to base the liability on the intrinsic value of the SARs at the end of the reporting period (i.e. the difference between the fair value of the shares and the exercise price, if any). It can be argued that the additional cost and effort of using an option pricing model is not justified given that the cumulative expense is always trued up to the actual cash payment. However, the IASB rejected this approach and concluded that measuring SARs at intrinsic value would be inconsistent with the fair value measurement basis applied in the rest of IFRS 2.

The following example, which is taken from the implementation guidance accompanying IFRS 2, illustrates the application of these requirements.
Example 6.2.1  
Cash-settled share appreciation rights

[Guidance on implementing IFRS 2:IG Example 12]

**Background**

An entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employ for the next three years.

During year 1, 35 employees leave. The entity estimates that a further 60 will leave during years 2 and 3. During year 2, 40 employees leave and the entity estimates that a further 25 will leave during year 3. During year 3, 22 employees leave. At the end of year 3, 150 employees exercise their SARs, another 140 employees exercise their SARs at the end of year 4 and the remaining 113 employees exercise their SARs at the end of year 5.

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below. At the end of year 3, all SARs held by the remaining employees vest. The intrinsic values of the SARs at the date of exercise (which equal the cash paid out) at the end of years 3, 4 and 5 are also shown below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Fair value</th>
<th>Intrinsic value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CU14.40</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>CU15.50</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>CU18.20</td>
<td>CU15.00</td>
</tr>
<tr>
<td>4</td>
<td>CU21.40</td>
<td>CU20.00</td>
</tr>
<tr>
<td>5</td>
<td>CU25.00</td>
<td></td>
</tr>
</tbody>
</table>

**Application of requirements**

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Expense CU</th>
<th>Liability CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(500 – 95) employees × 100 SARs × CU14.40 × 1/3</td>
<td>194,400</td>
<td>194,400</td>
</tr>
<tr>
<td>2</td>
<td>(500 – 100) employees × 100 SARs × CU15.50 × 2/3 – CU194,400</td>
<td>218,933</td>
<td>413,333</td>
</tr>
<tr>
<td>3</td>
<td>(500 – 97 – 150) employees × 100 SARs × CU18.20 – CU413,333</td>
<td>47,127</td>
<td>460,460</td>
</tr>
<tr>
<td></td>
<td>+ 150 employees × 100 SARs × CU15.00</td>
<td>225,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>272,127</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>(253 – 140) employees × 100 SARs × CU21.40 – CU460,460</td>
<td>(218,640)</td>
<td>241,820</td>
</tr>
<tr>
<td></td>
<td>+ 140 employees × 100 SARs × CU20.00</td>
<td>280,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>61,360</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>CU0 – CU241,820</td>
<td>(241,820)</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>+ 113 employees × 100 SARs × CU25.00</td>
<td>282,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>40,680</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>787,500</td>
<td></td>
</tr>
</tbody>
</table>

Note that remeasurement of the liability is not recognised as one amount immediately. Instead this amount is spread over the remaining vesting period of the liability.
### 6.2.2 Share price denominated in a foreign currency

**Example 6.2.2**

**Cash-settled share-based payment arrangement with share price and option exercise price denominated in a foreign currency**

Company E is a UK entity with Sterling as its functional currency. Company E is registered on the New York Stock Exchange with a current market price of US$15 per share. Company E issues 100 options to its employees with an exercise price of US$15 per share and a vesting period of three years. The share options can only be cash settled.

For cash-settled share options, the liability recognised would be considered a US dollar denominated liability and would need to be remeasured at the end of each reporting period (the remeasurement would include the effect of changes in the foreign exchange rate).

This issue is considered at 5.2.3.6 in relation to equity-settled share-based payments.

### 6.3 Vesting conditions

An issue that arises is whether vesting conditions should be considered in determining the fair value of cash-settled share-based payments. The requirements of IFRS 2 are not clear in this regard.

IFRS 2:30 requires that the liability incurred from a cash-settled share-based payment transaction should be measured at the fair value of the liability. There is no discussion in IFRS 2 regarding whether the fair value of the liability for a cash-settled share-based payment should include the effects of vesting conditions.

The definition of fair value is “[the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction].” [IFRS 2:Appendix A] From this perspective, the fair value measurement should include all terms and conditions, including all vesting conditions.

However, non-market vesting conditions are excluded from the grant date fair value of equity-settled share-based payments because the ‘true up’ model is applied to those transactions. As noted in IFRS 2:19, the exclusion of non-market vesting conditions from the measurement of equity-settled share-based payments has the effect of creating a measurement that is not a true fair value measurement. Similar statements are not made regarding the measurement of cash-settled share-based payments.

Example 6.2.1 (which is taken from the implementation guidance accompanying IFRS 2) provides an illustration of the accounting for one form of cash-settled share-based payments (share appreciation rights, or SARs). In this illustration, employees must remain in the entity’s employment for the next three years for their SARs to vest. The illustration does not include the effects of this vesting condition in determining the fair value of the SARs at the end of each reporting period, but bases the total liability on the best estimate of the number of SARs that will vest.

While example 6.2.1 excludes one type of non-market vesting condition (remaining in the employment of an entity for a specified period of time), it is not clear whether the implication of this exclusion should extend to other non-market vesting conditions, such as achieving a target revenue.

Given the lack of clarity regarding how vesting conditions should be reflected in the fair value measurement, it appears that there are two acceptable approaches; an entity should measure the liability arising from a cash-settled share-based payment on one of the following bases:

- at true fair value (i.e. the fair value measurement of the liability reflects all vesting and non-vesting conditions, including service and non-market performance conditions); or
- by analogy to the measurement of equity-settled share-based payments (i.e. the fair value measurement of the liability reflects market and non-vesting conditions only. Service and non-market performance conditions are taken into account by adjusting the number of rights to receive cash that are expected to vest).

An entity should choose one of the two approaches as an accounting policy and apply this policy consistently. Whichever approach is adopted, until the liability is settled, an entity should remeasure the fair value of the liability at the end of each reporting period and at the date of settlement with any changes in fair value recognised in profit or loss for that period.
6.4 Modifications to cash-settled transactions

6.4.1 Modifications, cancellations and settlements

IFRS 2 does not make specific reference to the treatment of modifications to cash-settled share-based payment arrangements.

A modification of a cash-settled share-based payment arrangement such as a share appreciation right (SAR) is accounted for as the exchange of the original award for a new award. However, because cash-settled share-based payment transactions are remeasured based on their fair value at each reporting date, no special guidance is necessary in accounting for a modification of a cash-settled award that remains a cash-settled award after the modification. The requirements of IFRS 2:33 apply to the measurement of cash-settled share-based payment transactions (i.e., the liability is measured at the fair value of the SARs multiplied by the proportion of the vesting period which has been completed). Any increase or decrease in the value of the liability would be recognised immediately in profit or loss or, when the relevant criteria are met, included in the cost of an asset (e.g., when a payment to employees relates to the construction of property, plant and equipment). The application of this treatment to two possible modifications of SARs is illustrated in examples 6.4.1A and 6.4.1B.

Example 6.4.1A
Reduction of the vesting period of a cash-settled share-based payment transaction

100 cash-settled SARs are granted on 1 January 20X0 with a fair value of CU10 each. The terms of the award require the employee to provide service for four years in order to earn the award. At the end of the second year of service (20X1), the employer modifies the terms of the award to require only three years of service from the employee to earn the award. The fair value of each SAR at each reporting date is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 20X0</td>
<td>CU12</td>
</tr>
<tr>
<td>31 December 20X1</td>
<td>CU20</td>
</tr>
<tr>
<td>31 December 20X2</td>
<td>CU15</td>
</tr>
</tbody>
</table>

The following journal entries reflect the accounting for the award at each period end (assuming there are no expected forfeitures).

At 31 December 20X0

Dr Profit or loss \( [CU12 \times 100 \text{ awards} \times 1 \text{ year}/4 \text{ years of service required}] \)

Cr Liability

\( 300 \)

To recognise the share-based payment expense and associated liability.

At 31 December 20X1

Dr Profit or loss \( [(CU20 \times 100 \text{ awards} \times 2 \text{ years}/3 \text{ years of service required}) = CU1,333 − CU300 \text{ previously recognised}] \)

Cr Liability

\( 1,033 \)

To recognise the share-based payment expense and remeasurement of associated liability.

At 31 December 20X2

Dr Profit or loss \( [(CU15 \times 100 \text{ awards} \times 3 \text{ years}/3 \text{ years of service required}) = CU1,500 − CU1,333 \text{ previously recognised}] \)

Cr Liability

\( 167 \)

To recognise the share-based payment expense and remeasurement of associated liability.
Example 6.4.1B
Cancellation of a cash-settled share-based payment transaction

100 cash-settled SARs are granted on 1 January 20X0 with a fair value of CU10 each. The terms of the award require the employee to provide service for four years in order to earn the award. At the end of the second year of service (20X1), the employer cancels the award without issuing any replacement award or cash. The fair value of each SAR at each reporting date is as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 20X0</td>
<td>CU12</td>
</tr>
<tr>
<td>31 December 20X1</td>
<td>CU5</td>
</tr>
</tbody>
</table>

The following journal entries reflect the accounting for the award at each period end (assuming there are no expected forfeitures).

At 31 December 20X0

\[
\begin{align*}
\text{Dr} & \quad \text{Profit or loss} \quad [\text{CU12 \times 100 awards \times 1 year/4 years of service required}] \\
& \quad 300 \\
\text{Cr} & \quad \text{Liability} \\
& \quad 300
\end{align*}
\]

To recognise the share-based payment expense and associated liability.

At 31 December 20X1

\[
\begin{align*}
\text{Dr} & \quad \text{Liability} \\
& \quad 300 \\
\text{Cr} & \quad \text{Profit or loss} \\
& \quad 300
\end{align*}
\]

To recognise the reversal of the share-based payment expense and associated liability.

Because, in this example, the award is cancelled without issuing anything in return, the value of the liability at 31 December 20X1 should be adjusted to CU-nil. Therefore, all prior share-based payment expense recognised should be reversed.

6.4.2 Changes to methods of settlement of cash-settled transactions

IFRS 2 does not specify how to account for a modification of a share-based payment arrangement from cash-settled to equity-settled; the guidance in IFRS 2 deals only with modifications to the terms and conditions of equity-settlement arrangements.

The principles of IFRS 2 are generally consistent with those of US GAAP, namely FASB Accounting Standards Codification (ASC) Topic 718, Stock Compensation. In particular, modifications to the terms and conditions of equity-settled share-based payments are generally treated consistently under IFRS 2 and ASC 718. ASC 718 also specifies how to account for a modification to a share-based payment arrangement that results in a change in its classification from being cash-settled to equity-settled, and it is appropriate for such modifications to be accounted for in the same way under IFRS 2.

The guidance in ASC 718 requires the existing cash-settled liability to be reclassified to equity at the date of modification. The cash-settled share-based payment expense recognised up to the date of modification is not adjusted and the expense recognised from the date of modification over the remainder of the vesting period is determined based on the fair value of the reclassified equity award at the date of the modification.

In other words, the modification is accounted for as if the liability existing at the date of modification is effectively settled with an equity award with the same fair value.

Example 6.4.2
Modification from cash-settled to equity-settled

On 1 January 20X3, Company A issues 100 share options to some of its employees with a strike price of CU15 per option. The share options vest if the employee remains in Company A’s employment after four years. The share options can only be cash-settled. Company A has determined that the fair value of the instrument at the date of grant is CU5 per option.

