

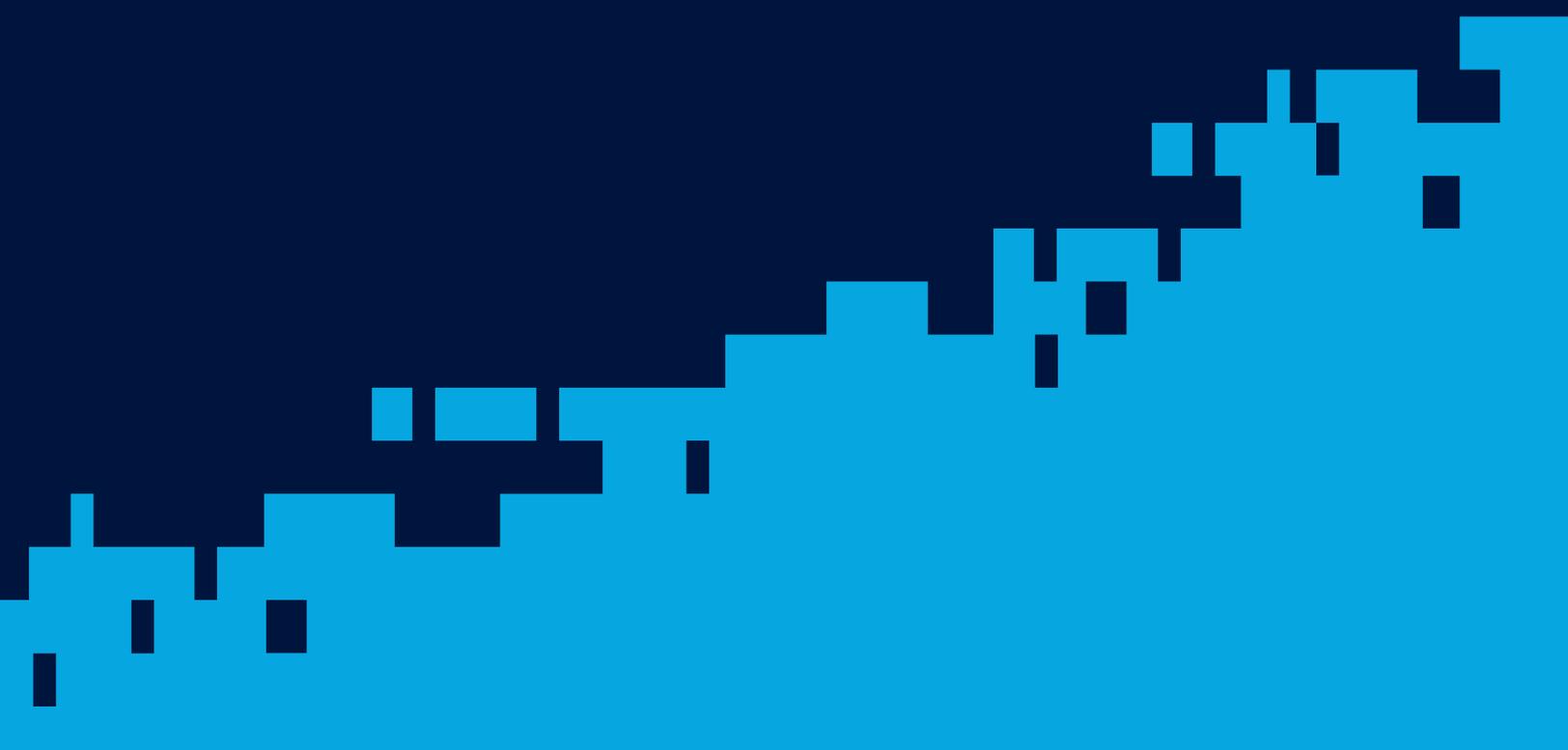
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Accounting for stock compensation

March 2026



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1. Introduction and scope

1.1 Information about this guide

This guide is intended to be a resource in understanding and analyzing the accounting for share-based payments with employees and nonemployees under FASB Accounting Standards Codification (ASC) 718, *Compensation—Stock Compensation*. ASC 718 addresses the accounting for various types of equity-based awards issued as compensation for goods or services. These equity-based awards include stock options, restricted stock, restricted stock units, stock appreciation rights, phantom stock and profits interests, as well as any other awards based at least in part on the value of an entity's equity.

In March 2024, the FASB issued ASU 2024-01, *Compensation—Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*. ASU 2024-01 amends ASC 718 by adding an example with four fact patterns to assist companies in determining whether profits interest and similar awards should be accounted for within the scope of the guidance in ASC 718 or ASC 710, *Compensation—General*. Entities have the option of adopting the guidance in ASU 2024-01 on a prospective or retrospective basis. ASU 2024-01 is effective for public business entities (PBEs) for annual periods and the interim periods therein beginning after December 15, 2024. For all other entities, ASU 2024-01 is effective for annual periods and the interim periods therein beginning after December 15, 2025. Early adoption, including in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance.

In November 2024, the FASB issued ASU 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*. For purposes of ASC 718, ASU 2024-03 updates the definition of an “employee” and adds the term “employee compensation” to the Master Glossary of the ASC. ASU 2024-03 is effective for PBEs for annual reporting periods beginning after December 15, 2026, and interim reporting periods beginning after December 15, 2027. Early adoption is allowed.

In May 2025, the FASB issued ASU 2025-04, *Compensation – Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Clarifications to Share-Based Consideration Payable to a Customer*. ASU 2025-04 clarifies the accounting for share-based consideration payable to a customer in conjunction with selling goods or services, including revising the Master Glossary definition of the term “performance condition” for share-based consideration payable to a customer. The revised definition includes vesting conditions that are based on the volume, monetary amount or timing of a customer's purchases of goods or services from the grantor. The updated definition also includes discussion of performance targets based on volume purchases made by other parties that acquire the grantor's goods or services from the grantor's customers (i.e., the grantor's customers' customers). ASU 2025-04 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual reporting periods. Early adoption is permitted as of the beginning of the annual reporting period for which the financial statements have not yet been issued or made available for issuance.

This guide addresses many of the aspects of accounting for share-based payment transactions. However, this guide does not address the income tax and earnings per share effect of share-based payments, nor does it address the accounting for employee stock ownership plans or employee share purchase plans.

Given the complexity of instruments issued in share-based payment arrangements and the relevant accounting guidance, management may also want to consider seeking external expertise to assist in the accounting analysis. Appropriate upfront consideration of the accounting ramifications can help to minimize the risk of unanticipated and undesirable accounting consequences. Additionally, while valuation is beyond the scope of this guide, management should be mindful of the potential need to seek

external expertise in developing the fair value estimates that may be necessary in appropriately accounting for share-based payments.

For ease of use, definitions for acronyms and titles for ASC topics and subtopics and other literature referred to in this guide are included in [Appendix A](#). In addition, several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition are provided in [Appendix B](#).

1.2 Principles of accounting for share-based payment arrangements

ASC 718-10-10 states that the overall objectives of accounting for share-based payment arrangements is to recognize in the financial statements:

- The goods or services received in exchange for equity instruments granted or liabilities incurred and the related cost to the entity as those goods or services are received (note that ASC 718 uses the terms “compensation” and “payment” in their broadest senses to refer to the consideration paid for goods or services or the consideration paid to a customer)
- The cost resulting from all share-based payment transactions

ASC 718 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 except for equity instruments held by employee stock ownership plans.

1.3 Scope

The guidance in ASC 718 is applicable to all entities entering into share-based payment transactions. This includes both public and nonpublic entities. However, there are certain differences in the accounting and disclosure requirements under ASC 718 for public and nonpublic entities. In particular, there are certain practical expedients available only to nonpublic entities. While these differences are elaborated on throughout the guide, it is important to first understand how a nonpublic entity is defined within ASC 718.



Master Glossary – 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.

1.3.1 Transactions subject to ASC 718

ASC 718 applies to share-based payments (or awards, as the terms are used interchangeably throughout this guide) through which the grantor obtains goods or services to be used or consumed in its own operation or provides consideration to a customer by issuing or offering to issue its shares or other equity instruments or by incurring a liability based, at least in part, on the price of the grantor’s shares or other equity instruments.

**ASC 718-10-15-3 [Prior to adoption of ASU 2024-01]**

The guidance in the Compensation—Stock Compensation Topic applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in the grantor's own operations or provides consideration payable to a customer by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee or a nonemployee 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.

ASU 2024-01 amends the structure of ASC 718-10-15-3 to improve the clarity and make the guidance more operational.

**ASC 718-10-15-3 [Following the adoption of ASU 2024-01]**

The guidance in the Compensation—Stock Compensation Topic applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in the grantor's own operations or provides consideration payable to a customer by either of the following:

- a. Issuing (or offering to issue) its shares, share options, or other equity instruments to an employee or a nonemployee
- b. Incurring liabilities to an employee or a nonemployee 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 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.)
 2. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

The guidance in ASC 718 also applies to awards issued to acquire goods and services from nonemployees (e.g., vendors, independent contractors, other suppliers of goods and services). With certain exceptions, a grantor's classification, measurement and recognition of share-based payment transactions is the same regardless of whether the grantee is an employee or nonemployee. As such, the term grantee is used throughout the guide when the guidance discussed is applicable to both employee and nonemployee awards.

Notwithstanding the general alignment, the two areas where the accounting guidance differs for employee and nonemployee awards are (1) certain inputs to an option pricing model used to value the share-based payment awards and (2) the attribution of cost (i.e., the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). As some differences in accounting continue to exist between employee and nonemployee awards, it is important to properly identify whether a grantee is an employee. Under ASC 718, the determination of whether an individual meets the

definition of an employee is based on the application of common law. See [Section 2.2.5](#) for further discussion on the definition of an employee.

Although a nonemployee director may not meet the common law definition of an employee, provided the director was elected by the employer's shareholders (or appointed to a board position to be filled by shareholder election upon expiration of the term), any awards granted to a nonemployee director in exchange for their service on the board of directors are treated as employee awards under ASC 718. See [Section 2.2.5.2](#) for further discussion.

1.3.2 Awards subject to ASC 718

As discussed in [Section 1.3.1](#), ASC 718 applies to any awards in which an entity issues its own shares or other equity instruments (or incurs a liability based on the price of its shares or equity instruments) in exchange for goods or services. The following are the most common types of awards provided as compensation:

- *Stock option.* An instrument that provides the grantee the right to buy a specified number of shares at a designated price (the exercise price) for a specified period of time.
- *Restricted stock or stock unit (nonvested share).* Stock that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Restricted shares could also be issued and subject to forfeiture. While ASC 718 defines a restricted share as "a share for which sale is contractually or governmentally prohibited for a specified period of time," the term as used in practice generally refers to nonvested shares.
- *Stock appreciation rights (SARs).* An award entitling grantees "to receive cash, stock, or a combination of cash and stock in an amount equivalent to any excess of the fair value of a stated number of shares of the employer's stock over a stated price."
- *Phantom stock.* Hypothetical stock units equivalent in value to shares of stock. The value of the phantom stock could be based on the full value of the underlying stock or the appreciation in the value of the stock over a specified amount. The grantee typically receives cash upon exercise or vesting.
- *Profits interest.* An equity compensation arrangement in a pass-through entity designed based upon the income tax regulations. Profits interest awards are designed such that the recipient is not provided with any immediate liquidation value. Rather, they allow the recipient to share in future profits and increases in value of the entity.
- *Long-term incentive plan.* A type of executive compensation that may involve the payment of cash based, in part, on the value of the grantor's stock.

1.3.3 Scope exceptions

ASC 718-10-15-5 through 15-8 excludes the following awards or transactions from all or portions of ASC 718:

- *Lenders or investors that provide financing.* ASC 718 is not applicable to transactions involving share-based payments to parties providing financing to the issuer, including a lender or an investor.
- *Awards to customers.* The measurement and classification guidance in ASC 718 is applicable to share-based payment awards granted to customers, unless the award is granted in exchange for a distinct good or service. Customer share-based payment awards that are not granted in exchange for a distinct good or service are accounted for as a reduction of the transaction price or consideration under ASC 606-10-32-25. If the customer award is issued in exchange for a distinct good or service from the customer, then the customer award should be accounted for in accordance with ASC 606-

10-32-26 (and also ASC 606-10-55-88AB upon adoption of ASU 2025-04). See our publication, [A guide to revenue recognition](#), for further information.

- *Consideration in a business combination.* ASC 805-30-30-9 through 30-13 provide guidance on determining whether share-based payment awards issued in conjunction with a business combination are consideration transferred in exchange for the acquiree, and within the scope of ASC 805, or are for continued service to be recognized in the post combination period under ASC 718. See our publication, [A guide to accounting for business combinations](#), for further information.
- *Employee stock ownership plans.* ASC 718-10 is not applicable to equity instruments held by an employee stock ownership plan.
- *Awards issued upon formation of a joint venture.* ASC 805-60-25-8 addresses whether a share-based payment award granted as part of the formation of a joint venture should be accounted for under ASC 805-60 or ASC 718.

1.3.4 Share-based payments from related parties and other economic interest holders

Employees or other service providers may receive share-based payments from other shareholders, rather than directly from the reporting entity. Pursuant to ASC 718-10-15-4, share-based payments made by a related party or other economic interest holder for goods or services provided to the reporting entity must be accounted for as share-based payments transactions under ASC 718 by the reporting entity, unless the payments are clearly for a purpose other than compensation for goods or services. The substance of a share-based payment made by an economic interest holder on behalf of the reporting entity is that the economic interest holder has made a capital contribution to the reporting entity, which the reporting entity then uses to compensate the grantee for goods or services. This transaction would be recognized through a debit to compensation cost and a credit to additional paid-in capital.

A related party is defined using the same definition as for related-party disclosures under ASC 850. However, an economic interest in an entity is more broadly defined and includes equity securities, debt arrangements, leases and other contractual arrangements.



Master Glossary – Economic Interest

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.

Examples of situations in which a share-based payment would be considered to be for purposes clearly other than compensation for goods or services rendered to the reporting entity (and therefore outside the scope of ASC 718) include those in which a familial relationship exists or the transfer is to settle an obligation of the economic interest holder unrelated to the reporting entity's operations.

1.3.5 Share-based payments between entities under common control

As explained in [Section 1.3.4](#), share-based payments by an economic interest holder on behalf of an entity result in the entity recognizing compensation cost. This would also be the case if other entities in a consolidated group made share-based payments on behalf of the entity. However, additional consideration needs to be given to the model under U.S. GAAP applicable to these awards. As a reminder, ASC 718 is generally only applicable to transactions in which the entity issues or promises to issue its own shares or incurs a liability based on its own shares for services consumed in its own operations.

Issue 21 and 22 of EITF 00-23 and FIN 44 addressed situations in which an entity grants options on its shares to employees of other companies within the same control group. Although FIN 44 and Issue 00-23 were superseded, we believe much of the guidance is consistent with ASC 718 and can be applied by analogy. Based on the consensus in Issue 00-23, for awards in the consolidated subsidiary's stock to employees (or nonemployees, by analogy) of the parent, given the parent has the ability to direct the actions of the subsidiary, the subsidiary should account for the transaction as a dividend to the parent at fair value with a corresponding credit to equity (or a liability, as applicable). This conclusion assumes that the subsidiary is not receiving any services or consideration in exchange for granting the award. We believe the provisions of ASC 718 would be applicable to the parent, as the parent derives its value in part from the value of the subsidiary.

Similar to the guidance on accounting for awards from economic interest holders, if the parent were to grant share-based awards in its stock to a consolidated subsidiary's employees (or nonemployees) for services the subsidiary is receiving, the subsidiary would record stock compensation for the services it is receiving and a capital contribution from the parent. We believe the provisions of ASC 718 would be applicable to both the parent and the subsidiary, as the parent derives its value in part from the value of the subsidiary.

ASC 718 is not applicable to transactions between two subsidiaries in the consolidated group in the standalone financial statements of those subsidiaries. For example, Subsidiary A and Subsidiary B are subsidiaries in the same consolidated group. If Subsidiary A were to issue stock options, for the purchase of its stock, to Subsidiary B's employees (or nonemployees) as compensation for services received by Subsidiary B, such a transaction would not be accounted for under the provisions of ASC 718. Effectively, the parent has directed Subsidiary A to issue stock options to the parent (a dividend), and the parent then issued the stock option to employees (or nonemployees) on behalf of Subsidiary B (a capital contribution). Subsidiary A would recognize a dividend to the parent and corresponding entry to equity. Subsidiary B would recognize compensation cost and a capital contribution. Subsidiary B should also consider whether guidance in ASC 815 on awards in the stock of other entities would be applicable.

For purposes of consolidated financial statements and the applicability of ASC 718, the stock of any consolidated group member is deemed to be equity of the consolidated group. Based on the conclusions in FIN 44, in the consolidated financial statements, ASC 718 is applicable provided the grantee is providing services that are consumed in the operations of any of the entities in the consolidated group. For example, ASC 718 applies to the accounting in the consolidated financial statements for awards based on parent stock granted to employees or nonemployees of a consolidated subsidiary and to awards in the stock of a consolidated subsidiary granted to employees of the parent. ASC 718 also applies to the accounting in the consolidated financial statements for awards based on a subsidiary's stock granted to the employees of another subsidiary. However, this is only the case for the consolidated financial statements. The following table summarizes the accounting for share-based payments between entities under common control.

Scenario	Accounting
<p>Parent grants share-based payment awards in its shares to subsidiary's employees</p>	<p><i>Financial statements of subsidiary:</i> Account for the awards as stock compensation under ASC 718. The subsidiary would debit compensation cost. If the subsidiary does not provide consideration to the parent for the awards, the offset is a capital contribution from the parent. If the subsidiary does provide consideration to the parent for the awards, the consideration paid is an offset to the capital contribution.</p> <p><i>Consolidated financial statements:</i> Account for the awards as stock compensation under ASC 718.</p>
<p>Subsidiary grants share-based payment awards in its shares to parent's employees</p>	<p><i>Financial statements of subsidiary:</i> Account for the transaction as a dividend to the parent with a corresponding credit to equity (or a liability, as applicable).</p> <p><i>Consolidated financial statements:</i> Account for the award as stock compensation under ASC 718.</p>
<p>Parent grants award based on their stock to employees of subsidiary for services consumed by the subsidiary and the awards can be cash settled by the parent at the employee's election</p>	<p><i>Financial statements of subsidiary:</i> Record stock compensation for the services it is receiving and a capital contribution from the parent. While the subsidiary will record changes in the remeasurement of the awards as compensation cost (as required for liability classified awards), it will not record a liability if it has no contractual obligation to settle the award.</p> <p><i>Consolidated financial statements:</i> Account for the award as liability-classified stock compensation under ASC 718. See Section 4.2.4 for additional guidance on cash settlement features and classification considerations.</p>
<p>Subsidiary A grants awards in its shares to Subsidiary B</p>	<p><i>Financial statements of Subsidiary A:</i> Recognize a dividend to the parent and corresponding entry to equity.</p> <p><i>Financial statements of Subsidiary B:</i> Recognize compensation cost and a capital contribution. Subsidiary B should also consider whether the guidance in ASC 815 on awards in the stock of other entities would be applicable.</p> <p><i>Consolidated financial statements:</i> Account for the award as stock compensation under ASC 718.</p>

1.3.6 Stock compensation arrangements involving employer loans

ASC 718-10-25-3 indicates that the accounting for share-based payments should reflect the rights conveyed and the obligations imposed without regard to how the transaction is structured. For example, the transfer of equity shares for a nonrecourse note (i.e., a note for which the grantor's only recourse is against the stock itself) is essentially the grant of a stock option and should be accounted for as such.



ASC 718-10-25-3

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 for a note that provides no recourse to other assets of the grantee (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.

If an employee is allowed to exercise an option with a note that was not provided for in the terms of the award when the options were granted, the terms (for example, the interest rate) of a note are changed, or the note is forgiven, the change would be considered a modification and should be accounted for as described in [Chapter 6](#).

1.3.6.1 Exercise with a recourse note

An exercise of an option or a purchase of shares with a recourse note generally represents a substantive exercise or purchase of shares. In such situations, consistent with the guidance in ASC 505-10-45-2, reporting the note as an asset is generally not appropriate. Instead, the note should be presented as a deduction from equity. However, an exercise on an unvested option with a recourse note for which shares remain subject to vesting (or a similar purchase of shares that remain subject to vesting) would instead be accounted for in accordance with the early exercise guidance discussed in [Section 3.6](#).

When the note's stated interest rate is equal to a market rate based on the rate environment at the date the award is exercised, the purchase price is equal to the principal of the note. If the note's stated interest rate is less than a market rate, the purchase price is equal to the fair value of the note, which is the fair value of the principal and interest using a discount rate equivalent to a market interest rate. The impact of a below-market rate would be shown as a reduction of the purchase price and an increase in compensation expense. A statutory rate such as the IRS Applicable Federal Rate does not necessarily represent a market rate. Rather, the rate of interest on the note at the date of exercise should consider the credit standing of the grantee and be determined such that the grantee would be indifferent as to whether a loan for the exercise price is obtained from the grantor or from another unrelated lender.

The legal form of a recourse note arrangement should generally be respected (that is, the option should be considered to be exercised in exchange for the recourse note) unless:

- While the employer does have legal recourse to the other assets of the employee, it has no intention of pursuing repayment beyond the shares issued upon exercise of the option.
- In the past, the employee has not pursued repayment of any loan amounts that exceeded the fair value of the related shares.
- The employee does not have adequate assets (other than the related shares) to support the recourse nature of the loan.
- The employer has a history of converting recourse notes to nonrecourse notes.

If any of the preceding fact patterns are present, the recourse note should be considered, in substance, nonrecourse. Accordingly, as described in [Section 1.3.6.2](#), the arrangement is or continues to be a stock option award. The exercise of the option is not substantive and would not be given accounting recognition as such. All other relevant facts and circumstances should be considered when determining the nature of the note. However, the SEC staff has previously indicated that if the note is later forgiven, a determination that the note was recourse would likely be challenged.

Some arrangements may provide for an employee exercise of a stock option award with a nonrecourse note and a recourse note for a portion of the total exercise price. This exercise structure is often tax-motivated and structured in such a way that each of the notes is not based on a percentage of the underlying shares. Instead, each note is based on a percentage of the total exercise price (i.e., not based on a pro-rata portion of the shares). If the notes are not based on a pro-rata portion of the shares, then the entire transaction will be treated as nonrecourse in nature with no substantive exercise of the options.

1.3.6.2 Exercise with a nonrecourse note

Loans made to employees to exercise options or purchase shares are often nonrecourse. This means the only collateral for the loan is the stock purchased and the employer's only recourse is against the stock itself. An employee purchase of an employer's stock with a nonrecourse note generally is accounted for as a stock option. This is because even after the original option is exercised or the shares are purchased, an employee could decide not to repay the loan if the value of the shares declined below the outstanding amount, and instead return the stock in satisfaction of the loan. The result would be the same as if an employee elected not to exercise an option whose exercise price exceeds the current share price.

When shares are exchanged for a nonrecourse note, the nonrecourse principal and, often, interest are considered to be part of the exercise price of the "option." When accounting for a nonrecourse loan, the interest on the note is considered part of the option exercise price if the accrued interest is nonrecourse or any interest paid is refundable if the stock is returned to settle the note. In this case, no interest income is recognized. When the note bears interest, the exercise price increases over time and, accordingly, the option valuation model must incorporate an increasing exercise price. This is done by valuing the options in a manner similar to indexed stock options (see ASC 718-20-55-70 for further guidance).

As the shares sold on a nonrecourse basis are accounted for as options, the issuance of the stock and the receipt of the note are not recorded by the employer. Instead, compensation cost is recognized over the requisite service period (not the term of the note) with an offsetting credit to additional paid-in capital. When an entity permits an employee to exercise options or purchase shares with a nonrecourse note, it is necessary to consider whether employees are required to provide future service to earn the award and keep the shares because this will impact the determination of the requisite service period (i.e., the period over which compensation cost is recognized). For example, if the employee is not required to perform any future service (i.e., the employee can repay the note at any time and keep the award), the entity should recognize the entire fair value of the award as compensation cost on the grant date. The term of the note typically does not impact the determination of the requisite service period over which compensation cost is recognized, but rather reflects the contractual term of the "option" for purposes of developing the expected term assumption to value the award.

Any periodic principal or nonrecourse interest payments by the employee on the note should be accounted for as a deposit. Refundable deposits are recorded as a liability until the note is paid off, at which time the deposit balance is transferred to additional paid-in capital. Nonrefundable deposits are immediately recorded as a credit to additional paid-in capital as payments are received. These shares are not treated as outstanding for the computation of basic earnings per share. Rather, they are included in diluted earnings per share following the treasury stock method, until the note is repaid.

The exercise of an option with a nonrecourse note may be, in substance, the issuance of a new option and would be accounted for as a modification unless the facts and circumstances indicate that such

exercise does not represent a substantive modification of the original grant. For example, the nonrecourse note may be viewed to be, in substance, part of the original option if the terms of the original option provide for or permit the exercise by issuing a nonrecourse note with a specified term and interest rate. See [Section 6.1](#) for guidance on the accounting for modifications of share-based payments.

