Substantial accounting changes for nonemployee share-based payments

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Introduction

Accounting Standards Update (ASU) 2018-07, *Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, clarifies the Financial Accounting Standard Board's (FASB) position that awards granted to nonemployees are economically like those with employees, and a separate model for nonemployee share-based payment transactions is not warranted. The amendments expand the scope of Topic 718 of the FASB's Accounting Standards Codification to include share-based payment transactions for acquiring goods and provisioning services from nonemployees (e.g., vendors, independent contractors and other suppliers of goods and services). As such, the terms compensation cost and compensation as used through this paper include both the cost attributed to nonemployee share-based payment awards issued in conjunction with the purchase of goods, as well as obtaining services. The amendments are not expected to result in practice changes for employee share-based payment awards.

ASC Subtopic 505-50, *Equity—Equity-Based Payments to Non-Employees,* which addresses certain aspects of accounting for nonemployee share-based payment transactions, is superseded in its entirety. With minimal exception, U.S. generally accepted accounting principles (GAAP) will no longer have separate classification, measurement and recognition guidance for share-based payment transactions with employees and nonemployees. Grantors of nonemployee share-based compensation will apply the comprehensive guidance in Topic 718, including whether to classify an award as equity or liability, accounting for income taxes and details on how to measure an award at fair value, among other provisions. For grantors of nonemployee share-based compensation, this means learning how to account for the transactions in a significantly different manner, because the majority of accounting guidance on particular aspects of matters addressed in Subtopic 505-50 differs from the accounting guidance for those matters in Topic 718.

Notwithstanding the general guidance alignment, guidance on accounting for nonemployee share-based payments will differ in two areas: (a) certain inputs to an option pricing model and (b) the attribution of cost (the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). The FASB decided against providing further guidance related to the attribution of compensation as feedback from outreach did not indicate this was an area of concern or confusion. The update does not provide prescriptive guidance on determining the vesting period or cost recognition pattern, and hence, grantors of nonemployee share-based payment transactions will continue to apply judgment in these areas.

The FASB is hopeful that the amendments will provide relief to privately held companies experiencing significant challenges valuing nonemployee stock-based compensation (e.g., start-up companies using equity compensation to pay vendors and independent contractors in exchange for property, services or other assets [except cash]). Practical expedients available to nonpublic entities' accounting for *employee* share-based payment transactions are now applicable to nonemployee compensation arrangements.

Nonpublic entities are defined in Topic 718 to clarify the provisions applicable to them. Nonpublic entities should not be confused with public business entity, used to define the effective date of ASU 2018-07, as follows.

The update is effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. For all other entities, the amendments are effective for fiscal periods beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity's adoption date of ASC Topic 606, *Revenue from Contracts with Customers.*

Scope

The amendments expand the scope of Topic 718 to include all share-based payment transactions in which a grantor acquiring goods or services to be used or consumed in its own operations issues shares, share options or other equity instruments or incurs liabilities to employees and nonemployees (collectively, grantees). Accordingly, share-based payments to nonemployees to raise capital are not under the scope of Topic 718. Equity instruments granted to a lender or investor providing financing to the grantor or equity instruments granted to the grantor's customers in conjunction with selling goods or services as part of a contract (e.g., sales incentives) are not within the scope of Topic 718. If the instrument is issued as payment for distinct goods or services received from the customer, then it would be within the scope of Topic 718.

Unlike Subtopic 505-50, Topic 718 does not include grantee accounting guidance. Grantees should follow the guidance in Topic 606 on accounting for contracts with customers where the arrangement involves stock-based compensation. ASU 2018-07 amends Topic 606 to clarify that consideration payable to a customer includes equity instruments granted in a transaction to sell goods or services (e.g. shares, share options, or other equity instruments).

For share-based payments to qualify for Topic 718 accounting, the compensation: (a) must be based at least in part on the price of the grantor's shares or other equity instruments or (b) may be settled with the grantor's shares or other equity investments. Such arrangements commonly include common shares and share options but may include stock purchase rights, stock appreciation rights and restricted stock.