At 31 December 20X4, the fair value of the cash-settled share-based payment is CU6 per option. To date, Company A has recognised a cumulative share-based payment expense of CU300 ([CU6 \times 100] \times 2/4 years) because Company A expects all of the options to vest.

On 1 January 20X5, Company A modifies the options such that they can only be settled by delivery of Company A’s equity instruments (one share option entitles the employee to one ordinary share of Company A, and there is no change to the strike price of CU15). No other terms or vesting conditions of the share-based payment arrangement are amended.
6.4.2 Modification from cash-settled to equity-settled

Applying the requirements of ASC 718, at the date of modification (1 January 20X5), Company A is required to derecognise the existing cash-settled liability because the liability has effectively been settled by the issue of an equity instrument. The existing cash-settled liability is, therefore, reclassified to equity. The cash-settled compensation cost recognised to date is not adjusted, except for subsequent ‘true up’ if vesting conditions are not met. The compensation cost to be recognised over the remaining vesting period is based on the fair value of the equity instrument at the time of the modification. Therefore, the cumulative compensation cost recognised for the share-based payment arrangement will reflect fair value for the equity award at 1 January 20X5.

In this example, the fair value at modification is CU6 per option. The cost to be recognised in each of 20X5 and 20X6 (Years 3 and 4 of the award), provided that all awards vest, will be CU150:

\[
\text{20X5: } \left(\text{CU6} \times 100\right) \times \frac{3}{4} \text{ years} = \text{CU300} \\
\text{20X6: } \left(\text{CU6} \times 100\right) \times \frac{4}{4} \text{ years} = \text{CU450}
\]

6.4.3 Repricing of cash-settled transactions

Example 6.4.3

Repricing of cash-settled transactions

Company T issues cash-settled share appreciation rights (SARs) to employees with a fair value of CU100 on 1 January 20X6. The SARs vest over a period of four years. At 31 December 20X6, the fair value of the SARs is CU120 and, therefore, Company T has a liability of CU30 \( \left(\text{CU120} \times \frac{1}{4}\right) \). On 1 January 20X7, Company T reprices the SARs so that the fair value of the award is now CU280. The modification affects no other terms or conditions of the SARs, and does not change the number of SARs expected to vest.

The repricing increases the value of the SARs and, therefore, the incremental value should be recognised over the vesting period. Because one quarter of the vesting period is complete, the liability should be increased to CU70 — requiring the immediate recognition of CU40 \( \left(\text{CU280} \times \frac{1}{4}\right) – \text{CU30} \) of remuneration expense. Therefore, if the fair value did not change in the remaining three years, CU70 \( \left(\text{CU280} – \text{CU70}\right) \times \frac{1}{3} \) would be recognised in profit or loss in each of the remaining three years.

7 Recognition and measurement: transactions with settlement alternatives

7.1 Transactions with settlement alternatives — general

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the transaction, or the components of that transaction, are accounted for:

[IFRS 2:34]

- as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets; or
- as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IFRS 2 contains more detailed requirements concerning how to apply this principle to share-based payment transactions in which the terms of the arrangement:

- provide the counterparty with a choice of settlement (see 7.2); and
- provide the entity with a choice of settlement (see 7.3).

Contingent cash settlement provisions are considered at 7.4. Circumstances when there is a modification to the terms of settlement are considered at 5.5.3 (for modification of an arrangement that has been accounted for as an equity-settled share-based payment transaction) and 6.4.2 (for modification of an arrangement that has been accounted for as a cash-settled share-based payment transaction).

References to cash, in the remainder of this section, also include other assets.
7.2 Counterparty’s choice as to the manner of settlement

7.2.1 Recognition of a compound instrument

If the counterparty has the choice as to whether an entity settles a share-based payment transaction in cash or with equity instruments, the entity has granted a compound financial instrument, similar to convertible debt. The instrument has:

- a debt component — the counterparty’s right to demand cash; and
- an equity component — the counterparty’s option to receive equity instruments rather than cash.

Each component is accounted for separately, in a manner similar to the equivalent requirements of IAS 32 Financial Instruments: Presentation, as described below.

Example 7.2.1 illustrates the need to consider the substance of the arrangement when the cash alternative is provided through a separate agreement.

Example 7.2.1

Counterparty choice in settlement of a share-based payment

Company A grants share options to its employees that vest over a three-year period. These share options can only be settled by the issue of Company A’s shares at the end of the vesting period. In a separate legal agreement entered into at the same time as the grant of the share options, Company A issues a put option to its employees that can (at the option of the employee) require Company A to settle the share options in cash, based on the intrinsic value of the options at the settlement date. The put option is only exercisable between the vesting date and the expiration of the options.

The two contracts (share options and written put option) should be linked and the transaction accounted for as a share-based payment with a cash alternative. The substance of this arrangement is the issue of an equity instrument to employees with a cash alternative. Therefore, the accounting should be the same whether the transaction is consummated through one or more contracts. As a result, Company A should measure the liability component at fair value first, and then measure the equity component at fair value, taking into account the fact that the employee must forfeit the right to receive cash in order to receive the equity instrument (see IFRS 2:37). Because the fair value of the equity component in this example would be nil (see 7.2.2), the transaction is accounted for in the same way as a cash-settled share-based payment up to the date of exercise.

7.2.2 Initial measurement of the debt and equity components

For transactions with parties other than employees, the fair value of goods or services is measured directly (if that is possible with sufficient reliability — see 5.2.2.1 and 5.4.8). For such transactions, the equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when goods or services are received. [IFRS 2:35] This is the basic approach that is adopted for compound instruments that are accounted for under IAS 32 (see section 3 of [GAAP] chapter B3 or, for entities that have not yet adopted IFRS 9 Financial Instruments, section 3 of [GAAP] chapter C3).

For other transactions, including those with employees, the fair value of the compound financial instrument is measured at the measurement date, taking into account the terms and conditions on which the rights to cash or equity instruments were granted. [IFRS 2:36] To do this, the debt component is measured first and then the equity component is measured. The fact that the counterparty must forfeit the right to receive cash to receive the equity instrument should be taken into account. The fair value of the compound financial instrument is the sum of the fair values of the two components. [IFRS 2:37]

Under IAS 32:32, the carrying amount of the equity instruments is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. This is straightforward when the fair value of the combined instrument is reliably known (e.g. when it is the proceeds of an issue for cash). However, IFRS 2:BC260 explains that, when this is not the case, it will be necessary to estimate the fair value of the compound instrument itself. The IASB therefore concluded, as stated above, that the compound instrument should be measured first by valuing the liability component (i.e. the cash alternative) and then valuing the equity component and adding the two components together.

Entities will often structure share-based payment transactions in which the counterparty has the choice of settlement in such a way that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights. In such cases, the fair value of the equity component is zero and, consequently, the fair value of the compound financial instrument is the same as the fair value of the debt component. [IFRS 2:37]
IFRS 2 notes that, conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component will usually be greater than zero. In such circumstances, the fair value of the compound financial instrument will be greater than the fair value of the debt component.

IFRS 2:BC259 explains that the fair value of the compound financial instrument will usually exceed both:

- the individual fair value of the cash alternative — because of the possibility that the shares or share options may be more valuable than the cash alternative; and
- that of the shares or options — because of the possibility that the cash alternative may be more valuable than the shares or options.

But, as explained above, in many practical situations the fair value of the settlement alternatives will be the same and there will be no equity component.

**Example 7.2.2**

**Share-based payment with settlement alternatives — measurement and recognition**

On 1 January 20X1, an entity enters into an agreement with 10 employees whereby the employees receive a bonus payment of CU300 if they complete a 3-year service period.

On completion of the 3-year service period, the employees can choose between the following settlement alternatives:

- Alternative A — receive the full amount of CU300 in cash; or
- Alternative B — receive CU150 in cash and the remaining 50 per cent of the reward in the form of shares that are, on 31 December 20X3, worth CU150 (say 500 shares).

Employees that opt for settlement Alternative B will, in addition to the original 500 shares, receive a further 500 shares (i.e. ‘matching shares’) upon completion of an additional 2-year service period (i.e. they have to be employed until 31 December 20X5). Employees that leave employment during the additional 2-year service period forfeit the matching shares and the original 500 shares awarded (i.e. they lose the first award even if the initial 3-year service period was completed).

The award can be summarised as follows:

- cash of CU300 at the end of Year 3; or
- cash of CU150 at the end of Year 3, plus shares worth CU300 as at 31 December 20X3 (original award of shares worth CU150 plus the matching shares worth CU150) with all shares subject to remaining in employment until the end of Year 5.

In accordance with IFRS 2:35, an entity that has granted a counterparty the right to choose whether a share-based payment transaction is settled in cash or by issuing equity instruments has granted a compound financial instrument which includes a debt component (the right to demand settlement in cash) and an equity component (the right to demand settlement in equity instruments).

The fair value of the compound financial instrument is measured at the grant date (1 January 20X1) taking into account the terms and conditions under which the rights to cash or equity instruments are granted. To arrive at this measurement, the fair value of the debt component should be measured first and then the fair value of the equity component should be measured, adjusting for the fact that the counterparty must forfeit the right to receive cash to receive the equity instrument. The fair value of the compound instrument is the sum of the fair values of the two components. [IFRS 2:37]

In this example, it is assumed for simplicity that the fair value of the debt component is CU300 and the fair value of the equity component is CU150.

In the three years to 31 December 20X3, expenses of CU300 and CU90 (CU150 × 3/5) are recognised on the debt and equity components, respectively.

If the employees choose Alternative B (i.e. they take settlement of part of the share-based arrangement in shares at 31 December 20X3), the portion of the liability settled in shares at that date (CU150) will be reclassified to equity.

If the employees opt for Alternative A (i.e. cash settlement at 31 December 20X3), the scheme has vested and the total grant date fair value of the compound financial instrument should, therefore, be recognised. As a result, the unrecognised portion of the equity component (CU150 × 2/5 = CU60) will be recognised as a share-based payment expense at 31 December 20X3.
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

7.2.3 Subsequent accounting for the debt and equity components
Once the debt and equity components have been separately identified and measured, the goods or services received in respect of each component are accounted for separately. For the debt component, the goods or services received, and a corresponding liability, are recognised in accordance with the requirements applying to cash-settled transactions (see section 6). For the equity component, if any, the goods or services received are recognised as the counterparty supplies goods or renders services in accordance with the requirements for equity-settled transactions (see section 5). [IFRS 2:38]

At the date of settlement, the liability is remeasured at its fair value. If equity instruments are issued in settlement rather than cash, the liability is transferred direct to equity as the consideration for the equity instruments issued. [IFRS 2:39]

If settlement is in cash rather than equity instruments, the payment made is applied to settle the liability in full. Any equity component previously recognised remains in equity. By electing to receive cash settlement, the counterparty forfeited the right to receive equity instruments. But this does not preclude a transfer from one component of equity to another. [IFRS 2:40]

The application of these requirements is illustrated by the following example which is taken from the implementation guidance accompanying IFRS 2. It illustrates the circumstances in which the cash alternative is less favourable than the equity-settled alternative and so the equity component is not zero.

Example 7.2.3
Subsequent accounting when counterparty has choice of settlement
[Guidance on implementing IFRS 2IG Example 13]

Background
An entity grants to an employee the right to choose either 1,000 phantom shares (i.e. a right to a cash payment equal to the value of 1,000 shares) or 1,200 shares. The grant is conditional upon the completion of three years’ service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At grant date, the entity’s share price is CU50 per share. At the end of years 1, 2 and 3, the share price is CU52, CU55 and CU60, respectively. The entity does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is CU48 per share.