1.3.6.3 Nonrecourse cash loans secured by employer shares

When an employer provides an employee with a nonrecourse cash loan that is collateralized by the employee's shares in the employer, both an accounting event and an economic event must be reflected in the entity's financial statements.

To regain full rights to the shares, the employee must repay the loan—an action similar to exercising an option. As a result, the employee effectively receives both cash and an option in exchange for giving up the full, unrestricted rights to the shares that were previously owned outright. The option closely resembles that of a stock option as referenced in ASC 718-10-25-3 and provides the employee the choice of repaying the loan in full and thereby retaining ownership of the shares or foregoing repayment and surrendering the shares. This arrangement insulates the employee from downside price risk, because the loss in share value below the loan balance does not affect the employee's other assets. At the same time, the employee retains unlimited upside potential if the value of the shares increases.

In such cases, the transaction should be accounted for as a repurchase by the entity of the shares previously held by the employee, coupled with the grant of a new option award in exchange for the nonrecourse note. In accounting for the substantive repurchase of shares and the issuance of an option, the entity should record compensation cost for any excess of the repurchase amount over the fair value of the shares, consistent with the guidance in ASC 718-20-35-7. The total consideration given to the employee (i.e., the repurchase amount) consists of the cash loan amount plus the fair value of the option represented by the nonrecourse loan. ASC 718 requires that the compensation cost be recognized over the requisite service period, if any, which may differ from the term of the loan. If there is no service period associated with the in-substance option, then the compensation cost would be recognized immediately.

1.3.7 Escrowed share arrangements

In ASC 718-10-S99-2, the SEC staff discusses their position on escrowed share arrangements, particularly, the staff's views on overcoming the presumption that escrowed share arrangements are compensatory for certain shareholders.

Escrowed share arrangements can exist between shareholders and the issuer entity or directly between existing shareholders and new investors, but they typically involve shareholders agreeing to place a portion of their shares in escrow in conjunction with an initial public offering or other capital-raising activity. Shares placed in escrow are released back to the shareholders only if specified performance-related criteria are met. The SEC staff has historically viewed an escrowed share arrangement involving the release of shares to certain shareholders based on performance-related criteria to represent compensation. Typically, such an arrangement has been viewed as equivalent to a reverse stock split followed by the grant of a restricted stock award.

In determining whether the presumption of compensation can be overcome, consideration must be given to the substance of the arrangement; in particular, whether release of the escrowed shares is contingent upon future employment. For example, as part of a financing transaction, investors may require a significant shareholder, who also may be an officer or a director, to participate in an escrowed share arrangement. If the escrowed shares will be released without regard to future employment, the facts and circumstances may support the arrangement being an inducement to facilitate the transaction on behalf of the entity, and not compensation. In these cases, the arrangement would be recognized and measured according to its nature and reflected as a reduction of the proceeds.

The SEC staff has indicated that, consistent with the principle in ASC 805-10-55-25(a), an escrowed share arrangement in which the shares are forfeited if employment terminates represents compensation.

The SEC staff also observed the benefit created by the shareholder's escrow arrangement should be reflected in the reporting entity's financial statements (i.e., the party receiving the benefit of the future employee service) even if the reporting entity is not a party to the arrangement. This view is consistent with the accounting for share-based payments made by related parties and other economic interest holders under ASC 718 as described in [Section 1.3.4](#).

2. Measurement of awards

2.1 Measurement basis

2.1.1 Measurement objective

When measuring share-based payments, the objective under ASC 718-10-30-6 is to estimate the fair value at the measurement date of the instrument that the entity is obligated to issue when the grantee has provided the required service and any other conditions necessary to earn the instrument have been satisfied. The fair value of the award is calculated based on the share price, as well as other relevant factors, such as expected volatility.

If practicable, ASC 718 requires all entities to use the fair-value-based method (see [Chapter 5](#)) to account for share-based payment arrangements that are classified as equity instruments. While there may be some cases in which it is not practicable for a nonpublic entity to reasonably estimate the fair value of its equity share options because of the challenges involved in estimating the volatility of their share prices, nonpublic entities should first consider whether they may have sufficient information available on which to base a reasonable and supportable estimate of the expected volatility of their share prices, before assuming estimation is impracticable. 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. For purposes of identifying otherwise similar entities, an entity would likely consider characteristics such as industry, stage of life cycle, size and financial leverage. An industry sector index (e.g., NASDAQ Computer Index) that is representative of the entity's industry, and possibly its size, may be useful in identifying otherwise similar entities. The public companies that make up that index may be a good starting point for identifying otherwise similar companies upon which to base the entity's volatility.

The measurement date is the date when the measurement of the share's cost is determined and differs based on the classification of the award. For equity-classified instruments, the measurement date is generally the grant date, as defined in [Section 2.2](#), unless the service inception date precedes the grant date (see [Section 3.3.1](#)). For liability-classified awards, on the other hand, the measurement date is the settlement date, meaning that liabilities incurred under share-based payment arrangements are remeasured at the end of each reporting period until settlement. The remainder of this section addresses measurement of equity awards. Refer to [Chapter 4](#) for additional information on liability awards.

2.1.2 Calculated value exception for nonpublic entities

In some cases, a nonpublic entity may lack the necessary information to estimate the expected volatility of its share price and be unable to find one or more similar public companies upon which to base its expected volatility. If it is not practicable for a nonpublic entity to estimate the expected volatility of its share price, ASC 718-10-30-19A through 30-20 allow such entities to use a calculated value, based on the historical volatility of an appropriate industry sector index, instead of the expected volatility of the entity's share price. However, it may be difficult for an entity to support an assertion that it is unable to identify peer group public companies in order to estimate its expected volatility, and use of calculated value should be limited. A nonpublic entity could only assert it is not practicable to estimate the expected volatility of its share price if it is unable to obtain sufficient historical information about past volatility, or other information, from similar public entities, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award without undue cost and effort.

If the use of calculated value is appropriate, there are many different indices available to consider in selecting an appropriate industry sector index. 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 indices 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 should select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances should a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000 or Dow Jones Wilshire 5000 because those indices are sufficiently diversified and not representative of the industry sector, or sectors, in which the nonpublic entity operates.

A nonpublic entity should use the selected index consistently in applying the calculated value method for all of its equity share options or similar instruments and in each accounting period, unless the nature of the entity's operations changes such that another industry sector index is more appropriate.

The calculation of the historical volatility of an appropriate industry sector index should 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 historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity should use the closing values for the longest period of time available. The method used should be consistently applied.

2.1.3 Use of intrinsic value when fair value is not reasonably estimable

In most cases, entities will be able to reasonably estimate the fair value (or calculated value for nonpublic entities) of most equity share options and other equity instruments at the date they are granted. However, in rare circumstances, the complexity of an award's terms may make it impossible to reasonably estimate the fair value or calculated value of an equity instrument at the grant date. In such cases, in accordance with ASC 718-10-30-22, the intrinsic value method should be used to estimate the value of the award. When an entity uses the intrinsic value, the award must be remeasured at each reporting date through the date of exercise or other settlement. As a result, the final measure of compensation cost will be the intrinsic value of the instrument at the date it is settled.

ASC 718-20-35-1 provides that compensation cost for each period until settlement should "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." See [Section 3.1](#) for guidance on determining the requisite service period.

It is also important to note that once the intrinsic method is deemed to be appropriate for an award, it must continue to be used to measure the value of those instruments, even if the entity subsequently concludes that it is possible to reasonably estimate the fair value of the award.

2.2 Grant date



Master Glossary – Grant Date

The date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers goods or renders services or purchases goods or services as a customer. 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 a grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the grantor's equity shares.

To properly apply the measurement and recognition provisions of ASC 718, the grant date must be established. Typically, recognition of an award would not occur prior to the establishment of a grant date. However, if certain criteria are met, the service inception date could precede the grant date and recognition would begin prior to the establishment of a grant date (see [Section 3.3.1](#)). Under ASC 718 there are five conditions that must be met to establish a grant date, each of which is examined in more detail within this section:

1. The grantor and grantee must have reached a mutual understanding of the key terms and conditions of a share-based payment award.
2. All necessary approvals have been obtained.
3. The grantor must be contingently obligated to issue equity instruments or transfer assets to a grantee who delivers the goods or renders the service.
4. The grantee begins to “benefit from,” or to be “adversely affected by,” subsequent changes in the price of the grantor's equity shares.
5. For an award to an employee, the recipient of that award must meet the definition of an employee in order for a grant date to be established.

2.2.1 Mutual understanding of key terms and conditions

For a grant date to exist, the grantor and grantee must have reached a mutual understanding of the key terms and conditions of a share-based payment award.

In some cases, both the grantor and the grantee are in a position to negotiate the terms and conditions. For example, a senior executive may engage in a series of negotiations to arrive at an agreement with the employer regarding the terms of the award. ASC 718-10-55-81 states that a mutual understanding of the key terms and conditions may be established through formal or informal agreements as well as the entity's past practices. However, in most cases, grantors document the understanding through a formal written agreement. Therefore, for a grant date to be established, a formal document that specifies, at a minimum, the exercise price, number of shares and vesting conditions is generally necessary to satisfy this condition. For an award that has a performance condition (e.g., annual EBITDA target), a grant date will generally not be established until the performance condition has been defined (e.g., the annual EBITDA target for the applicable year has been established) and a mutual understanding of the terms has been reached. A mutual understanding, and thus a grant date, may be established when the targets are defined and communicated. For example, a company grants a stock option that vests 20% per year over the next five years if budgeted annual EBITDA targets for that year are met. If the annual EBITDA target is initially only defined for the first separately vesting tranche, a grant date can only be established for the first tranche. For the remaining separately vesting tranches, a grant date will not be established until the EBITDA target for the related annual period is defined and communicated. See [Example 3-10](#), “Case B: Performance Targets Are Established at Some Time in the Future,” for further guidance.

In other cases, a grantee may not be in a position to influence the terms and conditions of the award. As a result, ASC 718-10-25-5 provides an exception to the usual concept of a mutual understanding and allows for a mutual understanding to be presumed to exist, even if the grantee has not agreed to the terms, if the award is approved in accordance with the relevant corporate governance requirements and both of the following conditions are met:

- The award is a unilateral grant and, as such, the grantee does not have the ability to negotiate the key terms and conditions of the award with the grantor.

- The key terms and conditions of the award are expected to be communicated to the grantee within a relatively short time period from the date of approval.

Determining the period of time that qualifies as “relatively short” is a matter of judgment. ASC 718 states that “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. Considering this definition, the exact period may differ based on the manner in which the entity communicates the terms of the awards to its employees. For example, if each employee’s supervisor is required to inform the individual of the award and its terms, it may be a matter of weeks to disseminate the information to the supervisors and schedule all the necessary meetings. If, on the other hand, the information is posted to an employee portal or sent out in an email, the appropriate period may be a matter of days.

2.2.2 All necessary approvals are obtained

One of the conditions to establish a grant date is that all necessary approvals have been obtained. The approval levels are generally specified in the plan document, and may include all shareholders, or a board or a committee. The level of approval necessary may also differ depending on the level of the employee receiving the award.

While ASC 718 does require that all approvals must be obtained, there is an exception available for situations in which the approval is a formality or may be considered perfunctory. However, it is important to note that a past history of shareholder approval is not sufficient for it to be considered a formality or perfunctory. For the approval of an award to be considered a formality (or perfunctory), the outcome must be controlled. For example, if the plan document requires the approval by a majority vote of shareholders, but the board controls enough shares to pass the award and will continue to control those shares until the date the full body of shareholders votes on the award, the approval by the shareholders may be considered perfunctory and a grant date may be established when the board approves the award.

In some limited cases, a board or compensation committee may be able to delegate the authority to approve awards, such that their approval may be considered perfunctory. For example, the board could authorize management to allocate awards as long as they do not exceed an approved pool. In this case, the board or compensation committee would need to set the terms of the grant and the number of awards to be granted, and would agree to formally approve management’s allocation at their next meeting. The approval of the allocation by the committee would be a formality; therefore, the grant date would be the date management allocates the award. Similarly, the board or committee could delegate the authority to issue standard term awards to new hires and newly promoted entities within specified ranges, which could result in the ratification of the awards by the committee being considered a formality.

2.2.3 Grantor becomes contingently obligated

For a grant date to exist, the grantor must be contingently obligated to issue equity instruments or transfer assets to a grantee who delivers the goods or renders the service. This condition is typically met by the time the mutual understanding of the terms and conditions has been established and the necessary approvals are obtained.

2.2.4 The grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the grantor’s equity shares

A grant date for a share-based award is not established until the grantee begins to “benefit from,” or be “adversely affected by,” subsequent changes in the price of the grantor’s equity shares. For example, an option where the exercise price is based on the entity’s share price at a future date would not have a grant date until the future date when the share is priced because the grantee does not begin to benefit from or be adversely affected by changes in the share price until that date. It is important to note that the FASB used the word “or” rather than “and” for this condition. Some options, called “look-back” share

options, state, for example, that the award's exercise price will be the lower of the share price either on the grant date of the award or on the employee's one-year anniversary date. Because of the terms of these options, the grantee knows that the exercise price will not be any higher than the price on the grant date. Any change to the exercise price would only cause it to be lower. As a result, the grantee begins to benefit from any increases in the share price from the date of the initial award. This is sufficient to meet the condition for a grant date even though the grantee would not be adversely affected by subsequent changes in the price of the grantor's shares.

2.2.5 Definition of an employee for employee awards

For an award to an employee, the recipient of that award must meet the definition of an employee in order for a grant date to be established. For example, an award granted to an individual that is about to be hired cannot have a grant date prior to the date the individual becomes an employee of the entity. Because of this requirement, if an award with a service condition is issued to an individual providing services to the entity prior to becoming an employee (for example, as a consultant), the award may have to be split into two awards: a nonemployee award for the period service was provided as a consultant, and an employee award for the service period after becoming an employee. As noted in [Section 1.3.1](#), with the issuance of ASU 2018-07, the accounting for employee and nonemployee awards is generally aligned. The remaining differences in accounting for employee and nonemployee awards generally relate to (1) how certain inputs into an option pricing model are determined (see [Section 5.2.3.3](#)) and (2) how the compensation cost is recognized (attribution method – see [Section 3.1.2](#)).



Master Glossary – Employee in Part

[Prior to the adoption of ASU 2024-03]

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...

[Following the adoption of ASU 2024-03]

An individual over whom a reporting entity 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...

When assessing whether an individual is an employee, the FASB requires that the individual be considered an employee under “common law.” The IRS definition of an employee for payroll tax purposes includes common law employees. As a result, generally, if an individual is not classified as an employee for U.S. payroll tax purposes, they cannot be classified as an employee under ASC 718 (unless the grantee is a leased employee as described below). However, if an individual is providing services to a pass-through entity (partnership, limited liability partnership, limited liability company) and qualifies as an employee of that entity under common law, they can be considered an employee for purposes of applying ASC 718, even if the pass-through entity does not classify the individual as an employee for U.S. payroll tax purposes. The fact that an individual is classified as an employee for U.S. payroll tax purposes is an indicator that the individual may be an employee but is not determinative because the grantee also must be an employee of the grantor under common law. IRS Revenue Ruling 87-41 provides 20 factors, designed as guidelines, which may be helpful for determining whether an employer-employee relationship passes the common-law test in the U.S. The 20 factors identified by the IRS are as follows:

Factor	Description
Instructions	If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
Training	Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner (which indicates employee status).
Integration	Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
Services rendered personally	If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
Hiring, supervision, and paying assistants	If the person for whom services are performed hires, supervises or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
Continuing relationship	A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
Set hours of work	The establishment of set hours for the worker indicates employee status.
Full time required	If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.
Doing work on employer's premises	If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.
Order or sequence test	If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
Oral or written reports	A requirement that the worker submit regular reports indicates employee status.
Payment by the hour, week, or month	Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
Payment of business and/or traveling expenses	If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.

Factor	Description
Furnishing tools and materials	The provision of significant tools and materials to the worker indicates employee status.
Significant investment	Investment in facilities used by the worker indicates independent contractor status.
Realization of profit or loss	A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
Working for more than one firm at a time	If a worker performs more than de minimis services for multiple firms at the same time, that generally indicates independent contractor status.
Making service available to the general public	If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.
Right to discharge	The right to discharge a worker is a factor indicating that the worker is an employee.
Right to terminate	If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.

2.2.5.1 Leased employees

In some cases, an individual may qualify as a common law employee for more than one entity, either because the individual works part time for both entities or is leased from one entity to another entity. In situations in which an individual is a common law employee for more than one entity for providing the same service (i.e., a leased employee), the FASB believes that, in substance, only one of the two companies is the employer, and therefore only one of the companies can qualify as the employer for the purposes of applying ASC 718. In most cases, the lessor is the employer of record for tax purposes, but the lessee is more likely to grant options to the employee. To address this, ASC 718-10-20 stipulates the following conditions that must all be met for a leased individual to be considered an employee of the lessee:



ASC 718-10-20

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. [Following the adoption of ASU 2024-03, The lessee

has the exclusive right to grant 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.

2.2.5.2 Nonemployee directors

Some companies grant share-based payment awards to their board members. For purposes of applying ASC 718, board members are treated as employees (pursuant to the limited exception with the employee definition) if they fulfill both of the following:

- They receive the award for their services provided in their role as a member of a board of directors.
- They are elected by the employer's shareholders, or are appointed to a board position that will be filled by shareholder election when their term expires.

The exception cannot be applied by analogy and cannot be applied to awards granted to individuals for services outside of their role as a director (e.g., as a consultant or advisor). It is also important to note that the title of "director" does not automatically qualify the individual for this exception. The directors must be subject to shareholder election. Additionally, if a consolidated group has multiple boards, nonemployee directors of subsidiary entities with their own boards are only considered eligible for this exception if they are elected by shareholders that are not controlled by the parent or another member of the consolidated group. In other words, the controlling shareholder would need to be precluded from voting for the directors of the subsidiary in order for any awards granted to such individuals to be accounted for as employee awards by the parent.

2.3 Effect of market, performance and service conditions on measurement of compensation cost

The terms of an award often include conditions that must be met in order for compensation to be earned. 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. The potential impact of each of these types of conditions on the measurement of the award cost (i.e., the calculation of grant-date fair value) is discussed in this section. The impact these terms have on the recognition of the award (i.e., when compensation cost is recognized) is discussed in [Section 3.1](#).

2.3.1 Market conditions

A market condition is “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” one of the following:

- *A specified price of the issuer’s shares.* For example, an award that vests when the issuing entity’s stock price reaches \$100 per share.
- *A specified amount of intrinsic value indexed solely to the issuer’s share.* For example, an award that vests when the issuer’s stock yields a 20% return on the original investment of its shareholders.
- *A specified price of the issuer’s shares in terms of a similar (or index of similar) equity security (securities).* For example, an award that vests when the entity achieves a return on its stock that is equal to or above the average three-year return of the upper quartile of the Russel 2000.

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.”

A common market condition in awards issued by nonpublic or pass-through entities is a vesting condition that specifies a certain rate of return to a majority shareholder for their investment. For example, an award vests if the investor’s multiple of invested capital (MOIC) exceeds a factor of 3.0, or an award vests if the investor’s internal rate of return (IRR) on their initial investment equals or exceeds 20%. In certain cases, the achievement of such a market condition, when based on distributions or returns received by investors within a limited time period, is unlikely or impossible to be met without a change in control or other liquidity event occurring (see [Section 3.2.2](#) for factors to consider in determining whether there is an implied performance condition).



RSM COMMENTARY: Within the award agreement, the vesting or exercisability conditions associated with a specified shareholder/investor return (e.g., MOIC or IRR target) are often labeled performance conditions. However, as noted above, they are generally considered to be market conditions for accounting purposes, and must be accounted for as such, regardless of how they are described or labeled within the grant agreement itself.

Market conditions should be reflected in the grant-date fair value. There are different techniques that may be used to estimate their impact, including path-dependent options such as the Lattice Model and the Monte Carlo Simulation (see [Section 5.2](#) for a discussion of valuation techniques). A closed-form valuation model such as the Black-Scholes-Merton may not be appropriate to value an award with a market condition ([Section 5.2.2](#)).

2.3.2 Performance conditions



Master Glossary – Performance Condition

[Prior to the adoption of ASU 2024-04]

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both of the following:

- a. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time
- b. Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s performance related to the grantor’s own operations (or activities).

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

Following the adoption of ASU 2025-04, the ASC Master Glossary defines a performance condition as follows:

1. For share-based payments in which a grantor acquires goods or services to be used or consumed in the grantor's own operations, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both of the following:
 - a. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time
 - b. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's performance related to the grantor's own operations (or activities).

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

2. For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
 - a. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's (the customer's) performance related to the grantor's own operations (or activities)
 - b. The grantee's purchase (or potential purchase) of the grantor's goods or services from either the grantor or the grantor's customers
 - c. A purchase (or potential purchase) of the grantor's goods or services from either the grantee or the grantee's customers.

The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer.

In addition to the examples of performance conditions included in the definition above, some entities are including environmental, social and governance (or ESG) targets in their award performance conditions.

Performance conditions that only 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 grantees have not yet earned the right. Compensation cost, for awards with a performance condition that affects vesting or the exercisability of options, is only recognized if it is “probable” that the performance condition will be satisfied. The term “probable” is generally interpreted in practice to represent a greater than 70% likelihood that an event will occur. [Section 3.2](#) discusses how the probability of meeting a performance condition impacts the recognition of compensation cost.

Performance conditions that affect an award’s exercise price, contractual term, quantity, conversion ratio or other factors can impact the measurement of an award’s grant-date fair value. Pursuant to ASC 718-10-30-15, a grant-date fair value should be estimated for each possible outcome of such a performance condition, and the final measure of compensation cost should be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied. The following two examples illustrate the impact of performance conditions on grant-date fair value:



Example 2-1: Accounting for performance conditions that affect an award’s quantity

On January 1, 20X5, Entity B grants to 500 employees an award of up to 300 stock options on its common stock. The estimated fair value is \$15.60 per share option at the grant date. The quantity of options awarded is based upon the entity’s increase in market share by December 31, 20X7, as follows:

- If market share increases by at least 5%, each employee vests in 100 share options.
- If market share increases by at least 10%, another 100 share options vest, for a total of 200.
- If market share increases by more than 20%, each employee vests in all 300 share options.

If employees do not remain employed as of December 31, 20X7, they forfeit their shares. Entity B’s accounting policy is to account for forfeitures as they occur (see [Section 3.4](#) for further guidance on accounting for forfeitures).

In accordance with ASC 718-10-30-15, Entity B estimates the following grant-date fair value of the award for each possible outcome of the performance condition:

- 100 shares x \$15.60 x 500 employees = \$780,000
- 200 shares x \$15.60 x 500 employees = \$1,560,000
- 300 shares x \$15.60 x 500 employees = \$2,340,000

As of January 1, 20X5, Entity B estimates it is probable the market share will increase by at least 5%, but it is not probable that it will increase by 10% or more. Therefore, Entity B measures total compensation cost at \$780,000. Entity B will continue to reassess the probability of meeting the different performance conditions throughout the service period and adjust compensation cost for any changes in that assessment. The final measurement of compensation cost will be based on the grant-date fair value for the condition or outcome that is actually satisfied. Refer to [Example 3-2](#) to walk through the timing of recognition of compensation expense.



Example 2-2: Accounting for performance conditions that affect an award's exercise price

The following example shows the computation of compensation cost if Entity B grants a stock option award with a performance condition under which the exercise price varies depending on the level of performance achieved.

On January 1, 20X5, Entity B grants to its chief executive officer stock options on 1,000 shares of its common stock which vest on December 31, 20X6, provided that the chief executive officer continues to be employed by Entity B (a two-year service period). The share price at the grant date is \$35, and the initial exercise price is also \$35. However, that price decreases to \$25 if the market share for Entity B's products increases by at least 10% by December 31, 20X6.

ASC 718-10-30-15 requires that Entity B estimate the grant-date fair value of the award for each possible outcome of the performance condition.

If market share growth is at least 10% over the two-year period, Entity B estimates a grant-date fair value of \$18 per option, based on the lower \$25 exercise price. Total compensation cost to be recognized if the performance condition is met would be \$18,000 (1,000 × \$18).

If market share growth is not at least 10% over the two-year period, Entity B estimates a fair value of \$12 per option, based on the \$35 exercise price. Total compensation cost to be recognized if the performance goal is not met would be \$12,000 (1,000 × \$12).

At the grant date, Entity B estimates it is probable that its market share growth will be at least 10% over the two-year performance period and measures compensation cost at \$18,000.

During the two-year requisite service period, Entity B will continue to reassess the probability of meeting the performance condition throughout the service period and adjust compensation cost for any changes in that assessment. The final measurement of compensation cost will be based on the grant-date fair value for the condition or outcome that is actually satisfied.