At the end of year 3, the employee chooses
Scenario 1: The cash alternative
Scenario 2: The equity alternative

Application of requirements
The fair value of the equity alternative is CU57,600 (1,200 shares × CU48). The fair value of the cash alternative is CU50,000 (1,000 phantom shares × CU50). Therefore, the fair value of the equity component of the compound instrument is CU7,600 (CU57,600 – CU50,000).

The entity recognises the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th></th>
<th>Expense</th>
<th></th>
<th>Equity</th>
<th></th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>CU</td>
<td></td>
<td>CU</td>
<td></td>
<td>CU</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td>Liability component: (1,000 × CU52 × 1/3)</td>
<td>17,333</td>
<td></td>
<td></td>
<td>17,333</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity component: (CU7,600 × 1/3)</td>
<td>2,533</td>
<td>2,533</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>Liability component: (1,000 × CU55 × 2/3) – CU17,333</td>
<td>19,333</td>
<td>19,333</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity component: (CU7,600 × 1/3)</td>
<td>2,533</td>
<td>2,533</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>Liability component: (1,000 × CU60) – CU36,666</td>
<td>23,334</td>
<td></td>
<td></td>
<td>23,334</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity component: (CU7,600 × 1/3)</td>
<td>2,534</td>
<td>2,534</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>End Year 3</td>
<td>Scenario 1: cash of CU60,000 paid</td>
<td></td>
<td></td>
<td></td>
<td>(60,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scenario 1 totals</td>
<td>67,600</td>
<td>7,600</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scenario 2: 1,200 shares issued</td>
<td></td>
<td>60,000</td>
<td></td>
<td>(60,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scenario 2 totals</td>
<td>67,600</td>
<td>67,600</td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>
7.3 Entity’s choice as to the manner of settlement

The terms of a share-based payment transaction may provide an entity with the choice as to whether to settle in cash or by issuing equity instruments. In this case, it is necessary to determine whether the entity has a present obligation to settle in cash and to account for the transaction accordingly. IFRS 2 states that the entity has a present obligation to settle in cash if:

[IFRS 2:41]

- the choice of settlement in equity instruments has no commercial substance, for example because the entity is legally prohibited from issuing shares; or
- the entity has a past practice or stated policy of settling in cash; or
- the entity generally settles in cash whenever the counterparty asks for cash settlement.

When the entity has a present obligation to settle in cash, the transaction is accounted for as a cash-settled transaction (see section 6). [IFRS 2:42]

If no such obligation exists, the transaction is accounted for in accordance with IFRS 2’s requirements for equity-settled transactions (see section 5).

The application of these classification requirements is illustrated in example 7.3.

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Example 7.3

Classification of an employee share option plan in which the entity has the choice of settlement

Company A, a listed entity, grants its employees options to acquire ordinary shares in Company A. Company A’s shares trade in an active market. The exercise of the options is conditional upon the achievement of certain performance conditions during the vesting period. In addition, the holders of the options have to be employed within the group headed by Company A or can be retired, if they retire at the normal retirement age.

Employees can exercise the options over a period of 5 years. Following the exercise of an option, the employee is required to sell the shares obtained immediately. Company A has first right to purchase these shares at a price equal to the market price at the moment employees exercise the underlying options. If Company A chooses not to purchase the shares, there are no constraints on how the employees dispose of the shares, or to whom. There is no enforcement mechanism by Company A.

Company A has the legal right to buy its own shares in the market, and has sufficient authorised capital to issue new shares to deliver the required number of shares to the employees upon exercise.

The share option scheme is a new arrangement, and there have been no other arrangements in the past when the entity has had a choice of cash or equity settlement; therefore, there is no evidence regarding past practice of settlement in cash. The share option scheme has been approved by the shareholders without objection, and no indication was provided as to what course of action Company A would take when the exercise date is reached (i.e. whether Company A would seek to acquire the shares based on its pre-emptive right or choose not to do so).

Company A represents that it will act in its own interest every time it has the right to buy back shares, and that it does not believe any situation exists which would force it to buy back the shares given to the employees under the scheme. Under applicable regulatory rules, employees cannot exercise their rights during a ‘closed period’. Therefore, employees will not be able to sell shares in a closed period.

When employees exercise the options granted by Company A, they are obliged to sell the shares on the date of exercise. Company A has first right to purchase these shares. In substance, this right to repurchase shares immediately gives Company A an option to settle the share-based payment transaction in cash. Therefore, IFRS 2:41 to 43 apply.

IFRS 2:41 requires an entity that has a choice of settlement to determine whether it has a present obligation to settle the share-based payment transaction in cash. The entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the entity is legally prohibited from issuing shares), or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

If an entity with a choice of settlement has no present obligation to settle the transaction in cash, IFRS 2:43 requires that “the entity shall account for the transaction in accordance with the requirements applying to equity-settled share-based payment transactions, in paragraphs 10 – 29”.

The management of Company A considers all relevant facts and circumstances to determine whether there are any factors that could create an obligation to deliver cash and concludes that there are no situations in which the entity would have a legal obligation, or has created a constructive obligation, to repurchase the shares and thereby deliver cash.
### Example 7.3 (continued)
#### Classification of an employee share option plan in which the entity has the choice of settlement

In particular:
- there is an active market in which the shares could be sold;
- from a legal perspective, Company A has sufficient authorised share capital in order to be able to issue new shares;
- current shareholders raised no objection to the scheme in the general shareholders’ meeting and the entity did not raise an expectation of a particular action;
- no restrictions on trading in a closed period apply as exercise is prohibited in this period; and
- there is no stated policy or constructive obligation created by past practice.

Therefore, this scheme should be accounted for as an equity-settled share-based payment arrangement.

However, it remains the responsibility of management to consider all facts and circumstances affecting the entity to determine whether there are any other circumstances in which the entity would have an obligation to repurchase the shares, resulting in a different conclusion.

On settlement of an arrangement that is accounted for as equity-settled (i.e. because there is no obligation to settle in cash):

[IFRS 2:43]
- if the entity elects to settle in cash, the cash payment is accounted for as the repurchase of an equity interest. It is, therefore, treated as a deduction from equity except as described below; and
- if the entity elects to settle by issuing equity instruments, no further accounting is required except as noted below and except for a transfer from one component of equity to another component of equity, if necessary.

These requirements are not consistent with the requirements of IAS 32 *Financial Instruments: Presentation* for other circumstances in which the entity has a choice of settlement. IAS 32 requires such arrangements to be classified wholly as a liability (if the contract is a derivative contract) or as a compound instrument (if the contract is a non-derivative contract). The IASB decided to retain this difference pending the outcome of its longer-term project on the distinction between liabilities and equity. [IFRS 2:BC266]

If the entity elects for the settlement alternative with the higher fair value, as at the date of settlement, the entity should recognise an additional expense for the excess value given. That is:

[IFRS 2:43]
- the difference between the cash paid and the fair value of the equity instruments that would have been issued; or
- the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid.

Thus, an additional expense is recognised when an entity elects to use the settlement alternative with the higher fair value. But this does not mean that the expense recognised will be the same as it would have been if the method of settlement assumed at the outset was the same as the actual method of settlement. For example, consider the case of share appreciation rights when the cash-settled and equity-settled alternatives have the same fair value because the cash payment is equal to the gain that would arise on exercise of the options. If these were assumed to be cash-settled from the outset, the cumulative expense recognised would be based on the actual cash payment made (i.e. intrinsic value on exercise). If these were assumed to be equity-settled from the outset, the cumulative expense recognised would be based on fair value at grant date (which would usually be lower).
If the entity concluded, at the outset, that there was no obligation to settle in cash but it subsequently did so, the expense recognised would be based on fair value at grant date and would not be adjusted to the amount of the cash payment made. The IASB considered and rejected the argument that an additional expense should be recognised in these circumstances as described in IFRS 2:BC267.

If the entity has the choice of settlement, it may, therefore, appear advantageous to conclude that there is no obligation to settle in cash and to account for the arrangements as equity-settled. When the entity has no past practice or stated policy of settling in cash, there is nothing in the Standard to prevent this. But an entity that tried to exploit this could do so only for a limited time because it might, in due course, establish a practice of settling in cash.

7.4 Contingent cash settlement provisions

IFRS 2 does not address specifically the treatment of provisions under which share-based payment transactions are settled in cash on the occurrence of a contingent event which is in the control of neither the entity nor the counterparty.

Example 7.4
Contingently cash-settled share-based payment whose contingent event is not within the control of the entity

An entity enters into an equity-settled share option arrangement. The terms of the arrangement stipulate that, if a change of control occurs before the end of the plan’s exercise period, the entity will be required to repurchase the outstanding share options, as well as any shares already issued under the plan, at fair value.

A change of control normally requires shareholder approval. The shareholders of an entity are generally not considered to be a part of the entity because they act as investors and not on behalf of the entity. When a shareholder is faced with a decision to sell his or her shares, he or she makes that decision as an investor and not as part of the entity even if he or she is also a director or an employee of the entity.

Therefore, a change of control by way of an Initial Public Offering or in some other manner should be regarded as an event that is not within the control of the entity because it is within the control of the shareholders (acting in their capacity as investors). Consequently, such share-based payment transactions should not be considered to provide the entity with a choice of settlement; they are not share-based payments with a cash alternative for either the employee or the employer.

8 Accounting by entities within groups

8.1 Accounting by entities within groups — general

As explained at section 2.4, it is often the case that employees of a subsidiary will receive part of their remuneration in the form of shares in the parent, or less commonly in some other group entity. When this is the case, IFRS 2 requires the entity that has received the benefit of the services to recognise the expense. This is so even if the equity instruments issued are those of another entity within the group.

IFRS 2 also specifies the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when the entity has no obligation to settle the share-based payment transactions (see 8.4.5).

This section also deals with some related issues, such as intragroup recharges, which are not addressed in IFRSs.

The requirements of IFRS 2 concerning share-based payment transactions among group entities focus on transactions with employees. They also apply to similar transactions with suppliers of goods or services other than employees. [IFRS 2:B46]

For share-based payment transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services measures the goods or services received as either an equity-settled or a cash-settled share-based payment transaction by assessing:

- the nature of the awards granted; and
- its own rights and obligations.
The amount recognised by the entity receiving the goods or services may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction. [IFRS 2:43A]

The entity receiving the goods or services measures them as equity-settled share-based payment transactions when:

- the awards granted are its own equity instruments; or
- the entity has no obligation to settle the share-based payment transaction.

The entity subsequently remeasures such an equity-settled share-based payment transaction only for changes in non-market vesting conditions. In all other circumstances, the entity receiving the goods or services measures them as a cash-settled share-based payment transaction. [IFRS 2:43B]

The entity settling a share-based payment transaction, when another entity in the group receives the goods or services, recognises the transaction as an equity-settled share-based payment transaction only if it is settled in the entity’s own equity instruments. Otherwise, the transaction is recognised as a cash-settled share-based payment transaction. [IFRS 2:43C]

Some group transactions involve repayment arrangements that require one group entity to pay another group entity for the provision of the share-based payments to the suppliers of goods or services. In such cases, the entity that receives the goods or services accounts for the share-based payment transaction in accordance with IFRS 2:43B regardless of any intragroup repayment arrangements.

The classification of common forms of share-based payment arrangement in consolidated, parent and subsidiary financial statements is summarised below.

<table>
<thead>
<tr>
<th>Entity receiving goods or services</th>
<th>Entity with obligation to settle</th>
<th>Settled in</th>
<th>Parent’s separate financial statements</th>
<th>Subsidiary’s individual financial statements</th>
<th>Consolidated financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Subsidiary’s equity</td>
<td>N/A (see 8.2)</td>
<td>Equity (see 8.2)</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Cash</td>
<td>N/A (see 8.4.3)</td>
<td>Cash (see 8.4.3)</td>
<td>Cash</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Parent’s equity</td>
<td>N/A (see 8.4.4)</td>
<td>Cash (see 8.3.3)</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Subsidiary’s equity</td>
<td>Cash (see 8.2)</td>
<td>Equity (see 8.2)</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Parent’s equity</td>
<td>Equity (see 8.4.2)</td>
<td>Equity (see 8.3.2)</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Cash</td>
<td>Cash (see 8.4.5)</td>
<td>Equity (see 8.4.5)</td>
<td>Cash</td>
</tr>
</tbody>
</table>

8.2 Share-based payment arrangements involving an entity’s own equity instruments

IFRS 2 addresses whether the following transactions involving an entity’s own equity instruments should be accounted for as equity-settled or cash-settled under the requirements of IFRS 2:

[IFRS 2:B48]

- an entity grants to its employees rights to equity instruments of the entity (e.g. share options) and either chooses or is required (either by contract or necessity) to buy equity instruments (i.e. treasury shares) from another party, to satisfy its obligation to its employees; and
- an entity’s employees are granted rights to equity instruments of the entity (e.g. share options), either by the entity itself or by its shareholders, and the shareholders of the entity provide the equity instruments needed.
Share-based payment transactions in which an entity receives services as consideration for its own equity instruments are accounted for as equity-settled. IFRS 2 confirms that this applies regardless of whether the entity chooses or is required to buy those equity instruments from another party to satisfy its obligations to its employees. This also applies regardless of whether:

- the employee’s rights to the entity’s equity instruments were granted by the entity itself or by its shareholders; or
- the share-based payment arrangement was settled by the entity or by its shareholders.

These requirements are straightforward and simply remove any doubt that such transactions should be accounted for as equity-settled even though the entity may not itself issue or transfer any equity instruments as part of the transaction.

If the shareholder has an obligation to settle the transaction with its investee’s employees, it provides equity instruments of its investee rather than its own. Therefore, if the investee is in the same group as the shareholder, the shareholder measures its obligation in accordance with the requirements applicable to cash-settled share-based payment transactions in the shareholder’s separate financial statements and those applicable to equity-settled share-based payment transactions in the shareholder’s consolidated financial statements. [IFRS 2:B50]

If the shareholder has no such obligation, it has no accounting entries to make because it is not party to the transaction.

**8.3 Share-based payment arrangements involving equity instruments of the parent — accounting in the subsidiary’s financial statements**

**8.3.1 Share-based payment arrangements involving equity instruments of the parent — general requirements for the subsidiary’s financial statements**

IFRS 2 also addresses share-based payment arrangements that involve two or more entities within the same group and relate to an equity instrument of another group entity. For example, the employees of a subsidiary may be granted rights to equity instruments of its parent as consideration for the services they provide to the subsidiary. [IFRS 2:B51]

IFRS 2 addresses the following share-based payment arrangements:

- a parent grants rights to its equity instruments direct to the employees of its subsidiary so that the parent (and not the subsidiary) has the obligation to provide the employees of the subsidiary with the equity instruments needed (addressed at 8.3.2); and
- a subsidiary grants rights to equity instruments of its parent to its employees so that the subsidiary (and not the parent) has the obligation to provide its employees with the equity instruments needed (addressed at 8.3.3).

IFRS 2 assumes that it is clear whether the parent or the subsidiary granted the rights to equity instruments and prescribes a different accounting treatment in each case. It may not, in practice, be clear which entity in a group granted the rights to the employees. Often this is done by mutual agreement between the subsidiary and the parent. The application of IFRS 2 in these circumstances is considered at 8.3.4.

IFRS 2 does not address the appropriate accounting for any intragroup payments that may be made in the scenarios described (which is considered at 8.5). However, the Standard does state that classification of the share-based arrangement is not affected by the existence (or otherwise) of payment arrangements between a subsidiary and parent.
8.3.2 Parent grants rights to its equity instruments to employees of its subsidiary

When a parent grants rights to its equity instruments to employees of its subsidiary, the subsidiary does not have an obligation to provide its parent’s equity instruments to its employees. The arrangement is accounted for as equity-settled in the consolidated financial statements. The subsidiary should, in its own separate financial statements, measure the services received from its employees in accordance with the requirements of IFRS 2 applicable to equity-settled share-based payment transactions. There will be a corresponding increase recognised in equity as a capital contribution from the parent. [IFRS 2:B53]

This requirement is straightforward to apply. The expense recognised in the consolidated financial statements is ‘pushed down’ into the accounts of the relevant subsidiaries that receive the services of the employees.

Example 8.3.2
Parent grants rights to its equity instruments to employees of its subsidiary

Parent P grants each of Subsidiary S’s 100 employees 30 shares in Parent P, subject to the conditions that they remain in employment for three years and that Subsidiary S meets a specified profit target. The fair value on grant date is CU5 per share. Assume that at the outset, and at the end of Years 1 and 2, it is expected that the profit target will be met and that no employees leave. Subsidiary S is not required to reimburse Parent P for the shares granted to its employees.

At the end of Year 3, the profit target is met.

Accounting by Subsidiary S

In each of Years 1 to 3, Subsidiary S will recognise an IFRS 2 expense in profit or loss, and a corresponding entry in equity, which reflects the capital contribution it receives from Parent P.

\[
\begin{align*}
\text{Dr} & \quad \text{Profit or loss [CU5 × 30 × 100 / 3 years]} & \quad 5,000 \\
\text{Cr} & \quad \text{Equity (capital contribution)} & \quad 5,000 \\
\end{align*}
\]

To recognise the share-based payment expense.

Because Subsidiary S has no obligation to reimburse Parent P for the share-based payment, no further accounting entries are required when the shares are transferred to the employees by Parent P.

There is no requirement in IFRSs to credit the capital contribution to a separate component of equity. Therefore, it may be credited to retained earnings if this is permitted in the legal jurisdiction in which Subsidiary S operates (see general discussion of this issue at 5.1.5). The accounting in the separate financial statements of the parent is addressed in example 8.4.2A.

8.3.3 Subsidiary grants rights to equity instruments of its parent to its employees

When the subsidiary grants rights to equity instruments of its parent to employees, the subsidiary accounts for the transaction with its employees as cash-settled. This requirement applies irrespective of how the subsidiary obtains the equity instruments to satisfy the obligations to its employees. [IFRS 2:B55]

The practical implications of accounting for arrangements as cash-settled in the subsidiary while they are equity-settled from the perspective of the group are considered further at 8.8.

IFRS 2 does not address the accounting required in the subsidiary when it has recognised a liability for a cash-settled share-based payment arrangement but subsequently makes no cash payment because the parent provides the shares without any right to reimbursement. IFRS 2 addresses transactions with settlement alternatives (see 3.4) but this guidance does not apply to the circumstances under consideration because the guidance envisages only the grantor of the rights or the counterparty having the choice whereas, in this case, the choice lies with a third party (i.e. the parent). If the parent satisfies the subsidiary’s obligation, the liability will be removed from the statement of financial position of the subsidiary with the credit recognised in equity as a capital contribution from the parent. The expense recognised in respect of the services received is not reversed (see example 8.4.4).
8.3.4 Determining which entity has granted the rights

To apply the requirements of IFRS 2 set out at 8.3.2 and 8.3.3, it will be necessary to determine which entity in the group granted the rights to the employees and thereby assumed the obligation to settle the transaction with the employees. This will require a careful assessment of the particular facts and circumstances. The factors to be considered include, but are not limited to:

- the contractual terms of the share scheme;
- any formal documentation provided to the employees that are granted the rights;
- any other communications provided to employees;
- whether the scheme is specific to one subsidiary or covers a number of subsidiaries within a group; and
- any other aspects of the arrangements, whether formally documented or not.

8.4 Share-based payment arrangements involving equity instruments of the parent — accounting in the parent’s separate financial statements

8.4.1 Share-based payment arrangements involving equity instruments of the parent — general requirements for the parent’s financial statements

IFRS 2 states that when a parent grants rights to its equity instruments to the employees of its subsidiary, the parent does have an obligation to settle the transaction with the subsidiary’s employees by providing the parent’s own equity instruments. Therefore, the parent measures its obligation in accordance with the requirements applicable to equity-settled share-based payment transactions. [IFRS 2:B54]

IFRS 2 offers no further guidance on application of the requirement to account for such transactions in the parent’s separate financial statements.

The illustrative example accompanying IFRIC D17 (the exposure draft upon which IFRIC 11 IFRS 2 — Group and Treasury Share Transactions was based) did, however, include entries in the separate financial statements of the parent. The illustrative example accompanying D17 dealt with the case when the parent has granted the rights so that the arrangement is equity-settled for both the group and the subsidiary but it is possible to apply the same principles in other cases (see 8.4.2 to 8.4.4).

8.4.2 Equity-settled for the group and the subsidiary

The illustrative example accompanying IFRIC D17 suggested that the parent should recognise an entry each year to debit the cost of investment in subsidiary and credit equity with an amount equal to the expense recognised in the subsidiary in accordance with IFRS 2. This was not explained in the Basis for Conclusions which accompanied IFRIC D17 but the rationale was that the parent had made a capital contribution to the subsidiary (assuming the subsidiary had not paid fair value as reimbursement to the parent) by taking on the cost of remunerating the subsidiary’s employees that the subsidiary would otherwise have had to bear, and had also granted an equity instrument in accepting the obligation to those employees. This is consistent with the credit to equity recognised in the subsidiary.

Increasing the cost of investment in a subsidiary may, in rare cases, give rise to impairment issues and this should be considered when appropriate.
Example 8.4.2A
Equity-settled for the group and the subsidiary (1)

The facts are the same as in example 8.3.2.

**Accounting by Parent P**

In each of Years 1 to 3, Parent P would recognise the enhancement to its investment in Subsidiary S, and a corresponding entry in
equity which reflects the capital contribution being made to Subsidiary S and the equity instruments being granted to Subsidiary S’s
employees.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
<td>Cost of investment</td>
</tr>
<tr>
<td>Cr</td>
<td>Equity</td>
</tr>
</tbody>
</table>

To recognise the grant of equity instruments to employees of subsidiary.

Additional entries will be required when Parent P transfers the shares to the employees. These entries will depend on whether Parent
P issues new shares or utilises shares purchased in the market and held as treasury shares. The entries may also be affected by the
involvement of an employee share trust (see 8.7).

In the same way that the subsidiary will ‘true up’ the IFRS 2 expense to reflect changes in non-market vesting
conditions, so will the parent ‘true up’ its contributions to the subsidiary. This will usually result in symmetrical
accounting for the capital contribution between the parent and subsidiary.

Example 8.4.2B
Equity-settled for the group and the subsidiary (2)

The facts are the same as in example 8.3.2 except that at the end of Year 3 the profit target is not met.

**Accounting by Parent P**

In each of Years 1 and 2, Parent P will recognise an enhancement to its investment in Subsidiary S, and a corresponding entry in equity,
which reflect the capital contribution being made to Subsidiary S and the equity instruments being granted to Subsidiary S’s employees.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
<td>Cost of investment</td>
</tr>
<tr>
<td>Cr</td>
<td>Equity</td>
</tr>
</tbody>
</table>

To recognise the grant of equity instruments to employees of subsidiary.