2.3.2.1 Impact of ASU 2025-04 on the definition of performance condition

ASU 2025-04 revises the ASC Master Glossary definition of the term "performance condition" for share-based consideration payable to a customer. The revised definition includes vesting conditions that are based on the volume, monetary amount or timing of a customer's purchases of goods or services from the grantor. The updated definition also includes discussion of performance targets based on volume purchases made by other parties that acquire the grantor's goods or services from the grantor's customers (i.e., the grantor's customers' customers).

Although the revised definition is expected to result in significantly fewer customer awards with service conditions, for those customer awards that are deemed to have service conditions, ASU 2025-04 eliminates the policy election permitting a grantor to account for forfeitures as they occur. As a result, the grantor is required to estimate the number of forfeitures expected to occur when measuring the share-based consideration payable to a customer. However, the current policy election for share-based payment awards with service conditions granted to employees and nonemployees in exchange for goods or services to be used or consumed in the grantor's own operations is still available.

ASU 2025-04 clarifies that the guidance in ASC 606 on constraining estimates of variable consideration does not apply to share-based consideration payable to a customer. As such, the guidance in ASC 718 is the only guidance applied to determine the probability that the award will vest.

2.3.2.2 Performance conditions that can be satisfied after service is provided

Some awards include performance targets that can be satisfied after an employee completes the requisite service period or a nonemployee completes the vesting period. For example, an award granted to an employee could require both five years of service and regulatory approval of a specific new pharmaceutical drug in order to vest. The regulatory approval can occur any time prior to expiration of the award even if the employee is no longer providing service to the entity.

In accordance with ASC 718-10-30-27, performance conditions that only affect vesting are not reflected in estimating the fair value of an award at the grant date. Therefore, the performance target is not reflected in estimating the fair value of the award at the grant date. Instead, compensation cost will only be recognized in the period in which it becomes probable that the performance target will be achieved. See [Section 3.2.1](#) for further guidance on recognition of an award with a performance condition that can be satisfied after service is provided.

2.3.2.3 Performance conditions based on a change in control

Many awards include a condition for vesting that is contingent upon a sale of the entity or other change in control event. This is a type of performance condition that only affects vesting and is therefore not reflected in estimating the fair value of an award at the grant date. However, such conditions do impact the amount of compensation cost recognized and the timing of recognition, given that compensation cost is only recognized when or if the event becomes probable. See [Section 3.2.2](#) for further guidance on recognition of an award with a performance condition based on a change in control event.



Example 2-3: Identification of vesting conditions

Company ABC is a limited liability company that adopted a new stock-based compensation plan during 20X5. Under the plan, Company ABC issued 2,000 profits interest units to its employees in June of 20X5. The profits interest units vest upon a change of control event as defined in the plan and if the principal investor's multiple of investment capital exceeds a factor of 2.5. In analyzing the accounting for the profits interest units, Company ABC identifies that the awards include a performance condition (change of control event) and a market condition (multiple of investment capital exceeded a factor of 2.5). The performance condition impacts vesting, but is not reflected in the fair value of the award ([Section 2.3.2.3](#)) while the market condition does not impact vesting but should be reflected in the fair value of the award ([Section 2.3.1](#)). See [Section 3.2.2](#) for further guidance on recognition of an award with a performance condition based on a change in control event.

2.3.3 Service conditions

A service condition is a condition “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 also considered a service condition. Like performance conditions, service conditions that affect vesting are not considered 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, service conditions that affect an award’s exercise price, contractual term, conversion ratio or other factors are considered in measuring an award’s grant-date fair value. For example, a service condition can indirectly impact the fair value of a stock option valued using the Black Scholes model. One of the inputs into the model is the “expected term,” which refers to the employee’s requisite service period and the time expected to elapse between vesting and exercise of the award.

2.4 Reload and clawback features

Awards of options sometimes include a provision that automatically grants additional options whenever an employee exercises previously granted options using the entity's shares, instead of cash, to satisfy the exercise price. This is known as a reload feature and should not be included in estimating the grant-date fair value of the award. Instead, any options subsequently granted as a result of such a provision should be accounted for as a separate award when the reload options are granted.

Some awards include contingent features that could cause a grantee to return either vested equity instruments or gains realized from the sale of vested equity instruments for no consideration or for consideration that is less than fair value on the date of transfer. An example of this would be a clawback feature that requires an employee to return vested awards if they go to work for a competitor. Such contingent events are not reflected in estimating the grant-date fair value of an equity instrument. Rather, the effect of such a contingent feature is accounted for if and when the contingent event occurs.

Public business entities should also consider the SEC's final rule, file number S7-12-15, [Listing Standards for Recovery of Erroneously Awarded Compensation](#), which requires the disclosure of an entity's policy on the recovery of compensation that was issued based on financial information that has subsequently been restated.

2.5 Dividend protected awards

Option-pricing models used to estimate the fair value of a share option generally take expected dividends into account. If option holders are not entitled to receive dividends, the expected dividends the option holders forego would be reflected in the model and thereby reduce the fair value of an option. However, options can be structured to protect the option holder by providing some form of a dividend right. In such cases, the effect of the dividend protection feature should be factored into the option's fair value estimate. For example, if an option is structured to protect option holders from dividend payments by reducing the option's exercise price to reflect dividend payouts to shareholders, the expected dividend assumption input to the option-pricing model used in estimating the option's fair value should be zero.

Another method used to protect option holders from the effect of dividends paid to shareholders is to allow grantees of options to be paid dividends or dividend equivalents on the underlying equity shares while the options are outstanding. The treatment of dividends or dividend equivalents paid to option holders depends on whether the awards are expected to vest.

If the awards are expected to vest, the dividends and dividend equivalents paid should be charged to retained earnings, in the same manner as dividends paid to shareholders. If the awards are not expected to vest, and the grantees are not required to return the dividends or dividend equivalents received if they forfeit their awards, the dividends and dividend equivalents paid should be recognized as compensation expense. Amounts not expected to vest should be estimated using the entity's estimated forfeiture rate on the related award and accounted for consistent with an entity's estimates of forfeitures. In other words, if an entity's accounting policy is to estimate the number of awards expected to be forfeited, the estimate of compensation cost should reflect its forfeiture estimate. Any changes to forfeiture estimates result in dividends and dividend equivalents being reclassified between retained earnings and compensation cost in a subsequent period. If an entity's accounting policy is to account for forfeitures when they occur, the entity should reclassify the amount of dividends and dividend equivalents previously charged to retained earnings to compensation cost in the period in which the forfeitures occur. See [Section 3.4](#) for further guidance on the accounting for forfeitures.

3. Recognition of compensation cost

The overarching recognition principle for share-based payment transactions is that an entity must recognize the goods acquired or services received in a share-based payment transaction as it obtains the goods or as services are received.



ASC 718-10-10-1

The objective of accounting for transactions under share-based payment arrangements is to recognize in the financial statements the goods or services received in exchange for equity instruments granted or liabilities incurred and the related cost to the entity as those goods or services are received.

ASC 718-10-35-2

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.

3.1 Employee requisite service period and nonemployee vesting period

3.1.1 Employee requisite service period

The requisite service period is the period during which an employee is required to provide service in exchange for the award, which often is the vesting period. The compensation cost for an award of share-based payments to employees should be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital or common stock for no par stock).

3.1.1.1 Estimating employee requisite service period

The requisite service period should be estimated at the grant date (or at the service inception date, if that date precedes the grant date as discussed in [Section 3.3.1](#)) and is based on an analysis of the terms of the share-based payment award. According to ASC 718-10-30-26, the initial best estimate of the requisite service period (and any subsequent adjustment to that estimate) for an award with a combination of market, performance or service conditions should 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

In other words, any performance or service condition that affects vesting and exercisability should be considered when estimating the employee's requisite service period. Performance and service conditions that affect factors other than vesting and exercisability, on the other hand, would be considered in estimating the fair value of the award (see [Section 2.3](#)).

3.1.1.2 Explicit, implicit and derived employee requisite service periods

The employee requisite service period may be explicit, or it may be implicit (i.e., inferred from an analysis of other terms in the share-based payment award, including other explicit service or performance conditions). The employee requisite service may also be derived.

If the service period is stated in the terms of a share-based payment award, it is considered an explicit service period. Explicit service periods are typical in awards that include a service condition requiring the

employee to work for a specified period of time in order to earn the award. For example, an award stating that it vests after five years of continuous employee service from a given date (usually the grant date) has an explicit service period of five years.

While an explicit service period is generally considered the most straightforward, there may be situations when, despite being stated in the contract, the explicit service period is not considered substantive. In such cases, the service period must be estimated, as illustrated in the following example.



Example 3-1: Impact of performance conditions that affect an award's quantity on recognition of compensation cost over an explicit service period

The following example is *Example 1—Estimating the Requisite Service Period*, from ASC 718-10-55-87 through 55-88:

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.

Because the employee is eligible to retire at the grant date, the award's explicit service condition is nonsubstantive. Consequently, Entity A has granted an award that does not contain a service condition for vesting, that is, the award is effectively vested, and thus, the award's entire fair value should be recognized as compensation cost on the grant date. 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.

There are also cases in which an award may contain an explicit service condition, but the interaction of the service condition with other performance conditions may impact the amount of compensation cost recognized, causing significant variations year over year. Consider the following example.



Example 3-2: Impact of performance conditions that affect an award's quantity on recognition of compensation cost over an explicit service period

The following example is a continuation of [Example 2-1](#) from [Section 2.3.2](#):

On January 1, 20X5, Entity B grants an award of up to 300 stock options on its common stock to 500 employees. The estimated fair value is \$15.60 per share option at the grant date. The quantity of options awarded is based upon the entity's increase in market share by December 31, 20X7, as follows:

- If market share increases by at least 5%, each employee vests in 100 share options.
- If market share increases by at least 10%, another 100 share options vest, for a total of 200.
- If market share increases by more than 20%, each employee vests in all 300 share options.

If employees do not remain employed as of December 31, 20X7, they forfeit their shares. Entity B's accounting policy is to account for forfeitures as they occur (see [Section 3.4](#) for further guidance on accounting for forfeitures).

In accordance with ASC 718-10-30-15, Entity B estimates the following grant-date fair value of the award for each possible outcome of the performance condition:

- 100 shares x \$15.60 x 500 employees = \$780,000

- 200 shares x \$15.60 x 500 employees = \$1,560,000
- 300 shares x \$15.60 x 500 employees = \$2,340,000

As of January 1, 20X5, Entity B estimates it is probable the market share will increase by at least 5%, but it is not probable that it will increase by 10% or more. Therefore, Entity B measures total compensation cost at \$780,000. Entity B will continue to reassess the probability of meeting the different performance conditions throughout the service period and adjust compensation cost for any changes in that assessment. The final measurement of compensation cost will be based on the grant-date fair value for the condition or outcome that is actually satisfied.

As the employees must remain employed through December 31, 20X7, the grant contains a three-year explicit service period, which represents the requisite service period. Entity B therefore 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.

The amount of compensation cost recognized when achievement of a performance condition is probable depends on the relative satisfaction of the performance condition based on performance to date. The following table shows the compensation cost that would be recognized in 20X5, 20X6 and 20X7 if Entity B estimates at the grant date that it is probable that market share will increase at least 5% but less than 10% (that is, each employee would receive 100 share options). That estimate remains unchanged until the end of 20X7, when Entity B's market share has increased over the three-year period by more than 10%. Thus, each employee vests in 200 share options.

Year	Total Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X5	\$780,000 (\$15.60 x 100 x 500)	\$260,000 (\$780,000 ÷ 3)	\$260,000
20X6	780,000 (15.60 x 100 x 500)	260,000 ([780,000 x 2/3] - 260,000)	520,000
20X7	1,560,000 (15.60 x 200 x 500)	1,040,000 (1,560,000 - \$520,000)	1,560,000

In some cases, the service period is not explicitly stated in the terms of a share-based payment award but can be inferred. For example, if an award vests upon achieving a particular sales target that is expected to be reached within 18 months of the grant date, the implicit service period is 18 months.

A derived requisite service period is used for an award that contains a market condition. For example, an award might vest upon the achievement of a specified share price. To estimate the requisite service period over which the specified share price will be achieved, certain valuation techniques may be used. 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 valuation techniques that are used to estimate fair value. All compensation cost would then be recognized over that estimated period, unless the market condition is satisfied prior to the end of the derived service period (see [Section 3.1.1.4](#)).

An award may have one or more explicit, implicit or derived service periods; however, an award will have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards. For example, if an award contains multiple performance conditions, each of which has a different requisite service period, the determination of both the amount of compensation cost recognized and the estimated requisite service period over which the compensation cost is attributed would depend upon the entity's assessment of the probability of achieving each of the performance conditions and whether it is necessary for all conditions to be met for an award to vest (or become exercisable). As illustrated in the [Example 3-3](#), if an award's vesting (or exercisability) is contingent 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. However, if an award's vesting (or exercisability) requires satisfaction of both market and performance or service conditions, the requisite service period is generally the longest of the explicit, implicit and derived service periods.



Example 3-3: Share-based payment award with market and service conditions and multiple service periods

The following example is *Example 5—Employee Share-Based Payment Award with Market and Service Conditions and Multiple Service Periods*, from ASC 718-10-55-101 through 55-106:

Cases A and B share the following assumptions.

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.

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

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.)

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

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.

3.1.1.3 Repurchase features that are implied vesting provisions

An award may include terms that are framed as a repurchase feature, but in fact imply a vesting provision. As discussed in [Section 4.2.2.4](#), repurchase features that allow an entity to reacquire shares for an amount equal to an award's original exercise price (or the lower of the original exercise price or fair value) if the grantee terminates employment within a specified period of time are essentially forfeiture provisions. The forfeiture provision will impact the determination of the requisite service period over which compensation cost is recognized; the requisite service period for the award would include the period until the repurchase feature expires (effectively the vesting period).



Example 3-4: Repurchase features that are forfeiture provisions

Company A grants Class B common units to certain employees for no consideration with terms that explicitly provide for immediate vesting (i.e., that no future service is required). The award also includes the following provision:

If a Series B common member's continuous service terminates prior to the second anniversary of the effective date, the Series B common units may be purchased by the Company, in its sole discretion, at a purchase price equal to the lesser of (i) the purchase price paid for each Series B common unit times the total number of Series B common units to be so purchased and (ii) the fair value of such Series B common.

The impact of this repurchase provision is to provide an in-substance two-year vesting provision. If the employee leaves prior to providing two years of service, the presumption is that the Company will buy back the units at the lower of the two amounts (usually \$0, as it is common for such awards to require no investment on the part of the employee).

3.1.1.4 Changes to employee requisite service period

Because the requisite service period is often estimated based on particular facts and circumstances, it may change over time. When there are changes to the facts and circumstances on which the estimate was based, entities should consider whether the initial estimated requisite service period should be updated. There are a variety of factors that must be considered in this determination, including:

- The nature of any service, market or performance conditions
- Changes in the actual and expected outcomes of service or performance conditions affecting vesting

ASC 718-10-55-75 through 55-79 addresses the accounting for changes to the requisite service period.

When there is a change in the initial requisite service period, the accounting result depends upon whether the change affects the grant-date fair value (including the quantity of instruments expected to vest) that is to be recognized as compensation cost. If it does, then the cumulative effect of the change is recorded as an adjustment in the period of the change. This would be the case if an award was not initially determined to be probable of vesting because a performance condition was not expected to be met. Once the assessment changes, and the award is expected to vest based on the probability of obtaining a performance condition, a cumulative effect adjustment would be recognized in the period of the change.



Example 3-5: Change to requisite service period – Scenario 1

An award vests upon satisfying both a service condition and a performance condition. The entity determined which outcomes were probable as part of its initial determination of the requisite service period. The award contains a five-year service condition and a performance condition, both of which need to be satisfied for the award to vest. Initially the five-year service condition is considered probable of being satisfied but not the performance condition. As such, no compensation cost was initially recognized. If the performance condition becomes probable two years after the grant date and the entity estimates the performance condition will be achieved at the end of the third year, the requisite service period would be five years, as that is the longest period of both the explicit service period and the implicit service period. Because the performance condition is now probable of being achieved, compensation cost will be recognized through a cumulative effect adjustment in the period of the change in estimate, in accordance with ASC 718-10-35-3. Compensation cost for the two years of service already provided 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 would be recognized prospectively over the remaining requisite service period of three years.

If, on the other hand, compensation cost is already being recognized over an initially estimated requisite service period, but another condition becomes the basis for determining the requisite period, then compensation cost would be recognized prospectively over the revised estimated requisite period. This is only the case if the change in the requisite service period does not affect the grant-date fair value (including the quantity of instruments expected to vest) that is to be recognized as compensation cost.



Example 3-6: Change to requisite service period – Scenario 2

An award vests upon satisfying either a service condition (for example, five years of service) or the satisfying of a performance condition. As part of its initial determination of the requisite service period, the entity estimated when, if at all, obtainment of the performance condition is probable. Initially the five-year service condition is considered probable of being satisfied, but the performance condition is not considered probable of being achieved; accordingly, the requisite service period is five years. However, if one year into the five-year requisite service period it becomes probable the performance condition will be achieved by the end of the third year, the requisite service period would be revised to three years (at that time, only two years of the three-year requisite service period would remain) and the remaining unrecognized compensation cost would be recognized prospectively over the revised remaining requisite service period.

As noted in ASC 718-10-55-77, if an award contains both a market condition and either a performance or service condition, and the initial estimate of the requisite service period is the market condition's derived service period, the requisite period should not change unless either of the following occurs:

- The market condition is satisfied before the end of the derived service period.
- Satisfying the market condition is no longer the basis for determining the requisite service period.

If the market condition is satisfied before the end of the derived service period, any unrecognized compensation cost would be recognized immediately. In other words, if the requisite service period is a derived service period of three years, all compensation cost would be recognized over that period, unless the market condition is satisfied before the end of that three-year period. For example, if the market

condition was the achievement of a particular stock price and that price was achieved after two years, any unrecognized compensation cost would be recognized immediately when the entity's stock price hits that target at the end of the second year.

3.1.2 Nonemployee vesting period

In transactions with nonemployees in which share-based payment awards are granted in exchange for the receipt of goods or services, the cost should be recognized when the goods or services are received. While the issuance of ASU 2018-07 generally aligned the accounting for share-based payments to nonemployees with the accounting for employee awards, this was one of the major exceptions. ASC 718 does not specifically address the period or the manner (that is, capitalize versus expense) in which the cost of nonemployee awards should be recognized, other than to require that an asset or expense be recognized in the same manner as if the grantor had paid cash for the goods or services.

If an entity grants fully vested, nonforfeitable awards to a nonemployee, it would recognize the equity instrument awards immediately either as compensation cost or a prepaid asset, as appropriate.



ASC 718-10-35-1A

A grantor shall recognize the goods acquired or services received in a share-based payment transaction with nonemployees 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 a share-based payment for an enforceable right to receive those goods or services. Nevertheless, the goods or services themselves are not recognized before they are received.

ASC 718-10-35-1B

If fully vested, nonforfeitable equity instruments are granted at the date the grantor and nonemployee enter into an agreement for goods or services (no specific performance is required by the nonemployee to retain those equity instruments), then, because of the elimination of any obligation on the part of the nonemployee to earn the equity instruments, a grantor shall recognize the equity instruments when they are granted (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 718-10-45-3) depends on the specific facts and circumstances.

ASC 718-10-35-1C

An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the nonemployee only after a specified period of time if the terms of the agreement provide for earlier exercisability if the nonemployee 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 instead of paying with, or using, the share-based payment awards.

ASC 718-10-45-3

As discussed in paragraph 718-10-35-1B, a grantor may conclude that an asset (other than a note or a receivable) has been received in return for fully vested, nonforfeitable, nonemployee share-based payment awards that are issued at the date the grantor and nonemployee enter into an agreement for goods or services (and no specific performance is required by the nonemployee to retain those equity instruments). Such an asset shall not be displayed as contra-equity by the grantor of the award. The transferability (or lack thereof) of the awards shall not affect the balance sheet display of the asset. This guidance is limited to transactions in which awards are transferred to nonemployees in exchange for goods or services.



Example 3-7: Expense recognition for an award granted to a nonemployee in exchange for consulting services

Company A has entered into an agreement with Consultant B to provide marketing services for six months. As part of the fee structure, Company A grants Consultant B options to purchase 1,000 shares of its common stock that are fully vested and nonforfeitable at the grant date, but are exercisable only after one year or upon completion of the marketing project, whichever comes first. The fair value of the options at the grant date is \$10 per share. Consultant B does not have to perform any services to retain the options once they are granted.

At the grant date, Company A should account for the options as a prepaid asset, because it has obtained an enforceable right to receive the marketing services from Consultant B. The prepaid asset is recorded at the fair value of the options, or \$10,000. The prepaid asset should not be presented as contra-equity, even though the options are not transferable by Consultant B until they become exercisable. Company A should also recognize a corresponding credit to equity (additional paid in capital). As Consultant B delivers the marketing services over the six-month period, Company A recognizes marketing expense and reduces the prepaid asset by the same amount. The expense recognition should be recorded as if Company A paid cash for the marketing services provided by Consultant B over that six-month service period.

3.2 Service and performance conditions that affect vesting

Service and performance conditions that only 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 grantees have not yet earned the right. Compensation cost, for awards with a performance condition that affects vesting of options, is only recognized if it is “probable” that the performance condition will be satisfied. The term “probable” is generally interpreted in practice to represent a greater than 70% likelihood that an event will occur. Awards subject to forfeiture provisions, or extensive repurchase features that function as forfeiture provisions, require careful consideration to determine what impact, if any, such provisions may have on the analysis of substantive vesting provisions and expense recognition for the award. See [Section 4.2.2.4](#) for additional discussion.

3.2.1 Performance conditions that can be satisfied after service is provided

Some awards include performance targets that can be satisfied after an employee completes the requisite service period or a nonemployee completes the vesting period. For example, an award granted to an employee could require both five years of service and regulatory approval of a specific new pharmaceutical drug in order to vest. The regulatory approval can occur any time prior to expiration of the award even if the employee is no longer providing service to the entity.

Performance conditions (or targets) that only affect vesting are not reflected in estimating the fair value of an award but do impact the timing of when the award is recognized. This is because compensation cost will only be recognized in the period in which it becomes probable that the performance target will be achieved.

If the performance target becomes probable of being achieved before the required service has been provided, the unrecognized compensation cost should be recognized prospectively over the remaining service period. Therefore, continuing with the example of the regulatory approval of the pharmaceutical drug, if the approval becomes probable at the end of year two, a proportional amount (two-fifths) of the fair value of the award calculated as of the grant date is recognized immediately as compensation cost through a cumulative effect adjustment (see further discussion at [Section 3.1.1.4](#)) and the remaining portion of the award is recognized prospectively over the remaining three-year service period.

If, on the other hand, the performance target becomes probable of being achieved after the required service has been provided, the unrecognized compensation cost is recognized when achievement of the performance target becomes probable. Therefore, if approval of the pharmaceutical occurred in year seven, after the five years of requisite service had been provided, compensation cost would be recognized in year seven.

3.2.2 Performance conditions based on a change in control

Many awards include a condition for vesting that is contingent upon a sale of the entity or other change in control event (i.e., a liquidity event). This is a type of performance condition that only affects vesting and is therefore not reflected in estimating the fair value of an award at the grant date; compensation cost is only recognized when the event becomes probable. As previously noted, the term “probable” is generally interpreted in practice to represent a greater than 70% likelihood that an event will occur. However, the business combinations literature in ASC 805-20-55-50 through 55-51 establishes the position that business combinations are not deemed to be probable until the transaction is consummated. As a result, most entities take the position that compensation cost related to performance awards that only vest upon consummation of a business combination (or other liquidity events, such as an IPO) should be deferred until consummation of the transaction.

In some cases, we believe a liquidity event performance condition may be implied when awards include explicit market conditions that require actual distributions to occur while an employee is providing services that are unlikely or impossible to be met without a change in control or other liquidity event. If these market conditions are not met while the employee is providing services and prior to any expiration date, the awards are forfeited. For example, a vesting requirement based on investors receiving cumulative cash proceeds equal to at least three times their investment may be considered to also contain a liquidity event performance condition if (a) the return to investors is based on actual distributions (i.e., not a hypothetical value calculation), (b) there is a limited time for the market condition to be achieved (i.e., the awards have an expiration date or cannot be retained upon termination of employment if the market condition has not been met), and (c) the company demonstrates it is unlikely or impossible for such returns to be achieved without a liquidity event occurring. In such circumstances, it may be appropriate for there to be no compensation cost recognized until a liquidity event occurs.

3.3 Service inception date

The service inception date is the beginning of the requisite service period. This is usually the same as the grant date, but there are situations in which the service inception date may fall before or after the grant date. Determining the correct service inception date is important because this is the date that the entity begins recognizing the costs of the award as compensation. The following example illustrates when the grant date and the service inception date are the same.



Example 3-8: Service inception date and grant date are the same

The following example is *Example 6— Service Inception Date and Grant Date*, from ASC 718-10-55-110:

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 upon 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 × \$40).

3.3.1 Situations in which service inception date may precede the grant date

In some cases, the service inception date may precede the grant date. ASC 718-10-55-108 specifies that all of the following criteria must be met in order for this to be the case:

- An award is authorized.
- Service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached.
- Either of the following conditions applies:
 - The award’s terms do not include a substantive future requisite service condition that exists at the grant date.
 - 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.