At the end of Year 3, the profit target is not met, so Parent P must ‘true up’ the amounts recognised to reflect the non-market vesting
condition not being met.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
<td>Equity</td>
</tr>
<tr>
<td>Cr</td>
<td>Cost of investment</td>
</tr>
</tbody>
</table>

To recognise the true up in respect of equity instruments granted to employees of subsidiary.

This true up in Parent P mirrors the accounting entries in Subsidiary S.

8.4.3 Cash-settled for the group and the subsidiary

A scheme will only be accounted for as cash-settled both by the group and by the subsidiary when the
subsidiary itself has the obligation to transfer cash or other assets (other than equity instruments of the group) to
its employees. (Historically, this approach might also have been applied by a subsidiary that was not yet applying
IFRS 2 as amended in July 2009 whose parent had the obligation to transfer cash or other assets (other than
equity instruments of the group) to that subsidiary’s employees. IFRS 2 now makes clear that such a subsidiary
should regard the arrangement as equity-settled — see 8.4.5.)

No accounting is required by the parent when the subsidiary has the obligation to its employees and makes a
cash payment to satisfy the obligation. When the subsidiary has the obligation to make a cash payment to its
employees but the parent settles the obligation on behalf of the subsidiary, the amount of the cash payment
is accounted for as a capital contribution, increasing the cost of investment in the subsidiary in the parent’s
separate financial statements and increasing equity in the subsidiary’s financial statements.
When the parent has the obligation to make a cash payment to the employees of its subsidiary, the parent recognises the amount of the cash payment as a capital contribution, increasing the cost of investment in its subsidiary. The subsidiary accounts for such a scheme as equity-settled. Such arrangements are considered further at 8.4.5.

### 8.4.4 Equity-settled for the group but cash-settled for the subsidiary

**Example 8.4.4**

**Equity-settled for the group but cash-settled for the subsidiary**

Subsidiary S has entered into a share-based payment arrangement with its employees under which Subsidiary S has the obligation to deliver shares of Parent P to its employees. Subsequently, Parent P provides the shares to the employees to satisfy Subsidiary S’s obligation. Parent P has no right to reimbursement from Subsidiary S.

**How should Subsidiary S and Parent P account for the original share-based payment arrangement and its subsequent settlement by Parent P?**

**Accounting by Subsidiary S**

IFRS 2:B55 requires that arrangements should be accounted for as cash-settled by the subsidiary if it is the subsidiary that has granted rights to employees over its parent’s equity instruments, irrespective of how the subsidiary obtains the equity instruments to satisfy its obligation to its employees. Therefore, in the circumstances described, Subsidiary S initially recognises a liability for its obligation, which is measured in accordance with the requirements of IFRS 2 regarding cash-settled transactions.

When the parent subsequently provides shares to the subsidiary’s employees for no consideration, the subsidiary should recognise the credit arising from the derecognition of the liability directly in equity as a capital contribution received from the parent. The expense recognised in respect of the services received is not reversed.

**Accounting by Parent P**

Parent P does not account for the share-based payment arrangement prior to settling the subsidiary’s obligation because it is not party to the share-based payment arrangement.

When Parent P provides the shares to the subsidiary’s employees for no consideration, it should recognise a capital contribution to Subsidiary S in its separate financial statements. There are two acceptable views regarding the value at which that capital contribution should be recognised:

- the equity-settled amount recognised in the consolidated financial statements; or
- the cash-settled amount recognised in the subsidiary’s financial statements.

Recognition at the equity-settled amount recognised in the consolidated financial statements is based on the argument that when the parent has not made a cash payment to settle the share-based payment award but has issued its own equity instruments to satisfy the obligation, the credit to equity in the parent’s separate financial statements should be the same as the equivalent credit in the consolidated financial statements because they relate to the same equity instrument.

However, recognition of a capital contribution for the same amount as the cash-settled amount recognised in the subsidiary’s financial statements is more logical and consistent with the fact that, under IFRS 2, the parent has no obligation. Although the group has an obligation that will be settled by the issuance of equity instruments, the parent creates an equity instrument of its own at the entity level only when it provides the shares to the subsidiary’s employees. From the parent’s perspective, the equity instruments are issued to settle the cash-settled liability of the subsidiary on its behalf and, therefore, measurement of that capital contribution for the same amount is reasonable.

The parent should select one of the approaches as its accounting policy and apply it consistently.

Practical application of these principles is considered further at 8.8.

### 8.4.5 Cash-settled for the group but equity-settled for the subsidiary

An entity may receive goods or services from its suppliers (including employees) under share-based payment arrangements that are cash-settled when the entity itself does not have any obligation to make the required payments to its suppliers. For example, a parent (not the entity itself) may have an obligation to make the required cash payments to the employees of the entity and:

[IFRS 2:B56]

- the employees of the entity will receive cash payments that are linked to the price of its own equity instruments; or
- the employees of the entity will receive cash payments that are linked to the price of its parent’s equity instruments.
In this case, the subsidiary does not have an obligation to settle the transaction with its employees. Therefore, the subsidiary accounts for the transaction as equity-settled and recognises a corresponding increase in equity as a contribution from its parent. The subsidiary remeasures the cost of the transaction subsequently for any changes resulting from non-market vesting conditions not being met. This differs from the measurement of the transaction as cash-settled in the consolidated financial statements of the group. [IFRS 2:B57]

The parent has an obligation to settle the transaction with the employees and the consideration is cash. The parent and the consolidated group measure the obligation in accordance with the requirements of IFRS 2 applicable to cash-settled share-based payment transactions. [IFRS 2:B58]

IFRS 2 does not address the treatment of the debit entry arising from recognition and remeasurement of the obligation in the parent’s separate financial statements. However, it will be debited to the cost of investment in the subsidiary as a capital contribution. The amount of this contribution will be a different amount from the capital contribution recognised in the subsidiary in accordance with IFRS 2:B57. In some cases, it may be necessary to consider whether the investment in the subsidiary is impaired.

8.5 Intragroup recharges

IFRS 2 does not address the appropriate accounting for intragroup recharges, except to say that intragroup payment arrangements should not affect the accounting for the underlying share-based payment arrangement.

Although the appropriate accounting for intragroup recharges is not addressed in IFRS 2, an illustrative example accompanying IFRIC D17 (the exposure draft upon which IFRIC 11 was based) indicated that if the parent levies an intragroup recharge on the subsidiary, the amount of that recharge is offset against the capital contribution arising for the share-based payment in the individual and separate financial statements of the subsidiary and in any separate financial statements of the parent. The example also indicated that if the amount of the recharge exceeds the capital contribution, that excess is accounted for as a distribution from the subsidiary to the parent. Thus, in effect, IFRIC D17 proposed to account for any difference between share-based payment expense and reimbursement as a transaction with shareholders (i.e. a capital contribution or distribution).

The same logic applies irrespective of whether an arrangement is an equity-settled or cash-settled share-based payment arrangement in the parent’s separate financial statements and the consolidated financial statements.

Some complexities may arise if the timing of the intragroup recharges is different from the recognition of the expense under IFRS 2. For example, it is possible that the recharge might be levied only when the options are exercised by the employees. Some of these issues are considered in detail in examples 8.5A to 8.5D.

These examples distinguish between circumstances in which a right to reimbursement exists at the inception of the share-based payment arrangement and circumstances in which no such right exists at that time. A right to reimbursement may exist in the absence of a written contract. For example, it may exist if it is the clear intention of the parties, when the share-based payment arrangement is established, that reimbursement will occur and the basis for calculating the amount of that reimbursement is also agreed at that time.

When the recharge made exceeds the expense recognised in accordance with IFRS 2, as will typically be the case if the recharge is based on the intrinsic value on exercise of the options, the excess will be accounted for as a distribution by the subsidiary. Consequently, it will not be recognised as an expense in the subsidiary’s financial statements, but will be recognised as a distribution received (dividend income) in the parent’s separate financial statements. This is illustrated in example 8.5D.

The fact that the excess recharge will be accounted for as a distribution does not necessarily mean that it will be a distribution as a matter of law. The position may vary according to the legal jurisdiction. Legal advice should be sought when necessary.

There is no specific requirement in IFRSs to present intragroup recharges for share-based payments in this way, but the net approach illustrated in IFRIC D17 appears reasonable and has been used as the basis for examples 8.5A and 8.5C when the parent has a right to reimbursement. Nevertheless, other approaches may also be acceptable, provided that they do not result in a misstatement of the amount of share-based payment expense recognised.
For example, an entity may elect to account separately for services received (as a capital contribution) and for payments made (as a distribution), without offsetting the two. Moreover, when the amount payable to the parent is conditional on share awards vesting, a reimbursement obligation might be measured at fair value. Whatever the approach adopted, careful judgement should be applied to ensure that the accounting properly reflects the substance of the arrangement.

**Example 8.5A**
Reimbursement over the term of the arrangement

A parent, Company P, grants 30 of its shares to each of 100 employees of its subsidiary, Company S, on condition that the employees remain employed by Company S for three years. Assume that at the outset, and at the end of Years 1 and 2, it is expected that all of the employees will remain employed for all three years. At the end of Year 3, none of the employees has left. The fair value of the shares on grant date is CU5 per share.

Company S agrees to reimburse Company P over the term of the arrangement for 75 per cent of the final expense recognised by Company S. Over that period, Company S expects to recognise an expense totalling CU15,000 and, therefore, expects the total reimbursement to be CU11,250 (CU15,000 × 75 per cent). Company S therefore reimburses Company P CU3,750 (CU11,250 × 1/3) each year.

The following illustrates one of several acceptable approaches (as discussed above) to accounting for recharges of share-based payment costs.

**Accounting by Company S**

In each of Years 1 to 3, Company S recognises an IFRS 2 expense in profit or loss, the cash paid to Company P, and the balance of the capital contribution it has received from Company P.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Profit or loss</td>
<td>5,000</td>
</tr>
<tr>
<td>Cr Cash</td>
<td>3,750</td>
</tr>
<tr>
<td>Cr Equity (capital contribution)</td>
<td>1,250</td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense and partial reimbursement to parent.*

**Accounting by Company P**

In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted, the cash reimbursed by Company S, and the balance of the capital contribution it has made to Company S.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cost of investment</td>
<td>1,250</td>
</tr>
<tr>
<td>Dr Cash</td>
<td>3,750</td>
</tr>
<tr>
<td>Cr Equity</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*To recognise the grant of equity instruments to employees of subsidiary less partial reimbursement from subsidiary.*

**Example 8.5B**
Reimbursement (if any) at the end of the arrangement when initially there exists no right to reimbursement

The facts are as in example 8.5A, except that, before vesting, there exists no right to reimbursement. At the end of the arrangement (i.e. when the shares vest), Company S agrees to pay Company P 75 per cent of the final expense recognised by Company S.

The following illustrates one of several acceptable approaches to accounting for recharges of share-based payment costs.

**Accounting by Company S**

In each of Years 1 to 3, Company S recognises the IFRS 2 expense in profit or loss and a capital contribution from Company P.