When these conditions are met, compensation cost should be accrued in reporting periods before the grant date based on the fair value of the award at the reporting date. Then, in the period in which the grant date occurs, the grantor should adjust cumulative compensation cost to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used.

The following example illustrates two scenarios in which the service inception date precedes the grant date.



Example 3-9: Service inception date precedes the grant date

The following example is a continuation of *Example 6— Service Inception Date and Grant Date*, from ASC 718-10-55-113 through 55-115:

If an award’s terms do not include a substantive future requisite service condition that exists at the grant date, the service inception date can 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.

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.

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.

3.3.2 Situations in which service inception date is after the grant date

There may also be cases in which the service inception date falls after the grant date. This occurs in awards with multiple vesting tranches, each of which vest based on different performance conditions and all of which are established upfront. The performance conditions must be established up front because the grantor and grantee must reach a mutual understanding of the key terms and conditions in order for a grant date to occur.

The following example illustrates how performance conditions may result in the establishment of multiple requisite service periods for which the service inception date may be after the grant date.



Example 3-10: Service inception date is after the grant date

The following example is *Example 3— Share-Based Payment Award with a Performance Condition and Multiple Service Periods*, from ASC 718-10-55-93 through 55-96:

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

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.

Case B: Performance Targets Are Established at Some Time in the Future

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

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.

3.4 Accounting for forfeitures

Most awards will include some sort of provision for forfeitures when service conditions or performance conditions are not satisfied. Entities have two options when it comes to accounting for pre-vesting forfeitures:

- Estimate forfeitures and adjust compensation costs recognized to reflect the estimate
- Recognize forfeitures as they occur

If an entity elects to estimate the number of forfeitures expected to occur, the entity bases initial accruals of compensation cost on the estimated number of instruments for which service is expected to be rendered or goods delivered (i.e., awards that are not expected to be forfeited). The entity will then revise that estimate if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the service is expected to be or has been rendered is recognized in compensation cost in the period of the change.

If, on the other hand, the entity elects to recognize the effect of forfeitures when they occur, the total amount of compensation cost recognized will be based on the assumption that no forfeitures will occur. Then, in the period in which an award is forfeited, the previously recognized compensation cost for a forfeited award is reversed in the period that the award is forfeited. This applies only to forfeitures of awards, not to awards that lapse unexercised or are cancelled. Previously recognized compensation cost

should not be reversed if an employee stock option (or share unit) for which the required service has been rendered expires unexercised (or unconverted) or if a stock option that a nonemployee has earned to right to exercise expires unexercised.

For awards with market conditions, previously recognized compensation cost is only reversed if the required requisite service was not completed by the employee or nonemployee.

When selecting a policy for accounting for forfeitures, an entity can make an entity-wide accounting policy election separately for all employee and all nonemployee share-based payment awards.

For awards issued to customers that have service conditions, ASU 2025-04 eliminates the policy election permitting a grantor to account for forfeitures as they occur. As a result, the grantor is required to estimate the number of forfeitures expected to occur when measuring the share-based consideration payable to a customer.

3.5 Graded vesting employee awards

Certain awards may include multiple vesting dates. This is referred to as graded vesting. Entities that issue employee awards with only service conditions that include graded vesting conditions must make a policy election on how to recognize compensation cost. There are two policy options for employee awards:

- *The graded-vesting method.* Under this method, an entity recognizes compensation cost on a straight-line basis over the requisite service period for each separately vesting portion of the award (i.e., tranche) as if the award was, in-substance, multiple awards.
- *The straight-line method.* Under this method, an entity recognizes compensation cost 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).

Because of the differences in compensation cost attribution, this accounting policy election does not apply to nonemployee awards. Compensation cost for nonemployee awards must be recognized in the same manner as if the entity had paid cash for the goods or services (see [Section 3.1.2](#)).

The following example illustrates the application of both methods available for employee awards with service conditions only.



Example 3-11: Share options with graded vesting

The following example is *Example 1—Accounting for Share Options with Service Conditions, Case B* from ASC 718-20-55-28 through 55-34:

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 (75 options). 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.

Share Option – Graded Vesting – Estimated Amounts		
Year	Number of Employees	Number of Vested Share Options
	Total at date of grant: 3,000	
20X5	3,000 – 90 (3,000 x .03) = 2,910	2,910 x 75 (300 x 25%) = 218,250
20X6	2,910 – 87 (2,910 x .03) = 2,823	2,823 x 75 (300 x 25%) = 211,725
20X7	2,823 – 85 (2,823 x .03) = 2,738	2,738 x 150 (300 x 25%) = 410,700
		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.

Share Option – Graded Vesting – Estimated Cost			
Year	Vested Options	Value per Option	Compensation Cost
20X5	218,250	\$13.44	\$2,933,280
20X6	211,725	14.17	3,000,143
20X7	410,700	14.69	6,033,183
	840,675		\$11,966,606

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.

Share Option – Graded Vesting – Computation of Estimated Cost			
	Pretax Cost to Be Recognized		
	20X5	20X6	20X7
Share options vesting in 20X5	\$2,933,280		
Share options vesting in 20X6	1,500,071	\$1,500,072	
Share options vesting in 20X7	2,011,061	2,011,061	\$2,011,061
Cost for the year	\$6,444,412	\$3,511,133	\$2,011,061
Cumulative cost	\$6,444,412	\$9,955,545	\$11,966,606

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 ($\$11,966,606 \div 3$). 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 [$2,910 \times 150 (300 \times 50\%)$] would be vested at the end of 20X5. Compensation cost amounting to \$5,866,560 ($436,500 \times \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).



RSM COMMENTARY: This example illustrates that an entity's policy for accounting for graded vesting awards can significantly change the timing of when compensation cost is recognized. As can be seen in the following table comparing the compensation cost recognized each year, electing to treat each tranche as an in-substance separate award will generally result in more compensation cost being recognized in the early years of the award.

Method	20X5	20X6	20X7
Graded-vesting	\$6,444,412	\$3,511,133	\$2,011,061
Straight-line vesting	3,988,868	3,988,868	3,988,868
Difference	\$2,455,544	(\$477,735)	(\$1,977,807)

Regardless of which method an entity elects, 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. For example, if an award vests 50%, 20% and 30% in years one, two and three, respectively, an entity using the straight-line attribution method must recognize 50% of the total measured compensation cost in year one, not 33% as would be calculated by a strict application of the straight-line method.

As indicated in ASC 718-20-55-26, "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" (i.e., whether the entity determines fair value for the entire award using a single expected term assumption or separately determines fair value for each tranche based on the expected term of each tranche). Additionally, the choice of attribution methods is limited to the graded-vesting method or the straight-line method. Other attribution methods, such as recognizing expense ratably or in line with the vesting schedule (e.g., award vests [and the expense is recognized] 20% in year one, 30% in year two and 50% in year three), are not deemed acceptable.

Additionally, the choice of attribution method applies to awards with only service conditions. Accordingly, for awards with performance or market conditions, an entity is required to recognize compensation expense using the graded-vesting model. However, if an award contains a provision that accelerates vesting upon a change in control, but otherwise only contains service conditions, we do not believe the existence of the change in control acceleration provision would eliminate the option of electing the straight-line method for recognition purposes. Although a change in control provision is in fact a performance condition, such a provision is generally not given accounting recognition until the change in control actually occurs; therefore, we do not believe such a provision need be considered in determining the choice of attribution methods.

3.6 Early exercise of a stock option

Under some stock option arrangements, an option holder may be able to exercise an option prior to vesting (i.e., before the requisite service is rendered). This is usually done in order to obtain a specific tax treatment. The exercise of "unvested" options results in the employee's deemed ownership, for U.S. federal income tax purposes, of the shares received when the exercise occurs.

Although on early exercise the employee is deemed to own the resulting shares for tax purposes, the employee has exercised the option award before it was vested based on its original terms. Accordingly, 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. In these situations, stock received by the employee may be subject to a contingent repurchase provision in the form of a call option held by the employer. The call option is exercisable by the employer only if the employee voluntarily or involuntarily terminates employment prior to the end of the remaining vesting period of the original option award and the call option lapses when the remaining vesting period has expired. The call option may have a strike price equal to either the original exercise price or to the lesser of the fair value of the stock at the call date or the original exercise price.

The strike price for the call option enables the grantor to recover the shares without transferring any appreciation in value to the employee if the employee terminates employment before the end of the original vesting period. The strike price for the call option also may be structured such that if the stock declines in value and the employee terminates prior to the end of the vesting period, the employer is able to repurchase the stock at its fair value at the termination date. This component of the call option pricing is for the purpose of establishing a stronger tax argument that the employee is the owner of the underlying shares from the date the option award is exercised (as the employee shares in the risks of stock ownership).

ASC 718-10-55-31 states that such early exercises are not substantive for accounting purposes. Additional guidance on the accounting for early exercise of a stock option award is provided in Issue 33 of EITF Issue 00-23. Although Issue 00-23 was superseded by the guidance in ASC 718, we believe much of the guidance is consistent with ASC 718 and can be applied by analogy. Based on the consensus in Issue 00-23, the following should be considered in the accounting for early exercises:

- The contingent repurchase provision (that is, the call option) held by the employer is a forfeiture provision that preserves the original vesting schedule with respect to an employee's ability to benefit from the rewards of share ownership if the call option (a) expires at the end of the original vesting period for the stock option award, (b) becomes exercisable only if a termination event occurs that would have caused the stock option award to be forfeited, and (c) has a strike price of either the employee's exercise price or of the lower of the employee's exercise price or the fair value of the underlying stock at the date the call is exercised.
- For accounting purposes, the call feature should be combined with the stock, resulting in an unvested award. As the early exercise is not substantive for accounting purposes, the award should continue to be recognized over the requisite service period. However, the early exercise provision may impact the

determination of the expected term in the valuation of the option (although the expected term still cannot be less than the substantive vesting period). The payment received by the employer for the exercise price should be recognized as a liability.

- A modification of a fixed stock option award to permit "early exercise" does not represent the acceleration of vesting because, as previously indicated, such an early exercise is not substantive for accounting purposes.
- Shares issued upon "early exercise" are not considered outstanding (prior to the lapsing of the employer repurchase provision) because the employee is not entitled to the rewards of ownership. The shares received by the employee are not issued until those shares vest. Vesting occurs when the employer call option lapses and the employee has all of the risks and rewards of ownership. Those shares are not shown as outstanding on the balance sheet (except perhaps for a reclassification of the par amount of the shares from additional paid-in capital to common stock and an indication in the disclosure of shares authorized, issued and outstanding that such shares are legally issued). The shares are excluded from basic EPS until the employer call option lapses and the shares are no longer subject to the repurchase feature; however, if the shares receive non-forfeitable dividends during the vesting period, the shares may be viewed as participating securities and the two-class method may apply. The shares would be included in the calculation of diluted EPS using the treasury stock method.

A modification to accelerate vesting occurs if the employee terminates during the requisite service period and the employer fails to exercise the call option. This is a Type III modification (i.e., improbable-to-probable modification) and, accordingly, a new measurement of compensation cost is required. Compensation cost based on the fair value of the award as of the modification date is recognized immediately. See [Chapter 6](#) for a discussion of modifications. Alternatively, the employer may exercise the call option and return the original exercise price to the employee when the fair value of the stock is less than that original exercise price. In that case, the employer's action is inconsistent with the strike price of the call option (i.e., the stated repurchase amount), and the excess of the original exercise price returned to the employee over the fair value of the stock represents additional compensation cost. If the employee terminates employment and the employer exercises its call option (as provided for under the original terms), the stock option has been forfeited and the employer has simply returned the prepaid exercise price.

3.7 Dividends on share-based payments

Some awards include a provision by which a grantee is entitled to receive dividends paid on an underlying equity share prior to the exercise of an option or even prior to vesting. Dividends or dividend equivalents paid to grantees on vested, unexercised options should be charged to retained earnings. Similarly, dividends on awards that are expected to vest should be charged to retained earnings. If, on the other hand, dividends are paid on awards that are not expected to vest, and the grantee is entitled to keep any dividends received regardless of whether they forfeit the award, the dividend payments should be recognized as additional compensation cost.

To estimate whether an award is expected to vest, entities should apply the same policy election made when accounting for forfeitures (see [Section 3.4](#)). If an entity's accounting policy is to estimate the number of awards expected to be forfeited, the estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest should be the same forfeiture rate used for vesting. When applying this policy, dividends and dividend equivalents are reclassified between retained earnings and compensation cost anytime the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates). If an entity's accounting policy is to account for forfeitures when they occur (see [Section 3.4](#) for guidance on accounting for forfeitures), the entity should only reclassify dividends from retained earnings to compensation cost in the period in which the forfeitures occur.

3.8 Capitalization of compensation costs

Typically, compensation cost is expensed as the employee performs, but in some cases the cost may instead be capitalized as part of the costs to acquire or construct an asset (e.g., inventory) and is recognized in the income statement at a later date, when the asset is disposed of or consumed.

3.9 Clawback features

Many employee awards will include a contingent feature that requires an employee to return vested awards if a specific contingent event occurs. This is known as a “clawback” feature and should only be recognized if and when the contingent event occurs, as illustrated in the following example.



Example 3-12: Share award with clawback feature

The following example is *Example 10—Share Award with a Clawback Feature* from ASC 718-20-55-85 through 55-86:

On January 1, 20X5, Entity T grants its chief executive officer an award of 100,000 shares of stock that vest upon the completion of 5 years of service. The market price of Entity T’s stock is \$30 per share on that date. The grant-date fair value of the award is \$3,000,000 (100,000 × \$30). The shares become freely transferable upon vesting; however, the award provisions specify that, in the event of the employee’s termination and subsequent employment by a direct competitor (as defined by the award) within three years after vesting, the shares or their cash equivalent on the date of employment by the direct competitor must be returned to Entity T for no consideration (a clawback feature). The chief executive officer completes five years of service and vests in the award. Approximately two years after vesting in the share award, the chief executive officer terminates employment and is hired as an employee of a direct competitor. Paragraph 718-10-55-8 states that contingent features requiring an employee to transfer equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration) are not considered in estimating the fair value of an equity instrument on the date it is granted. Those features are accounted for if and when the contingent event occurs by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains the contingent feature (\$3,000,000) and the fair value of the consideration received. This guidance does not apply to cancellations of awards of equity instruments as discussed in paragraphs 718-20-35-7 through 35-9. The former chief executive officer returns 100,000 shares of Entity T’s common stock with a total market value of \$4,500,000 as a result of the award’s provisions. The following journal entry accounts for that event.

Treasury stock	\$4,500,000	
Additional paid-in capital		\$1,500,000
Other income		\$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

If instead of delivering shares to Entity T, the former chief executive officer had paid cash equal to the total market value of 100,000 shares of Entity T’s common stock, the following journal entry would have been recorded.

Cash	\$4,500,000	
Additional paid-in capital		\$1,500,000
Other income		\$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

3.10 Secondary market transactions

Employees that receive share-based payments settled in the stock of nonpublic entities are often unable to monetize their awards due to the lack of a market in which to sell or liquidate their shares. Opportunities may arise where employees can sell their shares to other third parties or they may sell their shares to existing shareholders who want to increase their ownership interest in the entity. Such transactions are often referred to as secondary market transactions and may require the recognition of compensation cost by the entity.

In secondary market transactions, the entity itself may introduce the parties or facilitate a larger offering in which all or certain employees may participate in a secondary offering to sell their shares to new or existing shareholders. If the transaction involves the entity itself, related parties or existing holders of an economic interest in the entity, compensation cost may need to be recognized. ASC 718-10-20 defines economic interest in an entity as “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.” Often such transactions are not possible without the involvement of the entity coordinating the communications to the employees and organizing the transaction between the employees and the purchasing parties. As a result, if the entity is involved and the price paid for the employees’ stock is in excess of the fair value of the shares, then the excess may result in the recognition of compensation cost.



ASC 718-10-15-4

Share-based payments awarded to a grantee by a related party or other holder of an economic interest in the entity as compensation for goods or services provided to the reporting 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 goods or 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 the grantee in exchange for services rendered or goods received. 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 grantee that is unrelated to goods or services to be used or consumed in a grantor's own operations.

ASC 718-20-35-7

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 promised goods have not been delivered or the service has not been rendered has, in effect, modified the employee's requisite service period or nonemployee's vesting period to the period for which goods have already been delivered or 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.

ASC 505-30-30-2

An allocation of repurchase price to other elements of the repurchase transaction may be required if an entity purchases treasury shares at a stated price significantly in excess of the current market price of the shares. An agreement to repurchase shares from a shareholder may also involve the receipt or payment of consideration in exchange for stated or unstated rights or privileges that shall be identified to properly allocate the repurchase price.

ASC 505-30-30-3

For example, the selling shareholder may agree to abandon certain acquisition plans, forego other planned transactions, settle litigation, settle employment contracts, or restrict voluntarily the ability to purchase shares of the entity or its affiliates within a stated time period. If the purchase of treasury shares includes the receipt of stated or unstated rights, privileges, or agreements in addition to the capital stock, only the amount representing the fair value of the treasury shares at the date the major terms of the agreement to purchase the shares are reached shall be accounted for as the cost of the shares acquired. The price paid in excess of the amount accounted for as the cost of treasury shares shall be attributed to the other elements of the transaction and accounted for according to their substance. If the fair value of those other elements of the transaction is more clearly evident, for example, because an entity's shares are not publicly traded, that amount shall be assigned to those elements and the difference recorded as the cost of treasury shares. If no stated or unstated consideration in addition to the capital stock can be identified, the entire purchase price shall be accounted for as the cost of treasury shares.

The classification of share-based awards may also be impacted by secondary market transactions. If the secondary market transaction allows employees to sell unexercised stock options or exercise stock options that are then immediately sold, this may be deemed a repurchase of immature shares (i.e., shares held for less than six months). If the entity is determined to be involved in the transaction, a repurchase of immature shares may violate the guidance in ASC 718-10-25-9 and result in a change in the classification of employee awards from equity to liabilities. Judgment is required to determine whether the entity is establishing a practice of repurchasing immature shares, which may result in all awards granted under the plan being reclassified as liability-classified awards that must be remeasured at fair value each reporting period ([Section 4.2.2](#)).

4. Classification and accounting for liability awards

4.1 Overview

While ASC 718 establishes fair value as the measurement objective for both equity and liability-classified share-based payments, there are still significant differences between the accounting and measurement for liability-classified awards and equity-classified awards. Unlike equity-classified awards, which are generally carried at grant-date fair value, with no remeasurement necessary unless an award is subsequently modified, liability-classified awards are subject to remeasurement until an award is settled. There is also a measurement alternative available for nonpublic entities to measure liability awards at intrinsic value.

4.2 Awards requiring liability classification

ASC 718-10-25-6 through 25-19A specify the criteria for determining whether an award should be classified as a liability or as equity. The types of awards described in [Section 4.2.1](#) through [Section 4.2.7](#) below should generally be classified as liabilities. Awards requiring liability classification include:

- Instruments meeting certain criteria under ASC 480 ([Section 4.2.1](#))
- Awards with certain repurchase features ([Section 4.2.2](#))
- Stock options or similar instruments for which underlying shares are classified as liabilities ([Section 4.2.3](#))
- Awards with cash settlement features outside of the entity's control ([Section 4.2.4](#))
- Share-based payments with conditions other than service, performance or market conditions ([Section 4.2.5](#))
- Stock options or similar instruments with certain broker-assisted cashless exercise provisions ([Section 4.2.6](#))
- Awards with excess statutory withholding requirements ([Section 4.2.7](#))

Additionally, as discussed in [Section 4.2.8](#), SEC registrants must evaluate whether repurchase or cash settlement terms, which do not result in liability treatment under ASC 718, result in the need to present certain amounts outside of permanent equity (i.e., as temporary equity) in accordance with ASR 268 and ASC 480-10-S99-3A.

4.2.1 ASC 480 criteria

Even though awards under ASC 718 are excluded from the scope of ASC 480, unless otherwise specified, the classification criteria in ASC 480-10-25 and ASC 480-10-15-3 through 15-4 must still be considered in determining the classification of the award. For example, an award for mandatorily redeemable stock accounted for as a liability under ASC 480 would also be classified as a liability under ASC 718. In addition, an award to be settled for a fixed amount of value in a variable number of shares would also require classification as a liability pursuant to ASC 480-10-25-14.



Example 4-1: Awards settlement for a fixed amount with a variable number of shares

Company A grants the CEO an award that will be settled in shares worth \$500,000 upon the second anniversary of service. This award provides for settlement for a fixed amount of value in a variable number of shares and, accordingly, must be classified as a liability.

4.2.2 Repurchase features

Awards often include a repurchase feature under which the grantee can require the entity to repurchase shares issued under the share-based compensation arrangement for cash (a put option) or the entity has the option to repurchase the shares for cash (a call option). In some cases, the repurchase feature is part of the stock option or restricted stock awards. In other cases, the repurchase feature is contained in a separate shareholders' agreement between the entity and its significant shareholders or its management employees. These sorts of features are most commonly seen in awards issued by nonpublic companies as a means to provide liquidity to employees holding awards and to prevent wide dispersion of shares (i.e., to keep the entity closely held).

An award for which the underlying shares are subject to a put or call feature should be classified as a liability if (a) the repurchase feature allows the grantee to avoid the normal risks and rewards of equity share ownership for a reasonable period of time or (b) it is probable that the grantor would prevent the grantee from bearing those risks and rewards for a reasonable period of time. If neither of these conditions are met, the award may qualify for equity classification. ASC 718-10-25-9 defines six months or more as a reasonable period of time; this six-month period begins when the service has been rendered or the goods have been delivered and the shares have been issued. For stock options, the period begins at the date of exercise, provided the shares received upon exercise are not subject to a forfeiture provision; for restricted stock, the time period begins at the date the shares vest. Prior to the lapse of this six-month period, these awards are also known as immature shares.

Awards for which a grantee has not been subject to the risks and rewards of equity share ownership for a reasonable period of time include:

- Stock obtained by option exercise (or stock awards that have vested) within the first six months
- Nonvested stock
- Stock acquired with a nonrecourse note that has not been fully repaid or that was fully repaid within the prior six months

A fair value repurchase of shares by an employer beyond six months after option exercise or share issuance is a treasury stock transaction and does not result in compensation expense (unless the repurchase involves a premium).

Even if it is determined that an award with repurchase features should be classified as equity under ASC 718, SEC registrants also need to consider whether such awards should be classified as temporary equity under ASR 268, as discussed in [Section 4.2.8](#).

4.2.2.1 Put options

In accordance with ASC 718-10-25-9, if a put option would allow a grantee to avoid the risks and rewards of share ownership for a reasonable period of time, then liability classification is required (regardless of whether or not it is probable the grantee would exercise the put).

Accordingly, the assessment of a grantee put must consider (a) whether the repurchase feature permits the grantee to avoid bearing the risks and rewards normally associated with equity share ownership and (b) whether those risks and rewards are not retained for a six-month period of time from the date the required service has been rendered and the share is issued.

For example, an entity may grant shares under a share-based compensation arrangement that an 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. If, after the employee has vested in the shares and the shares are issued, a six-month period

lapses without the employee exercising the put option, the entity should then reclassify the award to equity (assuming all other criteria for equity classification are met); at that point the employee has been subject to the risks and rewards of share ownership for a reasonable period of time.

If an award of shares contains a put provision at fair value that cannot be exercised until more than six months after vesting, the award would generally be classified as an equity award, as the repurchase feature requires the employee to bear the risks and rewards of ownership for a reasonable period of time.

Alternatively, an entity might grant an award of shares that can be put to the entity only after the grantee has held them for a reasonable period of time after vesting, but at a fixed redemption amount. Those puttable shares would be classified as liabilities because the repurchase price is based on a fixed amount and not variations in the fair value of the entity's shares. The grantee cannot bear the risks and rewards normally associated with equity share ownership for a reasonable period of time because of the fixed redemption feature. If, instead, a share with a repurchase feature gives the grantee 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, the fixed amount over fair value must be recognized as additional compensation cost over the employee's requisite service period or the nonemployee's vesting period (with a corresponding liability being accrued).

If a repurchase feature provides for a repurchase price based on a formula price (e.g., a formula price based on book value), the award generally will be accounted for as a liability because the award is not subject to the normal risks and rewards of share ownership. However, in accordance with ASC 718-10-55-131, a nonpublic entity would not be precluded from classifying such an award as equity if all the purchases and sales of this class of stock and other classes of stock with substantially the same rights are based on the same formula price that is being used as a proxy for fair value. However, upon a liquidation event, distributions to the grantee must be based on their equity participation in the net assets of the company, rather than the formula price. Otherwise, the grantee would be prevented from bearing the risks and rewards normally associated with equity share ownership. Importantly, the grantee would still have to be subject to the risks and rewards of share ownership for a reasonable period of time (i.e., the shares have been vested and outstanding for six months or more) to support equity classification in accordance with ASC 718-10-25-9.

4.2.2.2 Call options

The concepts of (a) whether the repurchase feature permits the grantee to avoid bearing the risks and rewards normally associated with equity share ownership and (b) whether those risks and rewards are not retained for a reasonable period of time, are the same for an entity's call option as those discussed in [Section 4.2.2.1](#) for a grantee's put option. However, when evaluating whether a call option held by an entity triggers liability classification, as specified in ASC 718-10-25-9, the probability that the entity will prevent the grantee from bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time must be considered. As previously discussed, no probability assessment is allowed when analyzing a grantee put option.

The assessment of whether an entity's repurchase of immature shares at fair value is probable should be based on the entity's stated representation regarding its intent to call immature shares and all other relevant facts and circumstances. While an expression of management's intent to not call immature shares is important, this representation must be considered in conjunction with the other facts and circumstances. For example, the stated intent may be in contradiction with the entity's prior actions. If an entity states that it will not exercise a call right on immature shares but has done so in the past, there may not be a sufficient basis to conclude that future repurchases of immature shares is not probable. As provided in EITF Issue 00-23, factors to consider in assessing whether it is probable that immature shares will be repurchased may include the following (although EITF Issue 00-23 was superseded by the guidance in ASC 718, we believe much of the guidance is consistent with ASC 718 and can be applied by analogy):

- *The entity's history of calling immature shares.* If the entity has seldom exercised the right to call immature shares in the past, it may not be probable the entity would exercise the right in the future. On the other hand, if the entity had demonstrated a history of repurchasing immature shares from grantees, it may be reasonable to conclude that such repurchases will continue.
- *The circumstances under which immature shares have previously been called.* If immature shares have previously been called only in connection with certain infrequent events (such as significant staffing reductions) but the entity has no current plans for another such event, the exercise of the call right may not be probable.
- *Legal, regulatory or contractual limitations on the entity's ability to repurchase shares.* Any limitations on the entity's ability to repurchase shares should be considered.

Determining whether it is probable an entity will repurchase immature shares requires an ongoing evaluation. Awards initially classified as equity may be reclassified to a liability as a result of a change in the facts and circumstances. Conversely, if liability classification is initially required as a result of an assessment that a repurchase of immature shares is probable, liability classification would end when the repurchase of immature shares is no longer considered probable, when the call right expires or when the shares are no longer immature (i.e., the shares have been vested and outstanding for six-months or more), whichever is earliest; the award should be reclassified to equity. The effect of the change in assessment should be accounted for similarly to a modification from an equity to liability award or from a liability to equity award, as discussed in [Section 6.3](#).

If a repurchase feature provides for a repurchase price based on a formula price (e.g., a formula price based on book value), the award generally will be accounted for as a liability because the award is not subject to the normal risks and rewards of share ownership. However, in accordance with ASC 718-10-55-131, a nonpublic entity would not be precluded from classifying such an award as equity if all the purchases and sales of this class of stock and other classes of stock with substantially the same rights are based on the same formula price that is being used as a proxy for fair value. However, upon a liquidation event, distributions to the grantee must be based on their equity participation in the net assets of the company, rather than the formula price. Otherwise, the grantee would be prevented from bearing the risks and rewards normally associated with equity share ownership. Importantly, the grantee would still have to be subject to the risks and rewards of share ownership for a reasonable period of time (i.e., the shares have been vested and outstanding for six months or more) to support equity classification in accordance with ASC 718-10-25-9.

4.2.2.3 Contingent repurchase features

In many instances in which an entity grants share-based compensation awards to employees with a repurchase feature, the entity's right to repurchase the shares (the call option) or the employee's right to require the employer to repurchase the shares (the put option) is contingent upon a future event. For example, these rights may become exercisable only upon the employee's separation of service, death or disability. If one of the specified future events does not occur, the call option or put option never becomes exercisable.

ASC 718-10-25-9(a) specifies that a repurchase feature within the grantee's control (a put option), which can be exercised only upon the occurrence of a contingent event outside of the grantee's control, would not permit the grantee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time (and require liability accounting) until it becomes probable that the event will occur.

When a grantee's put option is contingent upon a future event, an assessment should first be made as to whether the grantee controls the events that would cause the put to become exercisable. If the events are within the grantee's control, the put feature should be considered to be a right held by the grantee (i.e., an active exercisable right).

If the grantee does not control the events that would cause the put option to become exercisable, an entity must assess whether the occurrence of the contingent event is probable on an individual basis. If it is not probable that the contingent event outside the grantee's control will occur, the contingent put does not require liability classification. This evaluation would need to be reassessed throughout the contingency period. If the contingent event is probable of occurrence before the grantee has been subject to the risks and rewards normally associated with equity share ownership for a reasonable period of time, liability classification is required. That is, while the grantee does not currently control the ability to require the entity to repurchase shares, it is expected that the grantee will obtain that ability during the period the shares are immature.

In addition, ASC 718-10-25-9(b) includes in its assessment of a repurchase feature within the control of the entity (a call option) the provision that the probability that the entity will exercise the call and prevent the grantee from bearing the risks and rewards of equity share ownership for a reasonable period of time be considered.

Accordingly, when the entity's right to repurchase the shares is contingent upon a future event, an assessment first should be made as to whether the entity controls the events that would cause the call option to become exercisable. For events or actions within the entity's control that would cause the call option to become exercisable, the call feature should be evaluated similarly to other call options (i.e., as if not contingent). However, in making this assessment, the entity should consider on an individual grantee-by-grantee basis whether it is probable that the entity will take the actions necessary to cause the call right to become exercisable.

When a call option is contingent upon events that are not controlled by the entity, an entity should assess whether the contingent event is probable of occurring on an individual grantee-by-grantee basis. If the contingent event is not probable of occurrence, the repurchase feature does not require liability classification. That evaluation would be reassessed throughout the contingency period. However, if the contingent event is probable of occurrence, the guidance on grantee call options should be applied as if not contingent.

Assessing whether an entity or grantee controls the events or actions on which a repurchase feature is contingent requires a detailed understanding of the provisions of the award and of the underlying plan. For example, the events necessary to activate a call feature that is contingent upon a grantee's termination by the entity (without cause) generally are within the entity's control. On the other hand, if a call feature is contingent upon termination for cause, the events necessary to activate the call are generally outside the employer's control.

If a repurchase feature provides for a repurchase price based on a formula price (e.g., a formula price based on book value), the award generally will be accounted for as a liability because the award is not subject to the normal risks and rewards of share ownership. However, in accordance with ASC 718-10-55-131, a nonpublic entity would not be precluded from classifying such an award as equity if all the purchases and sales of this class of stock and other classes of stock with substantially the same rights are based on the same formula price that is being used as a proxy for fair value. However, upon a liquidation event, distributions to the grantee must be based on their equity participation in the net assets of the company, rather than the formula price. Otherwise, the grantee would be prevented from bearing the risks and rewards normally associated with equity share ownership. Importantly, the grantee would still have to be subject to the risks and rewards of share ownership for a reasonable period of time (i.e., the shares have been vested and outstanding for six months or more) to support equity classification in accordance with ASC 718-10-25-9.



Example 4-2: Repurchase right upon termination of employment

During 20X5, Company XYZ granted nonvested stock awards to its employees. According to the terms of the awards, the stock awards vest 25% per year over a four-year period. Upon termination of employment, Company XYZ has the right, but not the obligation, to repurchase vested shares. The award agreement defines termination of employment as the employee's voluntary separation from the company or Company XYZ terminating the employee without cause. If the employee is terminated for cause, the employee forfeits all unvested and vested shares for zero consideration. The company retains the right to exercise the repurchase option for a period of 18 months after the termination date, with the repurchase price determined at fair value as of the date of repurchase. The plan document also specifies that the repurchase option is only available for shares that have been outstanding for more than six months.

Company XYZ is reviewing the plan document and related grant agreements to determine how to report the stock award in its year-end financial statements. Considering the repurchase option, should the award be classified as equity or as a liability?

Accounting analysis

The repurchase right is contingent upon an event (i.e., termination of employment) the control of which resides with both the company (terminate employee without cause) and the employee (voluntary separation). If the contingent event occurs, the decision to repurchase the shares remains at the discretion of Company XYZ, as there is no obligation for the company to proceed with the repurchase. Additionally, the repurchase right applies only to shares that have been outstanding for more than six months (referred to as mature shares), and the repurchase price will be the fair value on the date of repurchase. As a result, because the employee is subject to the risks and rewards of share ownership, the awards are equity classified. If the plan document did not require the shares to be outstanding for more than six months before becoming contingently eligible for repurchase, equity classification may still be appropriate. Company XYZ should assess the probability of the call option being exercised prior to the employee bearing the normal risks and rewards of share ownership for a reasonable period of time (i.e., six months). Even though it may be probable an employee's employment will terminate, resulting in share repurchase by the company, provided Company XYZ does not consider it probable this will occur within six months of vesting, equity classification remains appropriate. However, if it becomes probable that termination will occur within six months of vesting, the award should be reclassified as a liability. Company XYZ should revisit these facts and circumstances each reporting period to ensure nothing has changed that might affect the prior conclusion.

4.2.2.4 In-substance forfeiture provision

As discussed in EITF Issue 00-23, repurchase features that allow an entity to reacquire shares for an amount equal to an award's original exercise price (or the lower of the original exercise price or fair value) if the grantee terminates employment within a specified period of time are essentially forfeiture provisions. For example, an employee may be permitted to exercise a stock option prior to vesting, but if the employee terminates service within three years of the grant date, the entity may repurchase the share for the original exercise price (effectively unwinding the transaction). The purpose of the repurchase feature is to permit the employee's holding period for tax purposes to begin at an earlier date.

A repurchase feature that functions as a forfeiture (vesting) provision would not on its own trigger liability accounting. The forfeiture provision will impact the determination of the requisite service period over which compensation cost is recognized; the requisite service period for the award would include the

period until the repurchase feature expires (effectively the vesting period). Such an “early exercise” of a stock option (or the granting of “vested” shares subject to forfeiture) is not substantive for accounting purposes, and any payment received by the employer for the exercise price should be recognized as a liability. See [Section 3.6](#) for a further discussion of early exercise and forfeiture provisions.

Some companies issue shares under a share-based compensation arrangement with such extensive repurchase features (specifically repurchase features that are in-substance forfeiture provisions as discussed above) that consideration must be given as to whether the grantee has in fact vested in the shares or is probable of vesting in the shares. For example, some awards may specify an explicit vesting period but may allow an entity to repurchase the shares, at the lower of the original exercise price or fair value, whenever an employee or the employer terminates employment, except if termination is by the employer without cause or upon change in control, and the repurchase features do not expire. In this example, unless termination is by the entity without cause (e.g., a layoff) or a change in control occurs, the employee’s ability to retain the award is subject to continued employment. ASC 718 states that a share-based payment becomes vested at the date that the grantee’s right to receive or retain equity instruments is no longer contingent on satisfaction of either a performance condition or a service condition, as discussed in [Section 3.2](#). Compensation cost is only recognized for an award of share-based compensation if the requisite service is expected to be rendered (e.g., performance conditions are probable of being achieved). Accordingly, for awards for which the forfeiture provisions are so substantial that it is not deemed probable that true vesting will occur (i.e., the awards will become non-forfeitable) no compensation expense would be recognized until such time as it becomes probable the awards will vest and no longer be subject to forfeiture.

4.2.3 Classification of underlying shares

Options or similar instruments on shares must be classified as liabilities when the underlying shares are classified as liabilities. For example, an entity may grant an option in exchange for services that, upon exercise, would be settled by issuing mandatorily redeemable shares. If the mandatorily redeemable shares would be classified as a liability pursuant to ASC 480, the option must also be classified as a liability under ASC 718.

4.2.4 Settlement provisions

If an entity can be required to settle options or similar instruments by transferring cash or other assets, ASC 718 generally requires the awards be classified as liabilities. For example, a cash-settled stock appreciation right would be classified as a liability, whereas a share-settled stock appreciation right would be classified as equity (assuming all other criteria for equity classification are met). Additional consideration should also be given to whether an entity has the ability to deliver the shares (i.e., if there are sufficient shares authorized and available). If the number of authorized and available shares are insufficient, an entity may be required to settle the award in cash, thus requiring the award to be classified as a liability.

The accounting for an award must also reflect the substance of the arrangement. The written terms usually provide the best evidence of the substantive terms. However, an entity may have engaged in past practices that indicate the substantive terms of an award are different. For example, stock options that only provide for settlement in shares may meet the criteria for equity classification, but if an entity has established a past practice of settling the options in cash whenever a grantee asks, liability classification may be required. The entity’s past practice of cash settling the options may indicate the entity has a substantive liability.

ASC 718-10-25-11 specifies liability classification is not required for an award with a contingent cash settlement provision if the contingency is not probable and not within the grantee’s control. For example, an entity may issue a stock appreciation that is to be share-settled. However, upon a change in control event, the grantee has the option to elect cash settlement of the award. Such an award may initially be

classified as equity because a change in control is not within the control of the grantee and is generally not considered probable until it occurs (see [Section 3.2.2](#)). However, when the contingent cash settlement event becomes probable, in this case when the change in control occurs, and the holder can elect cash rather than share settlement of the award, the award would be reclassified to a liability. This guidance is not intended to address situations in which an award is share-settled, and the holder may then receive distributions upon a change in control in a manner similar to other shareholders.

Even if it is determined that an award with contingent cash settlement features should be classified as equity under ASC 718, SEC registrants also need to consider whether such features result in temporary equity classification for the award under ASR 268, as discussed in [Section 4.2.8](#).

4.2.5 Conditions other than market, performance or service

An award may also be indexed to conditions or factors other than just the entity's share price. If that additional factor is other than a market, performance or service condition, the award must be classified as a liability. For example, an award indexed to the price of a commodity, such as gold or oil, would be liability classified, even if the entity granting the award operates in the gold or oil market. That additional factor must also be reflected in the fair value determination for the award.

In determining whether additional conditions or factors exist, a stock option granted to employees or nonemployees of an entity's foreign operation that includes an exercise price denominated in either the foreign operation's functional currency or in the currency in which the employee is paid is not considered to contain an additional factor. For example, a stock option with an exercise price denominated in pesos is granted to employees of a U.S. entity's subsidiary in Mexico. The functional currency of the subsidiary is the peso. The stock option is not required to be classified as a liability, assuming there are no other provisions that would require liability classification. Further, a stock option would also not be classified as a liability even if the functional currency of the Mexican subsidiary is the U.S. dollar, if the employee is paid in pesos.

A stock option or similar award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades is not considered to contain an additional condition or factor. Accordingly, the stock option would be classified as equity, assuming there are no other provisions that require liability classification.

4.2.6 Broker-assisted cashless exercises

A broker-assisted cashless exercise occurs when a grantee simultaneously exercises an option and sells the shares through a broker. Under this method of exercise, the grantee never actually pays the exercise price before the sale of the option shares.



Master Glossary – Broker-assisted Cashless Exercise

The simultaneous exercise by a grantee 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 grantee 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 grantee.

A broker-assisted cashless exercise provision does not, on its own, result in liability classification if both of the following criteria under ASC 718-10-25-16 are met:

- A valid exercise of the stock option is required.
- The grantee is the legal owner of the option shares.

4.2.7 Maximum statutory withholding requirements

A share-based payment may include a provision for the direct repurchase of shares upon exercise of options (or the vesting of nonvested shares) or the indirect repurchase of shares upon exercise of options (or the vesting of nonvested shares) through a net-settlement feature, with any payment due employees withheld to meet the employer's statutory withholding requirements. Such a provision would not, on its own, require liability classification unless the amount withheld, or that may be withheld at the employee's direction, exceeds the maximum statutory tax rates in the employees' applicable jurisdictions. This is the case even if that rate exceeds the highest rate that may be applicable to the specific award grantee. For this purpose, the maximum statutory tax rates are based on the applicable rates of the relevant tax authorities (including federal, state and local). The computation of the employee's maximum statutory tax rate includes the employee's share of payroll taxes, as provided for under tax law, regulations or the authority's administrative practices, but may not exceed the highest statutory rate in that jurisdiction.

Pursuant to ASC 480-10-S99-3A(3)(d), the SEC staff would not expect SEC registrants to classify such employee awards outside of permanent equity as discussed in [Section 4.2.8](#), if the direct or indirect repurchase of shares is done solely to satisfy the employer's minimum statutory tax withholding requirements.

4.2.8 Classification of redeemable securities under ASR 268 – temporary equity

As discussed in Staff Accounting Bulletin (SAB) Topic 14.E, SEC registrants must evaluate whether the terms of share-based payment arrangements that are not classified as liabilities under ASC 718 result in the need to present certain amounts outside of permanent equity (i.e., as temporary equity) in accordance with ASR 268 and ASC 480-10-S99-3A.

In accordance with ASR 268, share-based payment awards that are redeemable for cash or other assets (a) at a fixed or determinable price on a fixed or determinable date, (b) at the option of the holder, or (c) upon the occurrence of an event not solely within the control of the issuer would require presentation outside of permanent equity. While only SEC registrants are required to follow the guidance in ASR 268, we believe it is appropriate that nonpublic entities follow the guidance as well.

The following are examples of awards that would be classified as equity instruments under ASC 718, but under ASR 268 may require presentation outside of permanent equity:

- Shares that are redeemable for cash at the holder's option, but only after six months from the date the shares vest (i.e., a six-month holding period)
- Options with underlying shares that are redeemable for cash at the holder's option, but only after six months from the date of option exercise
- An award with a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is not probable

In SAB Topic 14.E, the SEC staff clarified that instruments granted in conjunction with share-based payment arrangements with employees that do not, by their terms, require redemption for cash or other assets would not be assumed to require net cash settlement for purposes of applying ASR 268 in circumstances in which ASC 815-40-25 would otherwise require the assumption of net cash settlement.

For SEC registrants, options or similar instruments granted in conjunction with share-based payment arrangements with employees for which the terms may permit redemption of the option or underlying share, the initial amount classified outside of permanent equity should be based on the redemption amount of the instrument. The amount presented in temporary equity at each balance sheet date should take into account the proportion of consideration received in the form of employee services. For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon a change in control (an event generally considered to be outside of the entity's control), an amount representing the current intrinsic value of the option should be presented outside of permanent equity.

4.3 Equity-based compensation issued by partnerships and LLCs

The accounting for equity-based compensation arrangements entered into by partnerships and limited liability companies (LLCs) can be more complex than restricted stock awards issued by corporations. The features of such arrangements should be closely analyzed, and the accounting treatment should be carefully considered.

Equity compensation arrangements for pass-through entities often are designed based upon income tax regulations. A common form of compensation is the grant of a profits interest award. These awards are designed such that the recipient is not provided with any immediate liquidation value. Rather, they allow the recipient to share in future profits and increases in value of the entity. The grant is not taxable at the time of grant or vesting, but it is taxable as allocations of taxable income are made or upon the sale of the interest.

In determining the applicable accounting model for a profits interest award (or other awards issued by partnerships and LLCs) and evaluating whether a profits interest award meets the conditions in ASC 718-10-15-3 and is therefore within the scope ASC 718 (see [Section 1.3.1](#)), it is important to consider the terms of the award and the nature of the instrument. We believe factors to consider in determining the nature of the arrangement and, accordingly, the applicable accounting model, include:

- The legal form of the instrument
- Participation features such as voting rights, distribution rights and liquidation rights (an instrument would be expected to participate in the residual interest in the entity's net assets)
- Retention of vested interests upon termination of employment

For example, a profits interest award that is legal equity of the entity, participates in the residual value of the entity upon liquidation and substantively vests (i.e., can be retained upon termination of employment subject to a fair value call) would likely be accounted for as a share-based payment under ASC 718. On the other hand, a profits interest award that does not participate in the residual value of the entity upon liquidation and is forfeited upon termination of employment (i.e., allows the grantee to participate in distributions only based on continued employment) may be more appropriately accounted for as a profit-sharing arrangement under ASC 710.

ASU 2024-01 amended ASC 718 by adding an example with four fact patterns to assist companies in determining whether profits interest and similar awards should be accounted for within the scope of the guidance in ASC 718 (see below).



Example 4-3: Profits interest and similar awards

The following is *Example 10, Cases A through D* from ASC 718-10-55-138 through 55-148:

This Example illustrates how an entity should apply the guidance in paragraph 718-10-15-3 to determine whether a profits interest or similar award is a share-based payment arrangement and is within the scope of this Topic or is not a share-based payment arrangement and, therefore, is within the scope of other Topics. The guidance in this Example is limited to the application of paragraph 718-10-15-3 and does not address how to apply other Sections of this Topic, including recognition, classification, initial measurement, subsequent measurement, other presentation matters, and disclosure.

Cases A, B, C, and D share the following assumptions:

- a. Entity X is a partnership. Before June 1, 20X1, Entity X had Class A units outstanding. On June 1, 20X1, Entity X grants Class B incentive units to employees of a subsidiary of Entity X in exchange for services.
- b. An exit event may include an initial public offering, a change in control, or a liquidation of Entity X's assets.

Case A: Award Is a Share-Based Payment Arrangement

Additional assumptions are as follows:

- a. The Class B units are profits interest units that are subordinated to the Class A units because after vesting they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
- b. The Class B units cliff vest at the end of three years of service.
- c. Upon an exit event, the Class B units vest immediately if a grantee is still providing services to the subsidiary of Entity X. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a).
- d. If a grantee of the Class B units terminates employment with the subsidiary of Entity X (whether voluntarily, upon death, disability, or retirement or at the election of Entity X for reasons other than cause), any unvested Class B units will be forfeited for no consideration. If a grantee of the Class B units terminates employment after vesting, the grantee retains ownership of the vested Class B units, but upon the grantee's termination of employment, Entity X has a call right to repurchase the Class B units. If the call right is exercised, Entity X would pay the grantee of the Class B units an amount of cash equal to the fair value of the Class B units on the call date.

Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

- a. Either upon three years of service or an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met, if applicable) and the award will vest.
- b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate

to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-140(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

Case B: Award Is a Share-Based Payment Arrangement

Additional assumptions are as follows:

- a. The Class B units are profits interest units that are subordinated to the Class A units because once granted, they participate pro rata with the Class A units once the holders of the Class A units have received distributions equal to a predetermined distribution threshold established on the grant date of the Class B units.
- b. The grantee of the Class B units is eligible to begin participating in nonforfeitable operating distributions at the grant date.
- c. The Class B units only vest upon an exit event. Upon such an event, the grantee would retain the vested Class B units, or if Class B units are settled through the exit event, Entity X would distribute proceeds to the Class B unit holders in the same manner as is described in (a). Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units meet the condition in paragraph 718-10-15-3(a) because both of the following indicate that Entity X is offering to issue shares or other equity instruments:

- a. Upon an exit event, the grantor will have received the agreed-upon consideration (that is, the service will have been provided and the performance condition will have been met) and the award will vest.
- b. Holding the vested Class B units provides the grantee with the right to participate in the residual interest of Entity X through periodic distributions, upon an exit event, or upon settlement proportionate to ownership of Class B units of Entity X in accordance with the distribution waterfall described in paragraph 718-10-55-142(a).

Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

The grantee of the Class B units is not entitled to retain the units if the grantee ceases to provide services before an exit event. Upon termination of employment before an exit event, the grantee of the Class B units would forfeit all rights to future distributions and would forfeit Class B units for no consideration. Entity X would account for the grantee's right to participate in nonforfeitable operating distributions in accordance with paragraph 718-10-55-45.

Case C: Award Is a Share-Based Payment Arrangement

Additional assumptions are as follows:

- a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
- b. The grantee of the Class B units is not eligible to participate in distributions in the ordinary course of business.
- c. The grantee of the Class B units is eligible to receive cash upon an exit event. Upon an exit event, the Class B units vest immediately and must be settled in cash on the basis of the fair value of the Class B units. The fair value of the Class B units is calculated by reference to the price of Class A units of Entity X as determined at the date of the exit event.

- d. The grantee of the Class B units must be providing services when the exit event occurs to receive any proceeds, and the Class B units are forfeitable upon the grantee's termination for any reason at any time before an exit event.

Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing, or offering to issue, shares, share options, or other equity instruments. However, the condition in paragraph 718-10-15-3(b)(1) is met because the cash proceeds received by the grantee upon settlement in an exit event are based, at least in part, on the price of Entity X's shares. Therefore, Entity X would account for the Class B units by applying the guidance in this Topic.

Case D: Award Is Not a Share-Based Payment Arrangement

Additional assumptions are as follows:

- a. The Class B units do not entitle the grantee to receive equity instruments of Entity X. This type of unit is often referred to as a phantom share unit.
- b. The grantee of the Class B units is eligible to participate in operating distributions made by Entity X equal to 1 percent of the preceding fiscal year's net income. The grantee of the Class B units is eligible to begin participating in these operating distributions after three years of service.
- c. The grantee of the Class B units is not eligible to participate in any proceeds distributed upon an exit event.
- d. The Class B units are forfeitable upon the grantee's termination for any reason at any time (including after the grantee has rendered three years of service).