<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Profit or loss</td>
<td>5,000</td>
</tr>
<tr>
<td>Cr Equity (capital contribution)</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*To recognise the share-based payment expense.*
Example 8.5B (continued)
Reimbursement (if any) at the end of the arrangement when initially there exists no right to reimbursement

At the end of Year 3, all the shares vest and Company S pays Company P CU11,250. The payment is treated as a distribution to Company P.

\[
\begin{align*}
\text{CU} & \quad \text{CU} \\
\text{Dr} & \quad \text{Equity (distribution)} & 11,250 \\
\text{Cr} & \quad \text{Cash} & 11,250 \\
\end{align*}
\]

*To recognise the distribution to parent.*

**Accounting by Company P**

In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted and the capital contribution made to Company S.

\[
\begin{align*}
\text{CU} & \quad \text{CU} \\
\text{Dr} & \quad \text{Cost of investment} & 5,000 \\
\text{Cr} & \quad \text{Equity} & 5,000 \\
\end{align*}
\]

*To recognise the grant of equity instruments to employees of subsidiary.*

At the end of Year 3, all the shares vest and Company S pays Company P CU11,250. The payment is recognised as dividend income in profit or loss by Company P.

\[
\begin{align*}
\text{CU} & \quad \text{CU} \\
\text{Dr} & \quad \text{Cash} & 11,250 \\
\text{Cr} & \quad \text{Dividend income (profit or loss)} & 11,250 \\
\end{align*}
\]

*To recognise the distribution from subsidiary.*

If the increased cost of investment and reduction in the value of Company S from the payment of a dividend result in the carrying amount of Company P’s investment in Company S no longer being supportable, Company P should also recognise an impairment loss in respect of the cost of its investment in Company S.

---

Example 8.5C
Reimbursement at the end of the arrangement when there is a right to reimbursement

The facts are as in example 8.5A, except that, on grant date, Company S and Company P enter into a binding agreement under which Company S will reimburse Company P 75 per cent of the final expense recognised by Company S. The payment is made at the end of the arrangement (i.e. when the shares vest).

The following illustrates one of several acceptable approaches for accounting for recharges of share-based payment costs.

**Accounting by Company S**

In each of Years 1 to 3, Company S recognises the IFRS 2 expense in profit or loss, a payable due to Company P for 75 per cent of this amount, and a capital contribution from Company P for the balance.

\[
\begin{align*}
\text{CU} & \quad \text{CU} \\
\text{Dr} & \quad \text{Profit or loss} & 5,000 \\
\text{Cr} & \quad \text{Intragroup payables} & 3,750 \\
& & \quad \text{Equity (capital contribution)} & 1,250 \\
\end{align*}
\]

*To recognise the share-based payment expense and accrual of partial reimbursement to parent.*

At the end of Year 3, all the shares vest and Company S pays Company P CU11,250, settling the liability previously recognised.

\[
\begin{align*}
\text{CU} & \quad \text{CU} \\
\text{Dr} & \quad \text{Intragroup payables} & 11,250 \\
\text{Cr} & \quad \text{Cash} & 11,250 \\
\end{align*}
\]

*To recognise the settlement of reimbursement to parent.*
Example 8.5C (continued)
Reimbursement at the end of the arrangement when there is a right to reimbursement

Accounting by Company P
In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted and a receivable from Company S and the balance of the capital contribution it has made to Company S.

CU CU
Dr Intragroup receivables 3,750
Dr Cost of investment 1,250
Cr Equity 5,000
To recognise the grant of equity instruments to employees of subsidiary less accrual of partial reimbursement from subsidiary.

At the end of Year 3, all the shares vest and Company S pays Company P CU11,250.

CU CU
Dr Cash 11,250
Cr Intragroup receivables 11,250
To recognise the settlement of reimbursement by subsidiary.

For simplicity, this example assumes that any effect of discounting would not be material. When reimbursement balances are very large, consideration should be given to whether discounting is necessary.

Example 8.5D
Reimbursement at the end of the arrangement equal to the intrinsic value at that date when initially there is no right to reimbursement

The facts are as in example 8.5A, except that Company S pays Company P at the end of the arrangement an amount equal to the intrinsic value of the shares at that date. This amount is CU25,000.

For simplicity, it has been assumed that there is no entitlement to the reimbursement and that it is, therefore, accounted for only when made. Otherwise it would be necessary for Company S to estimate the amount of the accrued reimbursement to be recognised at the end of each reporting period.

The following illustrates one of several acceptable approaches for accounting for recharges of share-based payment costs.

Accounting by Company S
In each of Years 1 to 3, Company S recognises the IFRS 2 expense in profit or loss and a capital contribution from Company P.

CU CU
Dr Profit or loss 5,000
Cr Equity (capital contribution) 5,000
To recognise the share-based payment expense.

At the end of Year 3, all the shares vest and Company S pays Company P CU25,000. The payment is treated as a distribution by Company S.

CU CU
Dr Equity (distribution) 25,000
Cr Cash 25,000
To recognise the distribution to parent.
Example 8.5D (continued)
Reimbursement at the end of the arrangement equal to the intrinsic value at that date when initially there is no right to reimbursement

**Accounting by Company P**
In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted and the capital contribution made to Company S.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cu</th>
<th>Cr</th>
<th>Cu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of investment</td>
<td>5,000</td>
<td>Equity</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*To recognise the grant of equity instruments to employees of subsidiary.*

At the end of Year 3, all the shares vest and Company S pays Company P CU25,000. The payment is treated as dividend income by Company P.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cu</th>
<th>Cr</th>
<th>Cu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>25,000</td>
<td>Profit or loss (dividend income)</td>
<td>25,000</td>
</tr>
</tbody>
</table>

*To recognise the distribution from subsidiary.*

If the increased cost of investment and reduction in the value of Company S from the payment of a dividend result in the carrying amount of Company P's investment in Company S no longer being supportable, Company P should also recognise an impairment loss in respect of the cost of its investment in Company S.

### 8.6 Transfers of employees between group entities

#### 8.6.1 Transfers of employees between group entities: parent has obligation

A parent may grant rights to its equity instruments to the employees of its subsidiaries that are conditional upon the completion of continuing service with the group (rather than a specified subsidiary) for a specified period. An employee may, therefore, transfer employment from one subsidiary to another during the specified vesting period without the employee’s rights under the arrangements being affected. If the subsidiaries have no obligation to settle the share-based payment transaction with their employees, they account for it as an equity-settled transaction. When this is the case, each subsidiary measures the services received from its employee by reference to the fair value of the equity instruments at the date when the rights were originally granted by the parent and the proportion of the vesting period served by the employee with that subsidiary. [IFRS 2:B59]

Such an employee, after transferring between group entities, may fail to satisfy a vesting condition (e.g. the employee may leave the group before completing the required period of service) other than a market condition. In this case, because the vesting condition is service to the group, each subsidiary adjusts the amount previously recognised in respect of the services received from the employee in accordance with IFRS 2:19. Consequently, if the rights to equity instruments do not vest because of a failure to meet a vesting condition (other than a market condition), no amount is recognised on a cumulative basis for the services received from that employee in the financial statements of both subsidiaries. [IFRS 2:B61]

This requirement for all affected entities to ‘true up’ at vesting date means that a subsidiary may need to make adjustments to its share-based payment expense several years after an employee has transferred elsewhere within the group.

#### 8.6.2 Transfers of employees between group entities: subsidiary has obligation

If the subsidiary has an obligation to settle the transaction with its employees in its parent’s equity instruments, it accounts for the transaction as cash-settled. IFRS 2 requires that each subsidiary measures the services received on the basis of grant date fair value of the equity instruments for the proportion of the vesting period the employee served with each subsidiary. In addition, each subsidiary recognises any change in the fair value of the equity instruments during the employee’s service period with each subsidiary. [IFRS 2:B60]
Appendix F — Accounting for Share-Based Payment Awards Under IFRSs
A Roadmap to Accounting for Share-Based Payment Awards

IFRS 2:B61 deals with failure to meet vesting conditions and appears to refer back to IFRS 2:B60 because it begins with the words ‘such employees’. However, the requirements of IFRS 2:19 regarding the treatment of vesting conditions may not be relevant to cash-settled arrangements (see 5.3). In practice, any failure to meet a non-market vesting condition will be reflected in the remeasurement of the liability and accounted for in accordance with IFRS 2:B60 so there is no need to apply IFRS 2:B61.

In each case it will be necessary to consider which entity or entities in the group have the obligation to settle with the employee and recognise their liabilities accordingly. This will depend on the particular terms of the scheme. Each subsidiary will recognise an expense in relation to the period of service with that subsidiary in accordance with IFRS 2:B60. When one subsidiary assumes the cumulative liability for past service provided to other subsidiaries, the assumption of this liability at the date of transfer will be debited to equity as it is a form of distribution. The other subsidiaries should credit the release of their liability to equity as a capital contribution (i.e. the expense previously recognised for the service previously provided by the employee is not reversed merely because the liability will be settled by another party).

8.7 Effect of the use of employee share trusts

Employee share trusts may potentially be accounted for in two different ways depending on the circumstances. When the assets and liabilities of the trust are recognised as those of the sponsoring entity (see 5.12 in [I GAAP] chapter A29), any obligations of the trust will be regarded as obligations of the sponsoring entity.

The analysis will be different when the trust is regarded as a subsidiary (see section 9). In such circumstances, the rights and obligations of the trust will be reflected in its own individual financial statements, rather than those of the sponsoring entity.

It will be necessary to apply the requirements of IFRS 2:B46 to B61 and the other guidance in this section to the particular facts of each case. In particular, the guidance at 8.3.4 will be relevant to determining which entity has granted the rights and, therefore, has the obligation to employees.

The analysis might be further complicated when in practice three entities are involved in the arrangement. The third entity might be a fellow subsidiary or intermediate parent which grants the options and delivers the shares to the employees (either directly or via an employee share trust).

8.8 Subsidiary purchases parent’s shares

8.8.1 Subsidiary purchases parent’s shares to settle cash-settled obligation to employees

To settle its obligation to employees, the subsidiary will often need to acquire its parent’s shares either in the market or directly from the parent.

Example 8.8.1
Subsidiary purchases parent’s shares to settle cash-settled obligation to employees

A subsidiary has an obligation under a share-based payment arrangement to deliver its parent’s shares to its employees. To settle its obligation to its employees, the subsidiary will need to acquire its parent’s shares either in the market or directly from the parent.

In accordance with IFRS 2:43B, the subsidiary accounts for this as a cash-settled share-based payment arrangement.

The accounting by the subsidiary depends upon (1) whether it purchases the shares at the vesting date or at an earlier date, and (2) if it purchases the shares before the vesting date, whether the subsidiary applies IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement in accounting for its financial instruments.

(1) Subsidiary purchases shares at the vesting date

When the subsidiary purchases the required shares in the market at the vesting date, the price paid for the shares (less any exercise price paid by the employees) is usually the same as the liability already recognised, so that no gain or loss arises on settlement. The subsidiary is not required to recognise any movements in equity arising from the arrangements because it has not issued any equity instruments and it has not received any capital contribution from its parent.

When the parent issues the required shares to the subsidiary at the vesting date at market price, from the subsidiary’s perspective this is no different from purchasing shares in the market, and the treatment described in the previous paragraph is appropriate. The parent should recognise an issue of shares for full consideration in the usual manner.
Example 8.8.1 (continued)
Subsidiary purchases parent’s shares to settle cash-settled obligation to employees

When the parent issues the required shares to the subsidiary at the vesting date for no consideration, or for consideration lower than market price, the difference between the consideration paid and market value represents a capital contribution from the parent to the subsidiary and does not result in any change to the expense recognised under IFRS 2.