Entity X evaluates the conditions in paragraph 718-10-15-3 to determine whether to account for the Class B units by applying the guidance in this Topic. The Class B units do not meet the condition in paragraph 718-10-15-3(a) because they do not entitle the grantee to receive shares or other equity instruments of Entity X; therefore, Entity X is not issuing or offering to issue shares, share options, or other equity instruments. In addition, the condition in paragraph 718-10-15-3(b)(1) is not met because the proceeds received by the grantee related to operating distributions are based on an operating metric (1 percent of the preceding fiscal year's net income) of Entity X and are not based, at least in part, on the price of Entity X's shares. Furthermore, the condition in paragraph 718-10-15-3(b)(2) is not met because there is no circumstance in which Entity X would be required to issue its equity shares or other equity instruments. Therefore, Entity X would not apply the guidance in this Topic to account for the Class B units and, instead, would account for the Class B units in accordance with other Topics.

Where the arrangement has been determined to be a share-based payment arrangement under ASC 718, a further determination will have to be made as to whether the award should be classified as a liability or as equity. See [Section 4.2](#) for further guidance on classification of share-based payments.



RSM COMMENTARY: Companies issuing profits interests sometimes assume that the awards have no value at the grant date. This assumption might be based on the fact that the awards have no immediate liquidation value or that no value is assigned for tax purposes. Such an assumption would not be appropriate for accounting purposes. Rather, the equity instruments issued by a going concern entity would need to be valued using some form of valuation methodology that considers the potential upside, using reasonably possible cash flow projections.

The following example illustrates the accounting for a profits interest award under the ASC 718 model.



Example 4-4: Profits interest award under ASC 718

Entity A grants its CEO a profits interest award (Class B units) that vests 20% per year over a five-year period. The Class B units are legal equity of the Company and allow the holder of a vested profits interest award to participate in any distributions over the specified participation threshold. The participation threshold is \$80 million, the value of Entity A on the date of the grant. The profits interest award does not include voting rights and has limited transferability. However, it does allow the holder of vested units to participate in the residual interest of Entity A upon liquidation, and the CEO is able to retain vested profits interests upon termination, subject to Entity A's fair value call option.

Considering the guidance in ASC 718-10-15-3 and given that the profits interest award (a) is legal equity of the Company, (b) participates in the residual interest of Entity A through periodic distributions or upon liquidation proportionate to ownership of Class B units (albeit subject to a participation threshold), and (c) is retained upon termination of employment (subject to the Company's fair value call), the award will be accounted for as a share-based payment under ASC 718. Assuming all the criteria under ASC 718-10-20 are met for equity classification (see [Section 4.2](#)), Entity A would recognize the award based on its grant-date fair value over the five-year requisite service period with a debit to compensation cost and a credit to equity.

The \$80 million participation threshold, similar to other market conditions, will impact the valuation of the award but not whether compensation expense is recognized. In this situation, we believe it would be inappropriate to view the participation threshold as an implied liquidity event performance condition because distributions equal to the participation threshold do not have to occur for the employee to retain the award upon termination of employment or to realize value from the fair value call. See [Section 3.2.2](#) for further information on implied performance conditions.

4.4 Measurement objective and measurement date for liability-classified awards

At the grant date, the measurement objective for liability-classified share-based compensation arrangements is generally the same as the measurement objective for equity-classified awards. However, the final measurement date for liability-classified awards is the date of settlement. Accordingly, liability-classified share-based payment awards are remeasured at the end of each reporting period until the award is settled.

A public entity must remeasure a liability-classified award based on the award's fair value at each reporting date until the date of settlement. Compensation cost for each period until settlement is based on the change (or a portion of the change, depending on the percentage of the required service that has been rendered to date) in the fair value of the instrument for each reporting period.

A nonpublic entity must make a policy decision to either measure all of its liability-classified share-based payment arrangements at fair value or at intrinsic value. Regardless of the method selected, a nonpublic entity should also remeasure its liability-classified share-based payment arrangements at each reporting date until settled. This measurement alternative does not apply to awards determined to be consideration payable to customers; such awards must be measured initially and subsequently at fair value.

Changes in the fair value (or intrinsic value) of a liability that occur during the requisite service period for employee awards, and the vesting period for nonemployee awards, are recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) accrued as compensation cost at the end of each reporting period must equal the percentage of the requisite service rendered for an employee award or the percentage that would have been recognized had the grantor paid cash for the goods or

services instead of paying with a nonemployee award at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period for employee awards, and the vesting period for nonemployee awards, are compensation costs 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 is recognized as an adjustment of compensation cost in the period of settlement.

5. Estimating fair value

5.1 Fair value at grant date

When measuring share-based payments, the objective under ASC 718-10-30-6 is to estimate the fair value at the measurement date of the instrument that the entity is obligated to issue when the grantee has provided the required service and any other conditions necessary to earn the instrument have been satisfied. The fair value of the award is calculated based on the share price, as well as other relevant factors, such as expected volatility.

While ASC 718 refers to “fair value” as the measurement basis throughout the Topic, ASC 718-10-55-12 clarifies that ASC 718 actually utilizes a “fair-value-based method.” The fair value as determined under ASC 718 does not consider the impact of vesting provisions or other restrictions applicable prior to the grantee completing the requisite service or vesting period. Accordingly, “fair value” in ASC 718 is not a true fair value measure and differs from “fair value” as described in ASC 820.



ASC 718-10-55-12

An estimate of the amount at which instruments similar to share options and other instruments granted in share-based payment transactions would be exchanged would factor in expectations of the probability that the good would be delivered or the 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 grantees have delivered the good or rendered the 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 employee’s requisite service period or the nonemployee’s vesting period. Under the fair-value-based method required by this Topic, the effect of vesting conditions and other restrictions that apply only during the employee’s requisite service period or the nonemployee’s vesting period is reflected by recognizing compensation cost only for instruments for which the good is delivered or the service is rendered.

In determining the fair value of an award, restrictions and conditions included in the instrument are treated differently depending on whether they continue in effect after the requisite service has been provided and the award is vested. Only restrictions that remain in effect after an award vests, such as restrictions on transferring vested stock options or the inability to sell vested shares for a specified time, are considered in estimating the fair value of the award. For stock options, the fair value impact of a post-vesting restriction on transferability is generally reflected by factoring the restriction into the estimation of the option’s expected term.

In contrast, a restriction that results in forfeiture of an award for which a grantee has yet to earn the right is not considered in the fair value estimate. Provisions that lapse upon vesting include restrictions on exercising nonvested stock options or on the transfer of nonvested shares. Instead of impacting the fair value estimate, such restrictions are considered by recognizing compensation cost only for awards for which the requisite service is rendered or the related goods are delivered.

Keeping this in mind, the fair value of a nonvested share (commonly referred to as restricted stock in practice) should be determined as if the share was vested on the grant date. The fair value of a share that includes post-vesting restrictions (i.e., those that continue in effect after the employee has a vested right to the share) should be based on the amount a similarly restricted share would be issued to third parties.

Share-based payment awards ordinarily include performance or service conditions that must be met in order for the grantee to vest in an award. If the service or performance condition is not satisfied (for example, because the requisite service is not provided or goods are not delivered), no compensation expense is recognized for awards forfeited prior to vesting (see [Section 3.2](#)). Awards may also include market conditions. Unlike performance or service conditions, market conditions are considered in the fair value estimate. If all other terms were equal, an award with a market condition would generally have a lower fair value than an award without a market condition. This is because the uncertainty of obtaining the market condition, and the award becoming exercisable, is reflected in the fair value estimate. Because the effect of a market condition is reflected in the fair value of the award, compensation cost for an award with a market condition is recognized regardless of whether the market condition is achieved as long as the requisite service is provided or the goods are delivered. Thus, compensation cost recognized for an award would not be reversed solely because a market condition is not satisfied.

Performance conditions that affect an award's exercise price, contractual term, quantity, conversion ratio or other factors can impact the measurement of an award's grant-date fair value. As discussed in [Section 2.3.2](#), a grant-date fair value should be estimated for each possible outcome of such a performance condition, and the final measure of compensation cost should be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

5.2 Valuation techniques

5.2.1 General

Observable prices of identical or similar instruments in active markets provide the best evidence of fair value and, to the extent available, should be used in estimating the fair value of share-based payment awards. If available, the fair value of a stock option or a similar instrument should be measured based on the observable market price of a stock option with the same or similar terms. Otherwise, a valuation technique (such as the Black-Scholes-Merton formula) should be used to estimate the fair value of the award. Determining whether an instrument is similar should be based on an analysis of the award's terms and other relevant facts and circumstances.

If a valuation technique is used to estimate the fair value of the award, its application should be consistent with the fair value measurement objective and other requirements of ASC 718. The valuation technique must also be consistent with established principles of economic theory (such as time value of money) and should reflect all the substantive characteristics of the award (except as provided by ASC 718, including vesting provisions and reload features). The assumptions used in the valuation model should not represent the biases of a particular party. Some of these assumptions may be determined by reference to external data, while other assumptions may need to be derived from the entity's own historical experience (such as expected exercise behavior).

Keep in mind that the development of assumptions used in a valuation model is based on expectations and information available at the time of measurement (typically the grant date). While the fair value of an award may change over time as factors and expectations change, this is not indicative that a previous measurement, as of a single point in time, was incorrect. ASC 718-10-55-15 indicates:



ASC 718-10-55-15

Valuation techniques used for share options and similar instruments granted in share-based payment transactions 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.

5.2.2 Valuation techniques for stock options

ASC 718 does not indicate a preference for a particular valuation technique or model in estimating the fair values of stock options or similar instruments. A lattice model (such as a binomial model), a closed-form model (such as the Black-Scholes-Merton formula) and a Monte Carlo simulation are all examples of valuation techniques that may meet the criteria required by ASC 718 for estimating the fair values of a stock option or similar instrument. These valuation techniques or models are collectively referred to as option-pricing models.

While ASC 718 does not prescribe the use of a particular valuation technique or model, it does indicate that the technique or model chosen must be appropriate for the characteristics of the instrument being valued. For example, because the effect of a market condition must be factored into the valuation of an award, a model that can incorporate the impact of a market condition must be selected for estimating the fair value of a stock option with a market condition. Given a closed-form model does not incorporate the impact of a market condition, it would be an inappropriate choice to estimate the fair value of an award with a market condition. As different valuation techniques or models are designed to better reflect certain characteristics or conditions of an award, an entity that grants different types of instruments may appropriately use a different model for each type of instrument. However, an entity should use the same model for awards with similar substantive characteristics or conditions. Whatever technique or model is used to value an award, an entity must develop reasonable and supportable assumptions.

If an entity determines that a different model will result in a better estimate of fair value for stock options with certain characteristics, an entity can support changing the valuation technique prospectively. For example, an entity may determine that a lattice model would better achieve the ASC 718 measurement objective than the Black-Scholes-Merton model it had been using, and accordingly is able to justify a change in valuation technique. As a practical matter, justifying a switch from a lattice model to a closed-form model like Black-Scholes-Merton would be difficult. A change in valuation technique is considered to be a change in accounting estimate for purposes of applying ASC 250.

5.2.3 Selecting assumptions and inputs in an option-pricing model

A valuation technique or model used to value a stock option should at a minimum incorporate the following assumptions:

- The exercise price of the stock option
- The expected term of the stock option
 - In determining the expected term, the entity must consider the contractual term of the stock option and the vesting provisions of the award, as well as the impact of the grantee's expected exercise behavior and post-vesting termination behavior. When using a closed-form model, the expected term is an input to the model, but when using a lattice model, the expected term is an output.
- The current price of the underlying share
- The expected volatility of the underlying share price over the expected term
- The expected dividends on the underlying share over the expected term that would not be paid to the holder of the stock option

- This would not apply to dividend protected awards (i.e., stock options that are provided some sort of dividend right).
- The risk-free interest rate over the expected term of the stock option

The evaluation of the expected term, expected volatility and expected dividends may result in a range of reasonable estimates. If that is the case, the amount within the range that is more likely should be used. If no amount within the range is more or less likely than any other, an average of the amounts in the range is appropriate.

A good starting point for developing the assumptions in an option-pricing model is the historical experience of the entity. However, it may be necessary to adjust those expectations to the extent future circumstances are expected to differ. ASC 718 does not prescribe a weight to be placed on historical experiences; rather, ASC 718-10-55-24 indicates this is a matter of judgment based on the specific facts and circumstances and provides the following example.



Example 5-1: Adjustments to historical experiences based on future expectations

The following example is from ASC 718-10-55-24:

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 grantees' exercise and postvesting 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 grantees' exercise and postvesting 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 option or similar instrument; that expectation shall consider all relevant factors in paragraph 718-10-55-37, including possible mean reversion.

Historical information may not always be available to develop the assumption for use in an option-pricing model. Newly public entities and private companies often do not have sufficient historical pricing information upon which to base its stock volatility assumption. In those situations, the entity may determine its expected volatility by considering the average volatility of similar public entities (i.e., guideline public companies). Factors to consider in identifying similar entities include industry, size, stage of life cycle and leverage. Unless an entity is estimating calculated value, rather than fair value (as discussed in [Section 2.1.2](#)), it would not be acceptable to base expected volatility on an industry sector index.

5.2.3.1 Consistent methods for selecting assumptions

The methods used in developing assumptions and inputs in an option-pricing model should be applied in a consistent manner. For example, an entity may decide to use either the closing share price on the grant date or the share price at another specified time on the grant date as the "current" share price in estimating fair value. However, whichever method is selected, it must be applied consistently. A change in the method for developing assumptions used in a valuation model is a change in accounting estimate for purposes of applying ASC 250 and should be applied prospectively to new awards.

5.2.3.2 Risk-free interest rate assumption

The risk-free rate input in option-pricing models incorporates the time value of money by considering the impact of deferring the payment of the exercise price over the expected term of the option. A higher risk-free rate will result in a higher option value. ASC 718-10-55-28 provides guidance on determining the risk-free rate.



ASC 718-10-55-28

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 Black-Scholes model (a closed-form model) actually uses a continuous interest rate, which differs from the quoted rate available. Accordingly, the quoted yield must be adjusted to the continuously compounded interest rate. For example, using the Black-Scholes model, a quoted rate of 6.50 results in a continuously compounded interest rate of 6.30%.

5.2.3.3 Expected term assumption

While the fair value of a traded stock option is based on its contractual term, the fair value of an employee stock option must be based on its expected term, that is, the period of time an option is expected to be outstanding. This is because, while it is economically advantageous to hold a traded option until the end of its contractual term, employees (who typically hold nontransferable options) can only exercise the option to realize an economic benefit. A longer expected term will result in a higher option value.



ASC 718-10-55-29

The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable 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 option's value because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value. In addition, some employee share options contain prohibitions on exercise during blackout periods. To reflect the effect of those restrictions (which may lead to exercise before the end of the option's contractual term) on employee options relative to transferable options, this Topic requires that the fair value of an employee share option or similar instrument be based on its expected term, rather than its contractual term (see paragraphs 718-10-55-5 and 718-10-55-21).

When determining the fair value of a nonemployee stock option, an entity may elect, on an award-by-award basis, to use the contractual term as the expected term. If the entity does not elect to use the contractual term, the expected term should be determined in a manner consistent with that for employee awards, including considering factors such as whether the stock is transferable.

The expected term is the period of time between the service inception date and the exercise or settlement date. The expected term cannot be less than the vesting period or greater than the contractual term.



ASC 718-10-55-30

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 paragraphs 718-10-50-2 through 50-2A), 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.

Factors to consider in determining the expected term include:

- The vesting period, as the expected term must at least include the vesting period
- The entity's historical experience with employee exercise and post-vesting employment termination behavior for similar awards
- The expected volatility of the underlying share, as the share price volatility may impact employees' exercise behavior (e.g., if an option has been out-of-the money for an extended period of time, an employee may exercise soon after the option becomes in-the-money)
- Any blackout periods
- Employees' ages, lengths of service and locations (domestic or foreign)

Averaging the different exercise and post-employment termination behavior of different groups of employees to determine the expected term will potentially misstate the value of the entire award. Accordingly, it may be necessary to aggregate employees into identifiable and relatively homogenous groups and determine the expected term separately for each group. For example, the historical experience of an employer may indicate that the exercise and post-vesting termination behavior differs for

hourly employees, salaried employees and executives. As such, the entity may determine it is appropriate to separately determine an expected term for each group of employees.

Nonpublic entity practical expedient for determining the expected term

Nonpublic entities may elect a practical expedient for determining the expected term of stock options or similar awards with all of the following characteristics:

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

For stock options or similar instruments meeting these conditions, a nonpublic entity may make an entity-wide accounting policy election to determine the expected term under the practical expedient as follows:

- If the stock option only includes a service vesting condition, the expected term is estimated as the midpoint between the requisite service or vesting period and the contractual term of the award.
- If the stock option includes a performance vesting condition:
 - If the performance condition is probable of being achieved, the expected term is estimated as the midpoint between the requisite service or vesting period and the contractual term.
 - If the performance condition is not probable of being achieved, the expected term is estimated as either the contractual term, if the service period is implied, or the midpoint between the requisite service or vesting period and the contractual term, if the service period is stated explicitly.

If an award is liability-classified, the expected term estimate would be updated each reporting period until the award is settled. ASC 718-10-55-50A specifies that the updated estimate should reflect changes in time value, as well as any changes in the assessment of whether a performance condition is probable of being achieved.

Public entity practical expedient for determining the expected term

In SAB Topic 14.D (as codified in ASC 718-10-S99-1), the SEC staff provides a simplified method for calculating the expected term for employee stock options in certain situations.

SAB Topic 14.D.2 (in part):

Facts: Company E grants equity share options to its employees that have the following basic characteristics:⁷⁰

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;⁷¹
- 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.

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: 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: $\text{Expected term} = ((\text{vesting term} + \text{original contractual term}) / 2)$. 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.⁷² 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.⁷³

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. In addition, this simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

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.

⁷⁰ Employee share options with these features are sometimes referred to as “plain-vanilla” options.

⁷¹ In this fact pattern the requisite service period equals the vesting period.

⁷² Calculated as $\frac{[(1 \text{ year vesting term (for the first 25\% vested)} + 2 \text{ year vesting term (for the second 25\% vested)} + 3 \text{ year vesting term (for the third 25\% vested)} + 4 \text{ year vesting term (for the last 25\% vested)}] \div 4 \text{ total years of vesting} + 10 \text{ year contractual life}}{2}$; that is, $\frac{((1+2+3+4)/4) + 10}{2} = 6.25$ years.

⁷³ 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. Bizjak; and Michael L. Lemmon, "Exercise behavior, valuation, and the incentive effects of employee stock options," *Journal of Financial Economics*, May 2005, pp. 445-470. 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.

5.2.3.4 Expected volatility assumption

Volatility represents the amount by which the underlying stock price has either fluctuated or is expected to fluctuate during a period. A higher expected volatility will result in a higher option value. This is because a more volatile stock price provides the option holder with greater opportunity to benefit from potential increases in the value of the underlying stock, and an option's value is not affected by expected decreases in the underlying stock price below the strike price. While ASC 718 does not specify a method for determining the expected volatility assumption, it does indicate the estimate must be reasonable and supportable.



ASC 718-10-55-36

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 expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Because an option's value is unaffected by expected negative returns on the shares, other things equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility. This Topic does not specify a method of estimating expected volatility; rather, the following paragraph provides a list of factors that shall be considered in estimating expected volatility. An entity's estimate of expected volatility shall be reasonable and supportable.

ASC 718-10-55-37

Factors to consider in estimating expected volatility include the following:

- a. 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.
- b. 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.
 - c. 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.
 - d. 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.
 - e. 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.

ASC 718-10-55-38

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.

ASC 718-10-55-39

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.

ASC 718-10-55-40

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:

- a. Shall comprehend an identification of information available to the entity and applicable factors such as those described in paragraph 718-10-55-37
- b. Shall include a procedure for evaluating and weighting that information.

ASC 718-10-55-41

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).

After considering the factors for estimating expected volatility in ASC 718-10-55-37, an entity may reasonably conclude that exclusive reliance on either historical or implied volatility would provide a reasonable estimate of expected volatility. SAB Topic 14.D has guidance for companies with exchange traded options about the use of implied volatility and when exclusive reliance may be placed on implied volatility. Specifically, SAB Topic 14.D indicates that exclusive reliance may be placed on historical volatility when all of the following factors are present, and the methodology is consistently applied:

- The entity has no reason to believe that its future volatility is likely to differ from its past.
- The computation of historical volatility is based on a simple average calculation.
- The historical data is sequential and over a period at least equal to the expected term (if using a Black-Scholes-Merton closed-form model) or contractual term (if using a lattice model) of the share option, as applicable.
- There is a sufficient number of price observations used, which are measured at consistent points throughout the historical period.

SAB Topic 14.D further provides, in computing historical volatility, the following factors should be considered:

- *Method of Computing Historical Volatility.* The method selected to compute historical volatility should produce an estimate that represents a marketplace participant's expectations about its future volatility over the expected term or contractual term (as applicable) of its employee stock options. Certain methods may not be appropriate for longer-term employee share options if they weight the historical experience of the most recent periods much more heavily than earlier periods.
- *Amount of Historical Data.* While entities should consider historical volatility over a period generally commensurate with the expected or contractual term (as applicable) of the stock option, an entity could utilize a longer period of historical data if it reasonably believes the additional historical information will improve the estimate.
- *Frequency of Price Observations.* An entity should use appropriate and regular intervals for stock price observations in determining its historical volatility. Consideration should be given to the frequency of trading and length of trading history in determining an appropriate frequency for stock price observations. Using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides sufficient data points on which to base the estimate.
- *Consideration of Future Events.* An entity should consider those future events that it reasonably concludes a marketplace participant would also consider in estimating expected volatility. For example, if an entity has recently announced a merger with an entity that would change its business risk in the future, then the entity should consider the impact of the merger if it concludes a marketplace participant would consider this event.

- **Exclusion of Periods of Historical Data.** In some situations, a period of historical volatility data may not be relevant in determining expected volatility. This would be the case if the stock prices during that period are attributable to discrete and specific historical events and similar events are not anticipated during the expected term or contractual term (as applicable) of the share option. In those circumstances, it is appropriate to disregard data from that period. The SEC staff indicated they expect such situations would be rare and that if a company does disregard a period of historical volatility, it should be prepared to support its conclusion.

5.2.3.5 Expected dividends

In estimating the fair value of a stock option, option-pricing models consider the value of dividends that the option holder will forgo (i.e., is not entitled to receive as an option holder). Accordingly, an expected dividend (either the yield or payments) on the underlying share over the expected term is an input to an option-pricing model. However, this input would not be applicable to dividend-protected awards (i.e., stock options that are provided some sort of dividend right). A higher expected dividend assumption will result in a lower option value. ASC 718 provides the following guidance on estimating expected dividends:



ASC 718-10-55-42

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).

ASC 718-10-55-43

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.

ASC 718-10-55-44

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.

5.2.3.6 Current price

Nonpublic entity practical expedient for current price

The inputs into an option-pricing model include the fair value of the equity shares underlying a stock option (also called the current price input). With the issuance of ASU 2021-07, the FASB provided nonpublic entities with a practical expedient for determining the current price input.

Under the practical expedient, a nonpublic entity may use for the current price a value determined by the reasonable application of a reasonable valuation method. This practical expedient is only applicable for determining the fair value of an equity-classified award at the grant date or upon a modification. This practical expedient may not be used for liability-classified awards. ASC 718-10-30 describes factors and characteristics to consider in determining whether a valuation method is reasonable as well as additional considerations related to the application of the practical expedient.



ASC 718-10-30-20D

The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, shall be made based on the facts and circumstances as of the measurement date. Factors to be considered under a reasonable valuation method include, as applicable:

- a. The value of tangible and intangible assets of the nonpublic entity
- b. The present value of anticipated future cash flows of the nonpublic entity
- c. The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the nonpublic entity for which the stock is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's-length private transaction)
- d. Recent arm's-length transactions involving the sale or transfer of stock or equity interests of the nonpublic entity
- e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the nonpublic entity, its stockholders, or its creditors
- f. The nonpublic entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers.

In addition to the factors described in ASC 718-10-30-20D, a reasonable application of a reasonable valuation method must have the following characteristics:

- The reasonableness of the evaluation is evaluated as of the measurement date of the award.
- All available information material to the value of the entity is considered.
- If a previously calculated value is used, that value is within 12 months of the measurement date and is updated for any information available after the date of the calculation that may materially affect the value of the entity (for example, occurrence of a significant business combination or resolution of a material litigation).

The same factors and characteristics are used in Section 409A of the U.S. Internal Revenue Code (the Treasury Regulations) to describe the reasonable application of a reasonable valuation method for income tax purposes. Therefore, a valuation performed in accordance with the Treasury Regulations would meet the requirements of the practical expedient. Accordingly, for an entity adopting the practical expedient, it would not be necessary to obtain separate valuations to comply with ASC 718 and Section 409A of the Internal Revenue Code.

In BC20 of the Background Information and Basis for Conclusions of ASU 2021-07, the FASB notes that while a reasonable application of a reasonable valuation is not limited to a valuation by an independent

appraisal, it expects that an independent appraisal will often be the method used under the practical expedient.



BC20 of ASU 2021-07

The population of valuations that would be considered the reasonable application of a reasonable valuation for purposes of the practical expedient is not limited to the three methods that achieve the presumption of reasonableness under the Treasury Regulations. That is, other valuations, including internal valuations, could have the characteristics described in the practical expedient. However, it is expected that most nonpublic entities would use a valuation determined by an independent appraisal to determine the current price of a share underlying a share-option award. Outreach indicates that nonpublic entities often seek to achieve the rebuttable presumption of reasonableness for tax purposes and that an independent appraisal is the most common method used by nonpublic entities to achieve that rebuttable presumption. The other methods that achieve the rebuttable presumption of reasonableness are subject to restrictions, which results in those methods being used much less frequently.

A nonpublic entity electing the current price practical expedient must do so on a measurement-date-by-measurement-date basis. That is, the practical expedient would be applied to all awards within the scope of the practical expedient with the same underlying share and the same measurement date.

Entities should also consider the guidance included in the AICPA publication, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation – Accounting and Valuation Guide*, when determining or evaluating the current stock price input into the selected option pricing model.



Spotlight on change:

The AICPA's [Financial Reporting Executive Committee](#) (FinREC) has issued a working draft of the updated AICPA Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*. This proposed update reflects the continued evolution of what the AICPA Equity Securities Task Force considers to be best practices both in valuation and in the application of GAAP in this area, as well as changes in the authoritative accounting guidance since the date of the last edition of the guide. There are substantive changes to a number of sections of this guide, including updated guidance on allocating value between different classes of securities in complex capital structures and the impact of secondary transactions. We recommend entities consider these updates and monitor the progress of this project.

Public entity considerations when in possession of material non-public information

In SAB Topic 14.D, the SEC staff provides guidance on the proper recognition and disclosure of compensation costs for “spring-loaded” awards made to executives. Spring-loaded awards are share-based compensation arrangements through which an entity grants stock options or similar awards while in possession of material non-public information to which the market is likely to react positively when the information is announced (e.g., an earnings release with better-than-expected results or the disclosure of a significant transaction).

In order for or a valuation technique to be consistent with the fair value measurement objective of ASC 718, the SEC staff believes that the determination of the current price of the underlying share should consider whether adjustments to observable market prices are required. In this regard, the SEC staff believes that non-routine spring-loaded grants merit particular scrutiny.

When an entity is in possession of positive material non-public information, the SEC staff believes the entity should consider the impact that the information will have upon release and whether adjustments to the current price of the underlying share or the expected volatility of the price of the underlying share for

the expected term are necessary when estimating the fair value of a stock option or similar award. (In other words, when recognizing compensation cost for the award, the entity should reflect the additional value conveyed to the recipients from the anticipated announcement of the material information.) SAB Topic 14.D includes examples where such adjustments may be necessary.

6. Modifications of awards

6.1 Accounting for modifications

6.1.1 General

Under ASC 718, a modification is a change in any of the terms or conditions of an award. Common examples of modifications include:

- Repricing of an award
- Change in an award's vesting terms
- Acceleration of an employee's vesting in an award (see [Section 6.2](#))
- Reclassification of an award (equity to liability or vice versa) (see [Section 6.3](#))
- An inducement (see [Section 6.4](#))
- Modification in an equity restructuring or business combination (see [Section 6.5](#))

Under ASC 718, an entity should apply modification accounting unless the following guidance is applicable:



ASC 718-20-35-2A

An entity shall account for the effects of a modification as described in paragraphs 718-20-35-3 through 35-9, unless all the following are met:

- The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification.
- The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified.
- The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified.

The disclosure requirements in paragraphs 718-10-50-1 through 50-2A and 718-10-50-4 apply regardless of whether an entity is required to apply modification accounting.

A modification of an equity-classified award is generally accounted for as the exchange of the original award for a new award. The only exception to the standard accounting for modifications occurs when the modification results in all of the following:

- No change in the fair value of the award (based on a comparison of the value of the award immediately before and after the modification)
- No change in the vesting conditions of the award
- No change in the classification of the award

If all three of these criteria are met, then the modification is excluded from the scope of the modification accounting guidance discussed in this section. However, the disclosure requirements for modifications discussed in [Chapter 7](#) still apply.

ASC 718-20-35-3 addresses the accounting treatment for a modification.



ASC 718-20-35-3

Except as described in paragraph 718-20-35-2A, 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 718-10-35-1D or 718-10-35-3 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 promised good is expected to be delivered (or has already been delivered) or the 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 718-10-35-1D or 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 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.

A modification of both equity and liability awards are generally 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. For modifications of equity awards, on the other hand, the entity in substance repurchases the original instrument by issuing a new instrument, incurring additional compensation cost for any incremental value transferred (the incremental compensation cost). Incremental compensation cost is recognized immediately for vested awards. For unvested equity-classified awards, incremental compensation cost is recognized prospectively, along with any remaining grant-date fair value, over the remaining service period.

To determine the incremental cost of the modification, the entity should compare the fair value of the modified award to the fair value of the award immediately before its terms are modified. If an equity award

was originally measured at intrinsic value in accordance with ASC 718-20-35-1, the incremental cost should be measured by comparing the intrinsic value of the modified award with the intrinsic value of the award immediately before the modification. The measurement of the fair value (or intrinsic value) of the award immediately before the modification should reflect the stock price and other assumptions as of that date. The incremental compensation cost, if any, is then added to the portion of the grant-date fair value of the award immediately before the modification for which the requisite service has been, or is expected to be, rendered.



If the modification changed the number of instruments expected to vest, that effect should be reflected in the calculation of the incremental compensation cost and will continue to be subsequently adjusted for changes in estimates, as necessary.

For an equity-classified award, total compensation cost recognized for a modified award should at least equal the original grant-date fair value if, at the date of modification, the performance or service conditions of the original award were expected to be satisfied.

Said differently, if the vesting conditions of the original award would have been satisfied, the entity must recognize compensation cost for at least the original grant-date fair value, regardless of whether the modified conditions are satisfied.

In contrast, if at the date of modification awards are not expected to vest under the original vesting conditions, an entity should recognize compensation cost only if the awards vest under the modified vesting conditions. In other words, if the entity believes that the original performance or service vesting condition is not probable of being achieved 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.

There are four possible combinations when considering the assessment of the probability of vesting immediately before and after modification:

Type	Expectations of vesting immediately before modification	Expectations of vesting immediately after modification
Type I	Probable	Probable
Type II	Probable	Improbable
Type III	Improbable	Probable
Type IV	Improbable	Improbable

The table below summarizes the accounting impact of each type of modification:

Type	Compensation expense to be recognized	Fair value measurement date(s)
Type I, Probable to Probable	Original grant date fair value plus any incremental fair value	Grant date and modification date (before and after modification)
Type II, Probable to Improbable	Original grant date fair value only unless modified vesting conditions become probable of occurring	Grant date
Type III, Improbable to Probable	Fair value of the modified award	Modification date (after modification)
Type IV, Improbable to Improbable	None – incremental fair value only if the modified vesting conditions become probable of occurring	Modification date (after modification)

The following examples illustrate the four types of modifications and the resulting accounting treatment.



Example 6-1: Type I Probable-to-probable modification

The following example is *Example 14—Modifications of Awards with Performance and Service Vesting Conditions, Case A* from ASC 718-20-55-109 and ASC 718-20-55-111 through 55-112:

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.

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.

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.



Example 6-2: Type II Probable-to-improbable modification

The following example is *Example 14—Modifications of Awards with Performance and Service Vesting Conditions, Case B* from ASC 718-20-55-109 and ASC 718-20-55-113 through 55-115:

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.

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
Incremental compensation cost of modification	\$-

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.

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.



Example 6-3: Type III Improbable-to-probable modification

The following example is *Example 14—Modifications of Awards with Performance and Service Vesting Conditions, Case C* from ASC 718-20-55-109 and ASC 718-20-55-116 through 55-117:

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.

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

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.



Example 6-4: Type IV Improbable-to-improbable modification

The following example is *Example 14—Modifications of Awards with Performance and Service Vesting Conditions, Case D* from ASC 718-20-55-109 and ASC 718-20-55-118 through 55-119:

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.

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.

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 \times \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.

The following examples demonstrate the accounting for the modification of vested and nonvested stock options.



Example 6-5: Modification of a vested share option

The following example is *Example 12—Modifications and Settlements, Case A* from ASC 718-20-55-94 through 55-96 and is based on Example 1, Case A (ASC 718-20-55-10), in which Entity T granted its employees 900,000 share options:

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.

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.

Fair value of modified share option at January 1, 20X9	\$7.14
Less: Fair value of original share option at January 1, 20X9	3.67
Additional compensation cost to be recognized	\$3.47

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.



Example 6-6: Share settlement of vested share options

The following example is *Example 12—Modifications and Settlements, Case B* from ASC 718-20-55-97 and is based on Example 1, Case A (ASC 718-20-55-10), in which Entity T granted its employees 900,000 share options:

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.



Example 6-7: Modification of nonvested share options

The following example is *Example 12—Modifications and Settlements, Case C* from ASC 718-20-55-98 through 55-101 and is based on Example 1, Case A (ASC 718-20-55-10), in which Entity T granted its employees 900,000 share options:

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.

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

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 ($\$14.69 \div 3$) 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

That amount is recognized during 20X6 and 20X7, the two remaining years of the requisite service period.

6.1.2 Impact of forfeiture policy on modifications

As discussed in [Section 3.4](#), an entity can make an accounting policy election to account for forfeitures as they occur. When computing the incremental compensation cost of the modification, an entity that has elected to account for forfeitures when they occur must assess at the date of the modification whether the performance or service conditions of the original award are expected to be satisfied. However, when subsequently accounting for the modified award, the entity would still continue to apply its accounting policy to account for forfeitures when they occur.

6.1.3 Accounting for modifications of market conditions

Rather than being considered a vesting condition, market conditions are used in determining the fair value of an award (see [Section 2.3.1](#)). As a result, the probability of meeting a market condition does not impact whether compensation cost is recognized for the award, nor does it impact the accounting for modifications of market conditions. As long as the requisite service is provided, the ultimate cost

recognized for a modified market condition award will be at least the original grant-date fair value, plus any incremental cost arising as a result of the modification. [Section 6.1.1](#) discusses the general principle of accounting for modifications.

6.2 Acceleration of vesting of deep out-of-the-money share options

Declines in stock values may lead companies to contemplate accelerating the vesting of out-of-the-money stock options. After considering the extent of market decline, companies may conclude that past awards of stock options containing exercise prices significantly higher than current stock prices (i.e., out-of-the-money) provide the employee and the entity with little value. Given the lack of future benefit, as there is little incentive for an employee to remain with the entity and complete the service period required for vesting, some companies consider modifications to the award that would immediately vest it and expect the accounting result to be immediate recognition of the remaining compensation expense. This is viewed by some as preferable to recognizing the compensation expense over the remaining original vesting period.

Acceleration of the vesting of out-of-the-money options raises some accounting issues. Under ASC 718, the compensation cost for an award of share-based employee compensation is recognized over the requisite service period. 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. Requisite service periods may be explicit, implicit or derived from certain valuation techniques, depending on the terms of the share-based payment award. [Section 3.1](#) discusses estimating the requisite service period.

ASC 718-10-55-67 specifies that the estimate of requisite service period should 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 later modified to accelerate vesting at a time when the award is deep out-of-the-money, that modification is not substantive, as the explicit service condition is replaced by a derived service condition. Considering the guidance provided in ASC 718, we believe the following conclusions on issues relating to acceleration of vesting of deep out-of-the-money options are appropriate:

6Q.6.1 *Does the acceleration of the vesting of a deep out-of-the-money option result in the acceleration of compensation cost?*

No. If the acceleration of the vesting of the award is determined to be nonsubstantive, it would not be appropriate to accelerate recognition of the remaining compensation expense.

The derived service period must be evaluated to determine whether the employee has received a benefit from the acceleration at the modification date. A service period is inferred from the application of certain valuation techniques used to estimate fair value (typically a lattice model).

The underlying presumption is that, because the option is out-of-the-money at the acceleration of the vesting date, it will take some time for the stock price to recover to the point of becoming in-the-money and, thus, of benefit to the employee. Accordingly, the acceleration of vesting of a deep out-of-the-money award will likely result in a derived service period for the modified awards. Effectively, the exercise price of an out-of-the-money option is considered a market condition because an employee must remain employed until the stock price recovers in order to benefit from the award.

6Q.6.2 *If it is determined that a modification to accelerate vesting is not substantive, should the derived service period become the requisite service period?*

No. If the acceleration is viewed as nonsubstantive, the remaining unrecognized compensation expense should be recognized over the remaining requisite service period of the original award, not the derived service period.

There are no rules of thumb as to when an option is deep out-of-the-money and when a modification is nonsubstantive, and, accordingly, judgment is required. However, in performing an evaluation of the derived service period, a resulting derived service period greater than the remaining original vesting period would be a clear indicator that the acceleration of vesting is nonsubstantive.

6.3 Modifications that change an award's classification

As discussed in [Chapter 4](#), awards may be classified as equity or liabilities, depending on a variety of factors. Accordingly, a modification to an award may result in a change in classification. In addition, an award may be initially classified as equity, but subsequently become a liability because a contingent cash settlement feature becomes probable or an entity's practice of cash settling awards indicates a substantive liability exists (even if the terms of the award do not provide for cash settlement). Such changes in classification due to a change in the probable settlement outcome are also accounted for as a modification.

[Section 6.1](#) describes the general accounting model that should be applied to modifications. Under this model, as long as the service or performance conditions are expected to be satisfied, compensation cost should be equal to at least the fair value of the award at the grant date.

When applying this principle to an equity award that is modified to a liability award, an entity would recognize cumulative compensation cost equal to the greater of:

- The grant-date fair value of the original equity award (assuming any service or performance conditions in the original award were probable of being achieved)
- The fair value of the modified liability award when settled

As of the modification date, the entity would recognize a liability based on the fair value of the award as of the modification date and the portion of the requisite service that has been rendered. To the extent that the liability is equal to or less than the amount previously recognized in equity for the award, the offsetting debit would be to equity. To the extent that the liability exceeds the amount previously recognized in equity for the award, the excess would be recognized as additional compensation cost. Going forward, the entity would need to apply the accounting for liability-classified awards discussed in [Chapter 4](#) and remeasure the award at each reporting date until settlement. Again, the amount of compensation cost recognized generally must be at least equal to the grant-date fair value of the original award. If the value of the liability declines below the grant-date fair value of the original award, the difference is credited to equity (not compensation cost).

An entity may also modify an award initially classified as a liability in a manner such that equity classification is appropriate. This would be the case if, for example, a cash settlement option is removed. When an entity modifies a liability award to become an equity award, it would first remeasure the liability one last time and then reclassify that amount to equity. Then modification guidance in [Section 6.1](#) would be applied, meaning it 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 in equity. Subsequent to the modification date, the award would no longer be revalued. If the award is modified from liability-classified to equity-classified, and upon reclassification, the fair value of the award has decreased as a result of the modification, that change in fair value is recorded to equity as a capital contribution. The change in fair value is not recorded as a reduction in compensation cost. The decision to accept an award at a lower fair value is made by the award holder as part of the modification of the award and therefore should be recorded to equity.

The following examples illustrate the application of this guidance to modifications that could impact the classification of an award.



Example 6-8: Equity to liability modification (share-settled share options to cash-settled share options)

The following example is *Example 16—Modifications Regarding an Award’s Classification, Case A* from ASC 718-20-55-123 through 55-133:

Entity T grants the same share options described in Example 1, Case A (see paragraph 718-20-55-10). As in Example 1, Case A, Entity T has an accounting policy to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3. The number of options for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 ($900,000 \times .97^3$). 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 ($821,406 \times \14.69), and the compensation cost to be recognized during each year of the 3-year vesting period is \$4,022,151 ($\$12,066,454 \div 3$). The journal entries for 20X5 are the same as those in paragraph 718-20-55-12.

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 ($821,406 \times \7), and the liability to be recognized at the modification date is \$1,916,614 ($\$5,749,842 \div 3$). The related journal entry follows.

Additional paid-in capital	\$1,916,614	
Share-based compensation liability		\$1,916,614

To recognize the share-based compensation liability.

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 ($\$4,022,151 - \$1,916,614$).

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:

- a. The grant-date fair value of the original equity award
- b. The fair value of the modified liability award when it is settled.

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 – \$1,916,614). 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.

Compensation cost	\$9,667,949	
Additional paid-in capital	\$2,105,537	
Share-based compensation liability		\$11,773,486

To increase the share-based compensation liability to \$13,690,100 and recognize compensation cost of \$9,667,949 (\$13,690,100 – \$4,022,151).

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.

Share-based compensation liability	\$5,476,040	
Compensation cost		\$1,623,646
Additional paid-in capital		\$3,852,394

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			
Year	Total Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X5	\$12,066,454 (821,406 x \$14.69)	\$4,022,151 (\$12,066,454 ÷ 3)	\$4,022,151
20X6	\$20,535,150 (821,406 x \$25.00)	\$9,667,949 [(\$20,535,150 x 2/3) - \$4,022,151]	\$13,690,100
20X7	\$12,066,454 (821,406 x \$14.69)	\$(1,623,646) (\$12,066,454 - \$13,690,100)	\$12,066,454

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.

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. The tax benefit is \$2,874,921 (\$8,214,060 × .35). Because 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 from the exercise of employee stock options to income tax expense in the income statement. The journal entries to reflect settlement of the share options are as follows.

Share-based compensation liability	\$8,214,060	
Cash (\$10 x 821,406)		\$8,214,060

To recognize the cash paid to settle share options.

Deferred tax expense	\$4,223,259	
Deferred tax asset		\$4,223,259

To write off deferred tax asset related to compensation cost (\$12,066,454 × .35 = \$4,223,259).

Current taxes payable	\$2,874,921	
Current tax expense		\$2,874,921

To adjust current tax expense and current taxes payable for the tax benefit from deductible compensation cost upon settlement of share options.

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 described in paragraph 718-20-55-132, all of the deferred tax asset of \$4,223,259 would be charged to income tax expense when the share options expire.



Example 6-9: Equity to equity modification (share options to shares)

The following example is *Example 16—Modifications Regarding an Award’s Classification, Case B* from ASC 718-20-55-134:

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. Entity T considers the guidance in paragraph 718-20-35-2A. Because the change in the terms or conditions of the award changes the vesting conditions of the award, Entity T applies modification accounting. However, 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.



Example 6-10: Liability to equity modification (cash-settled to share-settled stock appreciation rights)

The following example is *Example 16—Modifications Regarding an Award’s Classification, Case C* from ASC 718-20-55-135 through 55-138:

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).

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.

Compensation cost	\$2,738,020	
Share-based compensation liability		\$2,738,020

To recognize compensation cost.

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).

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.

Share-based compensation liability	\$2,738,020	
Additional paid-in capital		\$2,738,020

To reclassify the award as equity.

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.



Example 6-11: Liability to liability modification (cash-settled to cash-settled stock appreciation rights)

The following example is *Example 16—Modifications Regarding an Award's Classification, Case D* from ASC 718-20-55-139 through 55-143:

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).

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 ($\$4,107,030 \div 3$), 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.

Compensation cost	\$1,369,010	
Share-based compensation liability		\$1,369,010

To recognize compensation cost.

Deferred tax asset	\$479,154	
Deferred tax benefit		\$479,154

To recognize the deferred tax asset for the temporary difference related to compensation cost ($\$1,369,010 \times .35 = \$479,154$).

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).

Fair value of modified stock appreciation right award (821,406 x \$12)	\$9,856,872
Less: Fair value of original stock appreciation right (821,406 x \$5)	4,107,030
Incremental value of modified stock appreciation right	5,749,842
Divide by three to reflect earned portion of the award	÷ 3
Compensation cost to be recognized	\$1,916,614

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 $[(\$9,856,872 \div 3) - \$1,369,010 = \$1,916,614]$. As a result, Entity T would record the following journal entries at the date of the modification.

Compensation cost	\$1,916,614	
Share-based compensation liability		\$1,916,614

To recognize incremental compensation cost.

Deferred tax asset	\$ 670,815	
Deferred tax benefit		\$670,815

To recognize the deferred tax asset for the temporary difference related to additional compensation cost $(\$1,916,614 \times .35 = \$670,815)$.

Entity T would continue to remeasure the liability award at each reporting date until the award's settlement.



Example 6-12: Equity to liability modification (share options to fixed cash payment)

The following example is *Example 16—Modifications Regarding an Award's Classification, Case E* from ASC 718-20-55-144:

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. Entity T considers the guidance in paragraph 718-20-35-2A. Because the change in the terms or conditions of the award changes the classification of the award from equity to liability, Entity T applies modification accounting. This transaction is considered a modification instead of a settlement 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

$[(821,406 \times \$2) \times (1 \text{ year of requisite service rendered} \div 3\text{-year requisite service period})]$, 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 ($821,406 \times \2) should be fully accrued by the end of the requisite service period. Because the possible tax deduction of the modified award is capped at \$1,642,812, Entity T also must adjust its deferred tax asset at the date of the modification to the amount that corresponds to the recognized liability of \$547,604. That amount is \$191,661 ($\$547,604 \times .35$), and the write-off of the deferred tax asset is \$1,216,092 ($\$1,407,753 - \$191,661$). That write-off would be recognized as income tax expense in the income statement. Compensation cost of \$4,022,151 would be recognized in each of 20X6 and 20X7 for a cumulative total of \$12,066,454 (as calculated in Case A); of this, \$547,604 would be recognized as an increase to the liability balance, with the remaining \$3,474,547 recognized as an increase in additional paid-in capital. A deferred tax benefit would be recognized in the income statement, and a corresponding increase to the deferred tax asset would be recognized for the tax effect of the increased liability of \$191,661 ($\$547,604 \times .35$). The compensation cost recognized in additional paid-in capital in this situation has no associated income tax effect (additional deferred tax assets are recognized based only on subsequent increases in the amount of the liability).

6.4 Inducements

When attempting to modify, replace, settle or repurchase an existing award, entities will sometimes offer an inducement to encourage the award holder to accept their offer. When the offer is only available for a limited period of time, it is known as a "short-term inducement." A short-term inducement should be accounted for as a modification of the terms only for the awards of grantees who accept the inducement, rather than a modification of all awards subject to the inducement. The FASB does not define what is considered a limited period of time, but we believe it would generally be viewed as a few weeks, with consideration given to the amount of time necessary for the offer to be communicated, reviewed and accepted, as well as to comply with applicable securities law. When the inducement is not considered short-term, it should be accounted for as a modification of all awards subject to the inducement.

6.5 Equity restructurings

Exchanges of stock options or other equity instruments, or changes to their terms in conjunction with an equity restructuring or a business combination, are considered modifications. An "equity restructuring" is defined 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."

Because equity restructurings can have significant dilutive effects on the value of a stock option, many awards include antidilution provisions within the original award documents that are designed to keep the holder whole (i.e., keep the holder in the same economic position after the restructuring as before). However, if such a provision was not included, an entity may choose to add an antidilution provision at a later date. If, at the time of the modification to add an antidilution provision, there is no expectation of an equity restructuring, the award's fair value may not change as a result of the modification. In such cases, the change may not need to be accounted for as a modification, as it may meet the scope exception under ASC 718-20-35-2A described in [Section 6.1.1](#). That is, modification accounting would not be applied if (1) there is no change in the fair value (or other alternative measurement basis) of the award as a result of the modification, (2) there is no change in the vesting terms, and (3) the classification of the award remains the same after the modification. If, however, the modification to add an antidilution provision is made when an equity restructuring is being planned, the fair value of the modified award would likely be higher than the original award, which would result in the entity recognizing the incremental cost over the remaining vesting period.

Refer to Section 11.7 in [A guide to accounting for business combinations](#) for accounting considerations for share-based payment awards in a business combination.

The following examples illustrate the modification of awards as a result of an equity restructuring.



Example 6-13: Modification of an award that contains antidilution provisions

The following example is *Example 13—Modifications Due to an Equity Restructuring, Case A* from ASC 718-20-55-104:

In this Case, assume an award contains antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On October 12 the equity restructuring occurs and the terms of the award are modified in accordance with the antidilution provisions. In this Case, the modification occurs on October 12 when the terms of the award are changed. The fair value of the award is compared pre- and postmodification on October 12. The calculation of fair value is necessary to determine whether there is any incremental value transferred as a result of the modification, and if so, that incremental value would be recognized as additional compensation cost. If there is no change in fair value, vesting conditions, or the classification of the award, the entity would not account for the effect of the modification (see paragraph 718-20-35-2A).



RSM COMMENTARY: When an award contains a nondiscretionary antidilution provision designed to maintain the value of an award and there is an announcement of a future equity restructuring, the first criterion of ASC 718-20-35-2A is generally met, meaning that there is no change in the fair value. The exact manner in which the antidilution provision is executed in order to ensure the award holder is made whole does not impact this evaluation so long as adjusting the awards to achieve an equitable value is required.