Subsidiary purchases shares prior to the vesting date and applies IFRS 9

If a subsidiary purchases and holds shares in its parent, they are recognised and measured as financial assets in the individual financial statements of the subsidiary even though they are treated as treasury shares in the consolidated financial statements of the parent. Under IFRS 9, the shares will either be classified as at fair value through profit or loss (FVTPL) (which is the default category) or designated as at fair value through other comprehensive income (FVTOCI).

Under either classification, the carrying amount of the shares at the vesting date (less any exercise price paid by the employees) is usually the same as the liability already recognised, so that no gain or loss will arise on settlement (when assets are designated as at FVTOCI under IFRS 9, the cumulative gains or losses accumulated in other comprehensive income are not reclassified to profit or loss on disposal).

Subsidiary purchases shares prior to the vesting date and applies IAS 39

Under IAS 39 (for entities that have not yet adopted IFRS 9), in the subsidiary’s financial statements, the shares are either classified as available for sale (AFS) (which is the default category) or designated as at FVTPL if the relevant requirements of IAS 39 are met. Under IAS 39, one of the circumstances in which an asset may be designated as at FVTPL is when the designation results in more relevant information because it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring the assets or liabilities, or recognising the gains and losses on them, on different bases. The determination as to whether designation as at FVTPL eliminates or significantly reduces an accounting mismatch should be based on a careful analysis of the specific facts and circumstances in each case. When shares are classified as at FVTPL, the carrying amount of the shares at the vesting date (less any exercise price paid by the employees) is usually the same as the liability already recognised, so that no gain or loss arises on settlement.

When the shares are classified as AFS, although the carrying amount of the shares at the vesting date (less any exercise price paid by the employees) is usually the same as the liability already recognised, a gain or loss may arise on settlement because the cumulative gains or losses previously recognised in other comprehensive income are reclassified to profit or loss on disposal (i.e. when the shares are delivered to employees). The shares cannot be designated as a hedging instrument in a hedge of the share-based payment obligation.

8.8.2 Hedge accounting

Although ‘economic hedges’ can be achieved for some share-based arrangements, as described at 8.8.1, IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39) sets out detailed rules on hedge accounting, including which items can be hedged and which instruments can qualify as hedging instruments.

Under IFRS 9 (or IAS 39), it is not possible to apply hedge accounting to an equity-settled share-based payment arrangement because that Standard prohibits own equity as a hedged item.

Although a liability recognised under a cash-settled share-based payment arrangement can qualify as a hedged item, it is important to note that under IAS 39 the subsidiary cannot designate shares in its parent (whether held directly or via an employee share trust) as a hedging instrument. IFRS 9 permits a non-derivative financial asset measured at FVTPL, which would include a holding of an equity instrument, to be designated as a hedging instrument. Instead of purchasing the shares of the parent before the vesting date, a subsidiary might consider purchasing options over its parent’s shares and designating them as a hedging instrument in hedging the forecast employee expense. However, it will still need to meet the detailed requirements of IFRS 9 (or IAS 39) in order to achieve hedge accounting.

9 Employee share trusts

9.1 Background

Employee share trusts (sometimes established in conjunction with employee share ownership plans (ESOPs) or employee share plans), created by a sponsoring entity for employees, are designed to facilitate employee shareholding and are often used as vehicles for distributing shares to employees under remuneration schemes. The detailed structures of individual trusts are many and varied, as are the reasons for establishing them.
Reasons for establishing employee share trusts include the following (although it should be noted that some of these are not permitted in all jurisdictions):

- to fund a matching programme for a sponsor’s defined contribution plan or other employee benefits;
- to raise new capital or to create a marketplace for existing shares;
- to replace lost benefits from the termination of other employee benefit plans or to provide benefits under post-retirement plans (particularly medical benefits);
- to be part of the financing package in leveraged buy-outs;
- to provide tax-advantaged means for owners to terminate ownership;
- to be part of a long-term programme to restructure the equity section of a sponsor’s statement of financial position; and
- to defend the entity against a hostile takeover.

Employee share trusts can be leveraged or non-leveraged. In a leveraged employee share trust, the plan borrows money to purchase shares, usually guaranteed by the sponsor.

The detailed structure of an employee share trust often includes the following:

- the trust holds shares in the sponsoring entity (or another group entity) to be sold or transferred to employees under the terms of a share-based payment plan;
- the trust acquires shares either directly from the sponsoring entity or by purchasing them in the market. These acquisitions may be financed by a cash contribution or loan from the sponsoring entity or by a third-party loan (often guaranteed by the sponsoring entity); and
- the activities of the trust are narrowly defined, typically in a trust deed.

9.2 Determining whether an entity controls an employee share trust

9.2.1 Determining whether an entity controls an employee share trust — general

IFRS 10 Consolidated Financial Statements includes no scope exemption for employee share trusts. Accordingly, an entity applying IFRS 10 will need to consider whether it controls an employee share trust; if so, a number of accounting implications follow (see 9.3).

In accordance with the general definition of control in IFRS 10 (see section 5 of [iGAAP] chapter A24), an employee share trust should be consolidated if the sponsoring entity has:

- power over the relevant activities of the trust (see 9.2.2);
- exposure, or rights, to variable returns from its involvement with the trust (see 9.2.3); and
- the ability to use its power over the trust to affect the amount of its returns (see 9.2.4).
9.2.2 Power over the relevant activities of the trust

The relevant activities of an employee share trust will typically be the acquisition and disposal of shares (either to employees under the terms of a remuneration scheme or, in the case of excess shares held, returned to the sponsoring entity or sold in the market) and the financing of these activities.

A trust’s activities will typically be defined by a deed and managed by appointed trustees, meaning that it will generally not be controlled by means of voting rights. The sponsoring entity may retain power over these activities in a number of ways, for example:

- by including in the deed governing the activities of the trust or in another contractual arrangement (e.g. a loan agreement or loan guarantee) a requirement that the sponsoring entity’s shares be acquired and disposed of at the direction of the sponsoring entity;
- by appointing as trustees employees of the sponsoring entity who will make decisions as de facto agents of the sponsoring entity (see 8.3 in [iGAAP] chapter A24); or
- by limiting the scope of activities permitted by the trust deed to acquiring and distributing shares in accordance with remuneration schemes determined by the sponsoring entity.

9.2.3 Exposure, or rights, to variable returns from involvement with the trust

As discussed in IFRS 10:B56 (see 7.1 in [iGAAP] chapter A24), ‘variable returns’ are broadly defined. In the context of an employee share trust, it should be noted that generally the trust’s purpose and design is to hold assets that will be used to settle the sponsoring entity’s obligations under a remuneration scheme. Should the trust fail to do so (e.g. if there are not sufficient shares in the trust to settle the obligation), the sponsoring entity is likely to remain liable to its employees under the terms of the remuneration scheme (i.e. the sponsoring entity has, in effect, guaranteed that the trust will be in a position to provide sufficient assets to employees).

Variable returns from the trust may also include:

- default risk on a loan due from the trust;
- payments due as a result of the sponsoring entity’s guarantee of the trust’s loan from a third party;
- the return of surplus assets to the sponsoring entity if the shares do not vest or any profit made by the trust is required to be paid to the sponsoring entity;
- the sponsoring entity guarantees a minimum value of the shares; and
- the assets of the trust can be recaptured by the sponsoring entity or its creditors (e.g. in a bankruptcy situation).

9.2.4 Ability to use power over the trust to affect the amount of returns

The entity will need to consider whether its power over the trust can be used to influence its variable returns. For example, default risk on a loan from the trust could be affected by a decision regarding whether to use shares held by the trust to satisfy employee share plans or to sell them and use the proceeds to repay the loan. Alternatively, an entity’s ability to determine when shares are transferred to the trust could expose it to variability in its requirement to transfer additional shares sufficient to fulfil its obligations under remuneration schemes.

In addition, it should be noted that the trust’s primary purpose (settlement of the sponsoring entity’s obligations under remuneration schemes) suggests that the sponsoring entity will act on its own account (i.e. as principal) in making decisions related to the trust. IFRS 10:858 makes clear that a decision maker is not acting as an agent simply because other parties (in this case, the employees) can benefit from the decisions that it makes.
9.3 Accounting implications when a sponsoring entity has control over an employee share trust

When a sponsoring entity has control over an employee share trust, the assets and liabilities of the trust (including the shares it holds in the sponsoring entity) should be recognised in the consolidated financial statements. Shares in the sponsoring entity held by a consolidated employee share trust should, in accordance with paragraph 33 of IAS 32 *Financial Instruments: Presentation*, be treated as treasury shares. Accordingly:

- consideration paid or received for the trust’s purchase or sale of the sponsoring entity’s own shares should be shown as separate amounts in the statement of changes in equity;
- no gain or loss should be recognised in profit or loss on the purchase, sale, issue or cancellation of the sponsoring entity’s own shares;
- any dividend income on the sponsoring entity’s own shares should be excluded in determining profit before tax and deducted from the aggregate of dividends paid and proposed; and
- the sponsoring entity’s own shares held should be excluded from the denominator for the purpose of calculating both basic and diluted earnings per share.

In addition, finance costs and any administration expenses of the trust should be recognised as they accrue and not as funding payments are made to the trust.

Sufficient information should be disclosed in the financial statements of the sponsoring entity to enable readers to understand the significance of the trust in the context of the sponsoring entity. Specifically, an employee share trust will typically be considered a structured entity for the purposes of applying the disclosure requirements of IFRS 12 *Disclosure of Interests in Other Entities* (see [iGAAP] chapter A28) and any shares held by a consolidated trust will be disclosed in accordance with paragraph 79 of IAS 1 *Presentation of Financial Statements* (see 4.5.2.4 in [iGAAP] chapter A4).

9.4 Identification of sponsoring entity

As explained at 5.12 in [iGAAP] chapter A29, in some cases it will be appropriate to account for the assets and liabilities of an employee share trust in the separate financial statement of the sponsoring entity. However, it is not always straightforward to determine which entity within a group is the sponsoring entity.

If an employee share trust is set up to hold shares that will be used to settle share awards granted by a particular entity, it is likely that the entity that has the obligation to the employees will be the sponsoring entity of the trust because that is the entity that needs to acquire the shares to meet its obligations. Section 8.3.4 provides guidance on the factors to consider in determining which entity has this obligation.

When a parent makes a share award to the employees of its subsidiary, the parent has the obligation to settle the share award. When this is the case, it is unlikely to be appropriate to treat the subsidiary as the sponsoring employer of a trust set up to hold shares to settle the share awards because, as discussed at 5.12 in [iGAAP] chapter A29, this would result in recognition of the shares as an asset on the statement of financial position but there would be no corresponding obligation to settle the share awards. However, each situation will require judgement based on the particular facts.

9.5 Presentation of movements in equity relating to an employee share trust

This section considers the accounting entries that may be required within equity in the consolidated financial statements when an entity’s own shares are held by an employee share trust that is consolidated by the entity. From the perspective of the consolidated financial statements (and entity-only financial statements when a ‘look-through’ approach is applied (see 5.12 in [iGAAP] chapter A29)), such shares are ‘treasury shares’ and are deducted from equity in accordance with IAS 32:33. IAS 32:34 states that the amount of treasury shares held should be disclosed separately either in the statement of financial position or in the notes. This can be done either by presenting treasury shares as a separate component of equity or by including the deduction from equity within another component of equity, for example within retained earnings (disclosed by way of note). It may be clearer to present a separate component of equity when the amount is material.
Example 9.5
Presentation of movements in equity relating to employee share trusts

For the purposes of the following illustration, it is assumed that a separate employee share (or ESOP) reserve is maintained. When shares are purchased in the market by an employee share trust, they will initially be recognised as a debit to the employee share trust reserve for the price paid. For example, suppose that the price paid is CU1,000.

\[
\begin{array}{ccc}
\text{CU} & \text{CU} \\
\text{Dr} & \text{Employee share reserve} & 1,000 \\
\text{Cr} & \text{Cash} & 1,000 \\
\end{array}
\]

To recognise the acquisition of shares for cash.

Exercise price is lower than price paid by the employee share trust
If options are subsequently granted over those shares with an exercise price of CU800, the following entry will generally be required when the share options are exercised.

\[
\begin{array}{ccc}
\text{CU} & \text{CU} \\
\text{Dr} & \text{Cash} & 800 \\
\text{Dr} & \text{Equity} & 200 \\
\text{Cr} & \text{Employee share reserve} & 1,000 \\
\end{array}
\]

To remove balance from the employee share reserve when options are exercised.

This is because it is illogical to leave a balance on the employee share reserve which relates to shares that are no longer held. The difference between the price paid by the employee share trust to purchase the shares initially and the amount received when the shares are reissued upon exercise of the options must be recognised in equity and retained earnings may be an appropriate caption.

Exercise price is higher than price paid by the employee share trust
If options are subsequently granted over those shares with an exercise price of CU1,300, the following entry will generally be required when the share options are exercised.

\[
\begin{array}{ccc}
\text{CU} & \text{CU} \\
\text{Dr} & \text{Cash} & 1,300 \\
\text{Cr} & \text{Employee share reserve} & 1,000 \\
\text{Cr} & \text{Equity} & 300 \\
\end{array}
\]

To remove balance from the employee share trust reserve when options are exercised.

Any excess of the amount received upon exercise of the options over the price paid by the employee share trust to purchase the shares initially is accounted for directly in equity, for example in retained earnings or another part of equity specified by local law and regulations.

Note that this example does not deal with the accounting entries in equity that may be required by IFRS 2. These are discussed at 5.1.5. They will generally involve a credit to equity equal to the expense recognised. Whether this credit is recognised in retained earnings or as a separate reserve will depend on the entity’s accounting policy.

When recognising the IFRS 2 expense, it may be tempting to recognise the credit entry in the employee share reserve when one exists and the options are to be satisfied by using the shares held by the trust. However, in practice, this does not generally make sense. The credit entry is based on the fair value at grant date and is unlikely to coincide with the difference between the purchase price of the shares by the trust and the option exercise price (if any). Therefore, recognising the credit entry in the employee share reserve would likely result in an employee share reserve balance that is not meaningful because it represents neither the cost of treasury shares held by the trust nor the value of the IFRS 2 expense. In an employee share arrangement, it is, therefore, generally preferable for the credit entry arising from IFRS 2 and the effects of any purchase of own shares through the employee share trust to be considered separately.
9.6 Accounting for share awards settled via an employee share trust

Example 9.6
Accounting for share awards settled via an employee share trust

A trust is created by a sponsoring entity, Company P, which is a listed entity. The trust is designed to facilitate shareholding by employees and is used to distribute shares in Company P to its employees under its share-based payment arrangements.

The trust may be funded in a number of ways and may also obtain shares in Company P in a number of ways. For example, the trust may receive a loan from Company P with which it may either subscribe for new shares in Company P or purchase shares in Company P in the market. Alternatively, the trust may finance subscription for, or purchase of, shares in Company P by raising a third-party loan guaranteed by Company P.

The trust purchases 100 shares in Company P for CU10,000. At the same time, Company P grants 100 shares to 10 of its employees under a share-based payment arrangement; the principal terms of the arrangement are that each employee will be granted 10 shares conditional on completing three years of service. At the end of the three-year vesting period, the employees can elect to either receive the shares or to receive cash equal to the fair value of the shares at that time. When an employee exercises the option to receive cash, the trust may either sell the shares in Company P or it may obtain funding in order to settle Company P’s share-based payment arrangement with the employees on Company P’s behalf.

How should Company P and the trust account for this arrangement in their separate financial statements?

(This example does not consider the accounting for the transaction to finance the purchase of the shares.)

Company P

In Company P’s separate financial statements, the substance is a share-based payment arrangement for employees with a cash alternative (i.e. the entity has granted a compound financial instrument).

IFRS 2 will be applied in the usual way to determine the expense to be recognised in Company P’s profit or loss; the fact that a trust has been established to facilitate settlement of Company P’s commitment does not alter the accounting under IFRS 2.

The fair value of the liability component of the compound instrument should be determined first, and then the equity component should be measured at fair value, taking into account the fact that the employee must forfeit the right to receive cash in order to receive the equity instrument (see IFRS 2:37). In this scenario, the value of the equity component would be nil and, as a consequence, the transaction would be accounted for in the same way as a cash-settled share-based payment up to the date of exercise (see also example 7.2.1).

Depending on the nature of the trust, it may be appropriate for Company P to account for its investment in the trust as a subsidiary or to adopt a ‘look-through’ approach (i.e. accounting for the trust as, in substance, an extension of itself). For further guidance, see the discussion at 5.12 in [iGAAP] chapter A29.

Trust

The shares in Company P are recognised as an asset (as noted above, financing of this acquisition is ignored in this example).

The trust does not recognise a liability in respect of the share-based payment arrangement because it is not the employing entity and does not receive the benefit of the employee services and it does not have the obligation to the employees (i.e. the trust settles the award on Company P’s behalf).

10 Disclosure

10.1 Disclosure requirements — general

Paragraphs 44 to 52 of IFRS 2 set out detailed disclosure requirements for share-based payments. The main requirements are summarised below. Additional information should be disclosed if the detailed information required to be disclosed by the IFRS does not satisfy the principles in IFRS 2:44, 46 and 50 (see 10.2, 10.3 and 10.4). [IFRS 2:52]

When separate financial statements are presented for a parent, these disclosures will be required for both the parent’s separate financial statements and for the consolidated financial statements of the group. Some of the disclosures (e.g. regarding the nature of the schemes and the option pricing models used) will be common to both and need not be repeated. However, some details (e.g. regarding the numerical details of the number of options outstanding) will have to be disclosed separately for the parent as well as for the group.

Paragraph 8 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors states that accounting policies set out in IFRSSs do not need to be applied when the effect is not material. IAS 1:31 states that an entity need not provide a specific disclosure required by an IFRS if the information is not material. Both quantitative and qualitative factors should be assessed to determine materiality of share-based payment transactions. This applies not only to recognition and measurement but also to disclosures in the financial statements.
In addition to the IFRS 2 disclosure requirements, however, there may be local legal or regulatory requirements (e.g. in company law or listing rules). Such local requirements may apply irrespective of materiality, or different materiality considerations may be relevant (e.g. whether the arrangements are material to an individual director).

When no IFRS 2 disclosures are provided on the basis of materiality, but the existence of share-based payment arrangements is disclosed in other parts of the annual report, the potential implications should be considered. Users of the financial statements may interpret the inconsistency as an error. To avoid such a misunderstanding, it may be useful to include an explanation that the IFRS 2 disclosures have been omitted because the amounts involved are not material.

10.2 Nature and extent of share-based payments

An entity should disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period. [IFRS 2:44] To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed:

[IFRS 2:45]

- a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement such as:
  - the vesting requirements;
  - the maximum term of options granted; and
  - the method of settlement (e.g. whether in cash or equity).

An entity with substantially similar types of share-based payment arrangements may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in IFRS 2:44;

- the number and weighted average exercise prices of share options for each of the following groups of options:
  - outstanding at the beginning of the period;
  - granted during the period;
  - forfeited during the period;
  - exercised during the period;
  - expired during the period;
  - outstanding at the end of the period; and
  - exercisable at the end of the period;

- for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the weighted average share price during the period may instead be disclosed; and

- for share options outstanding at the end of the period, the range of exercise prices and weighted average contractual life. If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

As explained at 8.6.1, a parent may grant rights to its equity instruments to the employees of its subsidiaries which are conditional upon the completion of continuing service with the group, rather than a specified subsidiary, for a specified period. In accordance with IFRS 2:B59 and B61, each subsidiary will recognise an expense for the period of service of the employee with that subsidiary and may also need to ‘true up’ for the outcome of any non-market vesting conditions. The question arises as to whether the disclosure requirements described above apply only in relation to the current employees of a subsidiary or extend to former employees who are now employed elsewhere in the group.
When deciding on the appropriate disclosures, regard should be had to the principle in IFRS 2:44 that the information should enable users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period. Therefore, disclosures should, at a minimum, deal with options held by employees of the entity during the financial year. The table of options required by IFRS 2:45(b) should include a line or column to adjust for the numbers for employees transferring in or out of the entity. On this basis, the number of options outstanding at the end of the period will include only current employees; employees who have transferred to another subsidiary will be included in that subsidiary’s disclosures.

A subsidiary may remain exposed to adjustments to the expense recognised for former employees when there are non-market vesting conditions. This may require disclosure, in some cases, if the effect is, or is expected to be, material.

### 10.3 How fair value is determined

An entity should disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined. [IFRS 2:46]

To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed if the entity has measured the fair value of goods and services received indirectly, by reference to the fair value of the equity instruments granted:

[IFRS 2:47]

- for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how the fair value was measured, including:
  - the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
  - how expected volatility was determined, including an explanation of the extent to which it was based on historical volatility; and
  - whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition;
- for other equity instruments granted during the period (i.e. other than share options) the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was determined, including:
  - if the fair value was not measured on the basis of observable market price, how it was determined;
  - whether and how expected dividends were incorporated into the measurement of fair value; and
  - whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value; and
- for share-based payment arrangements that were modified during the period:
  - an explanation of those modifications;
  - the incremental fair value granted as a result of those modifications; and
  - information on how the incremental fair value was measured.

If the entity has measured directly the fair value of goods or services received during the period, disclosure is required of how that fair value was determined (e.g. whether fair value was measured at a market price for those goods or services). [IFRS 2:48]

The presumption in IFRS 2:13 is that, in the case of transactions with parties other than employees, the fair value of the goods or services received can be estimated reliably (see 5.2.2). If that presumption has been rebutted, that fact should be disclosed together with an explanation of why the presumption was rebutted. [IFRS 2:49]
10.4 Effect of share-based payment transactions on profit or loss and financial position

An entity should disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on its profit or loss for the period and on its financial position. [IFRS 2:50] To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed:

[IFRS 2:51]

- the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions; and

- for liabilities arising from share-based payment transactions:
  - the total carrying amount at the end of the period; and
  - the total intrinsic value at the end of the period of liabilities for which the counterparty’s right to cash or other assets had vested by the end of the period (e.g. vested share appreciation rights).

10.5 Illustrative disclosures

Illustrative disclosures for share-based payment transactions are included in the implementation guidance accompanying IFRS 2 (IFRS 2:IG23) and in Deloitte’s IFRS model financial statements, available on www.iasplus.com.

11 Future developments

In April 2014, after debating various issues in earlier meetings, the IASB formally added a new IFRS 2 project, Clarifications of Classification and Measurement of Share-based Payment Transactions, to its agenda.

A number of narrow scope amendments to IFRS 2 are proposed to clarify the classification and measurement of share-based payment transactions. The project will address three issues identified by the IFRS Interpretations Committee:

- accounting for cash-settled share-based payment transactions that include a performance condition;
- modification of share-based payment transactions from cash-settled to equity-settled; and
- share-based payments settled net of tax withholdings.

An exposure draft is expected in the fourth quarter of 2014.