Example 6-14: Modification of an award that does not contain antidilution provisions

The following example is *Example 13—Modifications Due to an Equity Restructuring, Case B* from ASC 718-20-55-105:

In this Case, the original award does not contain antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On July 26 the terms of an award are modified to add antidilution provisions in contemplation of an equity restructuring. On September 30 the equity restructuring occurs. In this Case, there are two modifications to account for. The first modification occurs on July 26, when the terms of the award are changed to add antidilution provisions. There must be a comparison of the fair value of the award pre- and postmodification on July 26 in accordance with paragraph 718-20-35-2A to determine whether the entity should account for the effects of the modifications as described in paragraphs 718-20-35-3 through 35-9. The premodification fair value on July 26 is based on the award without antidilution provisions taking into account the effect of the contemplated restructuring on its value. The postmodification fair value is based on an award with antidilution provisions, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation cost. Once the equity restructuring occurs, there is a second modification event on September 30 when the terms of the award are changed in accordance with the antidilution provisions. A second comparison of pre- and postmodification fair values is then required to determine whether the fair value of the award has changed as a result of the modification. If there is no change in fair value, vesting conditions, or the classification of the award, the entity would not account for the effect of the modification on September 30 (see paragraph

718-20-35-2A). Changes to the terms of an award in accordance with its antidilution provisions typically would not result in additional compensation cost if the antidilution provisions were properly structured. If there is a change in fair value, vesting conditions, or the classification of the award, the incremental value transferred, if any, would be recognized as additional compensation cost.



Example 6-15: Modification of an award that does not contain antidilution provisions but is modified on the date of an equity restructuring

The following example is *Example 13—Modifications Due to an Equity Restructuring, Case C* from ASC 718-20-55-106:

Assume the same facts as in Case B [[Example 6-14](#)] 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.

6.6 Repurchases or cancellations of equity awards

A repurchase occurs when an entity buys back a previously issued award, generally in exchange for cash or other assets, although a repurchase can also occur for no consideration. A repurchase feature for no consideration that is built into the original award may be considered an in-substance forfeiture provision (see [Section 4.2.2.4](#)). For example, a repurchase feature that allows an entity to reacquire shares at no cost if the grantee terminates employment within a specified period of time is essentially a forfeiture provision. However, when an entity cancels an award that is not accompanied by a concurrent replacement (see [Section 6.7](#)), that should be accounted for as a repurchase for no consideration.

ASC 718-20-35-7 provides that when repurchasing an equity award, the entity should compare the amount paid to repurchase the award to the fair value at the repurchase date. If the amount of cash or other assets transferred (or liabilities incurred) to repurchase the award is less than the fair value of the award, the entire amount should be charged to equity. If, on the other hand, the repurchase price exceeds the fair value, only the amount up to the fair value of the equity instruments repurchased at the repurchase date should be charged to equity. Any excess of the repurchase price over the fair value of the instruments repurchased should be recognized as additional compensation cost.

When an entity repurchases an award for which the service has not been rendered or the promised goods delivered, the entity has, in effect, modified the requisite service period to the period for which service already has been rendered and accelerated the vesting of the award. As a result, any remaining unrecognized compensation (as measured at the grant date) should be recognized at the repurchase date.



Example 6-16: Cash settlement of nonvested share options

The following example is *Example 12—Modifications and Settlements, Case D* from ASC 718-20-55-102 and is based on Example 1, Case A (ASC 718-20-55-10), in which Entity T granted its employees 900,000 share options:

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.

In determining whether an equity repurchase or settlement pursuant to ASC 718-20-35-7 or a modification to a liability pursuant to ASC 718-10-25-9 has occurred, there are several factors we believe an entity should consider. These include whether the repurchase was pursuant to an existing repurchase option (for example, a company call option) or a separately negotiated repurchase (for example, in conjunction with a recapitalization), as well as the frequency of such repurchases. Consideration should also be given to whether the settlement of the award continues to be indexed to the company's stock or if continued service is required.

If the repurchase of an award is not pursuant to an existing purchase option (for example, if the company's call is only available upon termination of employment), the guidance in ASC 718-20-35-7 for equity repurchases or settlements typically would apply. However, if the company has established a history of such repurchases or if the repurchase is of an immature share pursuant to an existing repurchase right, consideration should be given to whether the award was modified to a liability and, accordingly, if modification accounting is applicable.

6.7 Cancellation and replacement of awards of equity instruments

A cancellation of an award that is accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration should be accounted for as a modification. This is unlike a cancellation without a concurrent grant, which is accounted for as a repurchase for no consideration with any previously unrecognized compensation cost recognized at the cancellation date (see [Section 6.6](#)).

In applying the principles of accounting for a modification, incremental compensation cost should 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 determined as of the cancellation date. The total compensation cost measured would be the portion of the grant-date fair value of the original award for which the service is expected to be rendered (or has already been rendered) or the promised good is expected to be delivered at that date plus the incremental cost resulting from the cancellation and replacement.

6.8 Modifications of an award when the holder is no longer providing service

Pursuant to ASC 718-10-35-10, a freestanding financial instrument or convertible security issued to a grantee that is subject to initial recognition and measurement guidance in ASC 718 would continue to be subject to the recognition and measurement guidance in ASC 718 throughout the life of the instrument, unless its terms are modified after the grantee (a) is no longer an employee, (b) vests in an award and is no longer providing goods or services, or (c) vests in the award and is no longer a customer.

However, for purposes of applying ASC 718-10-35-10 and determining whether an award becomes subject to other GAAP, a modification does not include a change to the terms of the award solely to reflect an equity restructuring if there is no increase in the value of the award and all holders of the same class of equity instruments are treated the same in the modification.

**ASC 718-10-35-10A**

Only for purposes of paragraph 718-10-35-10, 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

For example, if subsequent to termination of employment, a former employee's vested stock options were modified in an equity restructuring, as long as the criteria in ASC 718-10-35-10A are met, the stock option would continue to be accounted for under ASC 718 and would not be subject to other applicable GAAP.

Other modifications of that instrument that take place when the holder is no longer an employee are subject to the modification guidance in ASC 718 as discussed above. Following the modification, recognition and measurement of the instrument should be determined through reference to other applicable GAAP (such as ASC 480 and ASC 815).

**ASC 718-10-35-11**

Other modifications of that instrument that take place after a grantee vests in the award and is no longer providing goods or services, is no longer a customer, or is no longer an employee should be subject to the modification guidance in paragraph 718-10-35-14. Following modification, recognition and measurement of the instrument shall be determined through reference to other applicable GAAP.

ASC 718-10-35-12

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.

ASC 718-10-35-14

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 the holder of the financial instrument. 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 grantees (or their beneficiaries) may stem from the employment or vendor 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.

7. Disclosure

ASC 718 provides the following overall guidance related to disclosure of information for share-based payment arrangements:



ASC 718-10-50-1

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:

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

This disclosure is not required for interim reporting. For interim reporting see Topic 270. See Example 9 (paragraphs 718-10-55-134 through 55-137) for an illustration of this guidance.

[Following the adoption of ASU 2025-11, the final paragraph will read:

This disclosure is not required for interim reporting. See Example 9 (paragraphs 718-10-55-134 through 55-137) for an illustration of this guidance.]

ASC 718-10-50-2

The following list indicates the minimum information needed to achieve the objectives in paragraph 718-10-50-1 and illustrates how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

- a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:
 1. The employee's requisite service period(s) and, if applicable, the nonemployee's vesting period and any other substantive conditions (including those related to vesting)
 2. The maximum contractual term of equity (or liability) share options or similar instruments
 3. The number of shares authorized for awards of equity share options or other equity instruments.
- b. The method it uses for measuring compensation cost from share-based payment arrangements.
- c. For the most recent year for which an income statement is provided, both of the following:
 1. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):
 - i. Those outstanding at the beginning of the year
 - ii. Those outstanding at the end of the year

- iii. Those exercisable or convertible at the end of the year
- iv. Those that during the year were:
 - 01. Granted
 - 02. Exercised or converted
 - 03. Forfeited
 - 04. Expired.
- 2. The number and weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured pursuant to paragraph 718-10-30-21) of equity instruments not specified in (c)(1), for all of the following groups of equity instruments:
 - i. Those nonvested at the beginning of the year
 - ii. Those nonvested at the end of the year
 - iii. Those that during the year were:
 - 01. Granted
 - 02. Vested
 - 03. Forfeited.
- d. For each year for which an income statement is provided, both of the following:
 - 1. The weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 718-10-30-21 through 30-22) of equity options or other equity instruments granted during the year
 - 2. The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.
- e. For fully vested share options (or share units) and share options expected to vest (or unvested share options for which the employee's requisite service period or the nonemployee's vesting period has not been rendered but that are expected to vest based on the achievement of a performance condition, if an entity accounts for forfeitures when they occur in accordance with paragraph 718-10-35-1D or 718-10-35-3) at the date of the latest statement of financial position, both of the following:
 - 1. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic entities), and weighted-average remaining contractual term of options (or share units) outstanding
 - 2. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic entities), and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).
- f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 718-10-30-21 through 30-22 is not required to disclose the following information for awards accounted for under that method):

1. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements
2. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):
 - i. Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and grantees' expected exercise and postvesting termination behavior into the fair value (or calculated value) of the instrument.
 - ii. Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. A nonpublic entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.
 - iii. Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.
 - iv. Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.
 - v. Discount for postvesting restrictions and the method for estimating it.
 - vi. Practical expedient for current price input. A nonpublic entity that elects to apply the practical expedient in paragraphs 718-10-30-20C through 30-20F shall disclose that election.
- g. An entity that grants equity or liability instruments under multiple share-based payment arrangements shall provide the information specified in paragraph (a) through (f) separately for different types of awards (including nonemployee versus employee) to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.
- h. For each year for which an income statement is presented, both of the following:
 1. Total compensation cost for share-based payment arrangements

- i. Recognized in income as well as the total recognized tax benefit related thereto
- ii. Capitalized as part of the cost of an asset.
- 2. A description of significant modifications, including:
 - i. The terms of the modifications
 - ii. The number of grantees affected
 - iii. The total (or lack of) incremental compensation cost resulting from the modifications.
- i. As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized
- j. [Subparagraph superseded by Accounting Standards Update No. 2016-09]
- k. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements
- l. A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.
- m. If not separately disclosed elsewhere, the policy for estimating expected forfeitures or recognizing forfeitures as they occur.

ASC 718-10-50-2A

Another item of minimum information needed to achieve the objectives in paragraph 718-10-50-1 is the following:

- a. 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 from stock options exercised during the annual period

ASC 718-10-50-4

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.

ASC 718-10-55-134 through 55-137 illustrate disclosures of certain share-based compensation arrangements.

Appendix A: Acronyms and literature references

Several acronyms are used throughout this guide and numerous references are made to specific ASUs, topics and subtopics in the ASC and other guidance. Provided in this section are an acronym legend, which lists the acronyms used throughout this guide and their corresponding definitions, and a literature listing, which lists the ASUs, topics and subtopics in the ASC, and other guidance referred to throughout this guide and their corresponding titles.

Acronym legend

Acronym	Definition
ASC	FASB's Accounting Standards Codification
ASR	SEC's Accounting Series Release
ASU	Accounting Standards Update
EITF	Emerging Issues Task Force
EPS	Earnings per share
FASB	Financial Accounting Standards Board
FIN	FASB Interpretation
GAAP	Generally accepted accounting principles
IPO	Initial Public Offering
LLC	Limited liability company
PBE	Public business entity
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission

ASC topics and subtopics

ASC topic or subtopic	Title
250	Accounting Changes and Error Corrections
270	Interim Reporting
480	Distinguishing Liabilities from Equity
480-10	Distinguishing Liabilities from Equity – Overall
505-10	Equity – Overall
505-30	Equity – Treasury Stock
606	Revenue from Contracts with Customers
606-10	Revenue from Contracts with Customers – Overall
710	Compensation—General
718	Compensation—Stock Compensation
718-10	Compensation—Stock Compensation – Overall
718-20	Compensation—Stock Compensation – Awards Classified as Equity
718-30	Compensation—Stock Compensation – Awards Classified as Liabilities
805	Business Combinations

ASC topic or subtopic	Title
805-10	Business Combinations – Overall
805-20	Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest
805-30	Business Combinations – Goodwill or Gain from Bargain Purchase, Including Consideration Transferred
805-60	Business Combinations – Joint Venture Formations
815	Derivatives and Hedging
815-40	Derivatives and Hedging – Contracts in Entity’s Own Equity
820	Fair Value Measurement
825-10	Financial Instruments – Overall
850	Related Party Disclosures

Other literature and guidance

Other literature	Issued by	Title
ASU 2018-07	FASB	Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting
ASU 2019-08	FASB	Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements—Share-Based Consideration Payable to a Customer
ASU 2021-07	FASB	Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards (a consensus of the Private Company Council)
ASU 2024-01	FASB	Compensation—Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards
ASU 2024-03	FASB	Income Statement—Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses
ASU 2025-04	FASB	Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Clarifications to Share-Based Consideration Payable to a Customer
ASU 2025-07	FASB	Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract
ASU 2025-11	FASB	Interim Reporting (Topic 270): Narrow-Scope Improvements
EITF 00-23	FASB	Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 [Superseded]
FIN 44	FASB	Accounting for Certain Transactions Involving Stock Compensation (an interpretation of APB Opinion No. 25) [Superseded]
SAB Topic 14	SEC	Share-Based Payment

Appendix B: Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition are provided in the table that follows. To the extent the term is defined in the Master Glossary of the ASC, that definition is provided.

Term	Definition
At-the-money	The term is used to describe share options whose exercise price is equal to the market price of the underlying share.
Award	The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single grantee or to a group of grantees. 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	<p>The simultaneous exercise by a grantee of a share option and sale of the shares through a broker (commonly referred to as a broker-assisted exercise).</p> <p>Generally, under this method of exercise:</p> <ol style="list-style-type: none"> The grantee authorizes the exercise of an option and the immediate sale of the option shares in the open market. On the same day, the entity notifies the broker of the sale order. The broker executes the sale and notifies the entity of the sales price. The entity determines the minimum statutory tax-withholding requirements. By the settlement day (generally three days later), the entity delivers the stock certificates to the broker. 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 grantee.
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.
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

Term	Definition
	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.
Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Convertible security	A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).
Corporate joint venture	A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
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

Term	Definition
	<p>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.</p>
<p>Economic interest in an entity</p>	<p>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.</p>
<p>Employee [prior to the adoption of ASU 2024-03]</p>	<p>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.</p> <p>A leased individual is deemed to be an employee of the lessee if all of the following requirements are met:</p> <ol style="list-style-type: none"> 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: <ol style="list-style-type: none"> 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).

Term	Definition
	<ol style="list-style-type: none"> 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. <p>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.</p>
<p>Employee [subsequent to the adoption of ASU 2024-03]</p>	<p>An individual over whom a reporting entity 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, an individual meets the definition of an employee if the reporting entity 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 reporting entity that classifies an individual potentially subject to U.S. payroll taxes as an employee also must represent that individual as an employee for payroll tax purposes (unless the individual is a leased employee as described below). An individual that meets the definition of an employee includes, but is not limited to, a full-time, part-time, temporary, or seasonal employee. An individual does not meet the definition of an employee solely because the reporting entity represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify an individual as an employee for U.S. payroll tax purposes does not, by itself, indicate that the individual is an employee because the individual also must be an employee of the reporting entity under common law.</p> <p>A leased individual is deemed to be an employee of the lessee if all of the following requirements are met:</p> <ol style="list-style-type: none"> 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: <ol style="list-style-type: none"> 1. The lessee has the exclusive right to grant compensation to the individual for the employee service to the lessee.

Term	Definition
	<ol style="list-style-type: none"> 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. <p>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 and other compensation granted to nonemployee directors for their services as directors. Awards granted and compensation paid to those individuals for other services shall be accounted for as awards and compensation to nonemployees.</p>
<p>Employee compensation [subsequent to the adoption of ASU 2024-03]</p>	<p>All forms of cash consideration (including deferred cash compensation), share-based payment arrangements, medical care benefits, pension benefits, postretirement benefits, and nonretirement postemployment benefits (including special or contractual termination benefits) given by an entity in exchange for service rendered by employees or for the termination of employment. This includes compensation cost arising from wages, salaries, profit-sharing, bonuses, one-time employee termination benefits, other postemployment benefits, employee stock ownership plans, employee share purchase plans, defined contribution plans, multiemployer plans, and any other compensation cost recognized in accordance with the guidance in Topic 710 on compensation, Topic 712 on nonretirement postemployment benefits, Topic 715 on retirement benefits, and Topic 718 on stock compensation. This also includes compulsory payments paid to the general government that confer entitlement to receive a (contingent) future social benefit, such as unemployment insurance benefits and supplements; accident, injury, and sickness benefits; old-age, disability, and survivors' pensions; and family allowances, reimbursements for medical and hospital expenses, or provision of hospital or medical services. For defined benefit plans within the scope of Topic 715, employee compensation includes only the service cost component of net periodic pension cost and the service cost component of net periodic postretirement benefit cost.</p>
<p>Employee stock ownership plan</p>	<p>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</p>

Term	Definition
	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.
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: <ul style="list-style-type: none"> 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.
Grant date	The date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers goods or renders services or purchases goods or services as a customer. 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 a grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the grantor'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.

Term	Definition
In-the-money	The term in-the-money is used to describe share options whose exercise price is less than the market price of the underlying share.
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.)
Issued, issuance, or issuing of an equity instrument	An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash, or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration. The grant of stock options or other equity instruments subject to vesting conditions is not considered to be issuance.
Joint venture	An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.
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.

Term	Definition
Market condition	<p>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:</p> <ol style="list-style-type: none"> 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). 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.
Market participants or marketplace participants	<p>Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:</p> <ol style="list-style-type: none"> a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary c. They are able to enter into a transaction for the asset or liability d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.
Measurement date	<p>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.</p>
Modification	<p>A change in the terms or conditions of a share-based payment award.</p>
Nonpublic entity	<p>Any entity other than one that meets any of the following criteria:</p> <ol style="list-style-type: none"> 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. <p>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.</p>

Term	Definition
Nonvested shares	Shares that an entity has not yet issued because the agreed-upon consideration, such as the delivery of specified goods or services and any other conditions necessary to earn the right to benefit from the instruments, has not yet been satisfied. 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 and stock purchase agreements entered into with grantees. Options are considered securities. See Call Option.
Out-of-the-money	The term out-of-the-money is used to describe share options whose exercise price is greater than the market price of the underlying share.
Performance condition [prior to the adoption of ASU 2025-04]	<p>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:</p> <ol style="list-style-type: none"> a. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time b. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's performance related to the grantor's own operations (or activities). <p>Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. A performance target might pertain to the performance of the entity as a whole or to some part of the entity, such as a division, or to the performance of the grantee if such performance is in accordance with the terms of the award and solely relates to the grantor's own operations (or activities).</p>
Performance condition [subsequent to the adoption of ASU 2025-04]	<ol style="list-style-type: none"> 1. For share-based payments in which a grantor acquires goods or services to be used or consumed in the grantor's own operations, 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: <ol style="list-style-type: none"> a. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time b. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference

Term	Definition
	<p>to the grantee's performance related to the grantor's own operations (or activities).</p> <p>Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. A performance target might pertain to the performance of the entity as a whole or to some part of the entity, such as a division, or to the performance of the grantee if such performance is in accordance with the terms of the award and solely relates to the grantor's own operations (or activities).</p> <p>2. For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:</p> <ul style="list-style-type: none"> a. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's (the customer's) performance related to the grantor's own operations (or activities) b. The grantee's purchase (or potential purchase) of the grantor's goods or services from either the grantor or the grantor's customers c. A purchase (or potential purchase) of the grantor's goods or services from either the grantee or the grantee's customers. <p>The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer.</p>
Probable	The future event or events are likely to occur.
Public business entity	<p>A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.</p> <ul style="list-style-type: none"> a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

Term	Definition
	<p>b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.</p> <p>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.</p> <p>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.</p> <p>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.</p> <p>An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.</p>
Public entity	<p>An entity that meets any of the following criteria:</p> <p>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</p> <p>b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market</p> <p>c. Is controlled by an entity covered by the preceding criteria. That is, a subsidiary of a public entity is itself a public entity.</p> <p>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.</p>
Related parties	<p>Related parties include:</p> <p>a. Affiliates of the entity</p> <p>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</p> <p>c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management</p> <p>d. Principal owners of the entity and members of their immediate families</p> <p>e. Management of the entity and members of their immediate families</p> <p>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</p>

Term	Definition
	<p>an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests</p> <p>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.</p>
Reload feature and reload option	A reload feature provides for automatic grants of additional options whenever a grantee 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 grantee 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 grantees are better termed nonvested shares because the limitation on sale stems solely from the forfeitability of the shares before grantees have satisfied the service, performance, or other condition(s) necessary to earn the rights to the shares. Restricted shares issued for consideration other than for goods or services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to an employee’s requisite service period or a nonemployee’s vesting 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 a grantee’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.

Term	Definition
Securities and Exchange Commission registrant	<p>An entity (or an entity that is controlled by an entity) that meets any of the following criteria:</p> <ol style="list-style-type: none"> 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). It is required to file financial statements with the Securities and Exchange Commission (SEC). It provides financial statements for the purpose of issuing any class of securities in a public market.
Security	<p>A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:</p> <ol style="list-style-type: none"> It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.
Service condition	<p>A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period or a nonemployee delivering goods or rendering services to the grantor over a vesting period. A condition that results in the acceleration of vesting in the event of a grantee's death, disability, or termination without cause is a service condition.</p>
Service inception date	<p>The date at which the employee's requisite service period or the nonemployee's vesting 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] for an illustration of the application of this term to an employee award).</p>
Settlement of an award	<p>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:</p> <ol style="list-style-type: none"> Exercise of a share option or lapse of an option at the end of its contractual term Vesting of shares Forfeiture of shares or share options due to failure to satisfy a vesting condition

Term	Definition
	<p>d. An entity's repurchase of instruments in exchange for assets or for fully vested and transferable equity instruments.</p> <p>The vesting of a share option is not a settlement because the entity remains obligated to issue shares upon exercise of the option.</p>
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.
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	<p>An arrangement under which either of the following conditions is met:</p> <ol style="list-style-type: none"> 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: <ol style="list-style-type: none"> 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. <p>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.</p> <p>Also called share-based compensation arrangements.</p>
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.
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

Term	Definition
	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.
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).
Vest	<p>To earn the rights to. A share-based payment award becomes vested at the date that the grantee'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.</p> <p>The stated vesting provisions of an award often establish the employee's requisite service period or the nonemployee's vesting period, and an award that has reached the end of the applicable period is vested. However, as indicated in the definition of requisite service period and equally applicable to a nonemployee's vesting period, the stated vesting period may differ from those periods in certain circumstances. Thus, the more precise terms would be options, shares, or awards for which the requisite good has been delivered or service has been rendered and the end of the employee's requisite service period or the nonemployee's vesting period.</p>
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 C: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition (June 2024):

Chapter 1 – Introduction and scope

- [Section 1.1](#) was updated to add discussion of newly issued ASUs, including ASU 2024-03 and ASU 2025-04, and remove discussion of ASUs that are now effective, including ASU 2018-07, ASU 2019-08 and ASU 2021-07.
- [Section 1.3.3](#) was updated for ASU 2019-08 and ASU 2023-05 now being effective and the issuance of ASU 2025-04.
- Added [Section 1.3.6.3](#) to address the topic of nonrecourse cash loans that are secured by employer shares.

Chapter 2 – Measurement of awards

- [Section 2.2.5](#) and [Section 2.2.5.1](#) were updated for the issuance of ASU 2024-03.
- [Section 2.3.2](#) was updated for the issuance of ASU 2025-04 and the updated definition of a performance condition.
- [Section 2.3.2.1](#) was added to discuss the issuance of ASU 2025-04 and the subsequent sections were renumbered accordingly.
- [Example 2-3](#) was added to [Section 2.3.2.3](#).

Chapter 3 – Recognition of compensation cost

- Updated [Section 3.2](#) to address awards with extensive repurchase features and the impact on expense recognition.
- Updated [Section 3.4](#) for the issuance of ASU 2025-04.
- Added [Section 3.10](#) to address secondary market transactions.

Chapter 4 – Classification and accounting for liability awards

- Added [Example 4-2](#) to [Section 4.2.2.3](#) to add an illustration of the impact of a repurchase right upon termination of employment to the classification of an award. Subsequent examples in Chapter 4 were renumbered accordingly.

Chapter 5 – Estimating fair value

- Updated [Section 5.2.3.6](#) to add a reference to the AICPA's publication, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation – Accounting and Valuation Guide*.

Chapter 6 – Modifications of awards

- [Section 6.1.1](#) was updated to add a table summarizing the accounting impact for each type of modification.

Chapter 7 – Disclosure

- [Chapter 7](#) was updated for the issuance of ASU 2025-11.

Appendices

- [Appendix A](#) was updated to include recently issued ASUs.
- [Appendix B](#) was updated to include additional definitions as a result of recently issued ASUs.
- [Appendix C](#) was added to summarize the changes to the guide since the last edition.

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