Middle Market Insights

Equity compensation can be a great tool for incentivizing employees and can be similarly beneficial in vendor relationships. Because equity compensation is tied to the company's value, its use can strengthen vendor loyalty and become an integral component of supply chain management—while keeping cash liquid. For insight into employee equity compensation and potential nonemployee stock compensation arrangements, refer to our article, Understanding equity compensation devices.

Highlights

Measurement and recognition objective

Share-based payment transactions within the scope of Topic 718 are measured by estimating the fair value of equity instruments an entity has or is obligated to issue. Accounting for share-based payment transactions should reflect the rights conveyed to the financial instrument holder and the obligations imposed to the financial instrument holder by the issuer. Recognition of the fair value of the cost of goods obtained or services received in exchange for equity instruments the grantor has issued or is obligated to issue occurs as the goods are delivered or the services are being consumed, provided all conditions necessary for the nonemployee to earn the right to benefit from the instruments have been satisfied.

Initial measurement date

The measurement date of a nonemployee award is now the grant date. The definition of grant date is the date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of the share-based payment arrangement.

On the grant date, the grantor becomes contingently obligated to issue equity instruments or transfer assets to the nonemployee who delivers the goods or renders the service. It is the day that a grantee begins to benefit from, or be adversely affected by, subsequent changes in the price of the grantor's equity shares. Determination of the grant date is based on the arrangement's terms and relevant facts and circumstances, which may be established through a formal written agreement, an informal oral agreement or based on an entity's past practice. In principle, a sufficient basis for both the grantor and the grantee to understand the nature of the relationship established by the award must exist for a grant date to be established. Additional guidance on determining the grant date is included in ASC 718-10-55-80 through 55-83 and ASC 718-10-25-5, including awards subject to shareholder, board of director or management approval.

Under legacy guidance in Subtopic 505-50, the measurement date for equity-classified nonemployee share-based payment awards is the earlier of the date at which the counterparty's performance is complete or a commitment for performance by the counterparty is reached. For situations in which no performance commitment date exists, an entity is required to measure an award's then-current fair value as of each financial reporting date for which a component of a nonemployee's share-based compensation needs to be recognized. Replacing the legacy concept of *measurement date* with a sole *grant date* eliminates the exercise of estimating an award's fair value at the end of each reporting period until the nonemployee's performance is complete and the award vests.

Spotlight on change: Measurement at the grant date

Under legacy guidance in Subtopic 505-50, grantors of nonemployee share-based payment awards typically measure the award when performance is complete (as opposed to the date at which a commitment for performance by the counterparty is reached), primarily due to difficulty in achieving the latter requirement. As a result, for situations in which recognition was appropriate prior to the completion of service, estimates of fair value were required at each reporting period. Replacing the legacy concept of *measurement date* with a sole *grant date* not only eliminates the requirement to perform multiple valuations in certain circumstances for equity-classified awards, but also eliminates the income statement volatility associated with those remeasurements.

Initial fair value measurement

Under legacy standards in Subtopic 505-50, nonemployee share-based payment transactions are measured at the fair value of the consideration received or the equity instrument issued, whichever is more reliably measurable. In practice, an organization's ability to estimate the fair value of consideration received is often challenging, and in response, the FASB changed the guidance to require a grantor to estimate, at the grant date, the fair value (or in certain situations, a calculated or intrinsic value, as discussed in the following sections) of equity-classified instruments it is obligated to issue as and when the equity instruments vest to the nonemployee.

Initial measurement entails the use of assumptions, which should reflect information that is (or would be) available to value the financial instruments being exchanged. Grantor entities may need to determine the appropriate measurement method, in addition to making certain policy decisions (e.g., on forfeitures) and subjective determinations on pertinent pricing factors (e.g., share price volatility). The outcome of this analysis and initial financial instrument measurement affects recognition of the share-based compensation, as discussed in the following sections.

Term of share options

Determination of a share option's term is an area that may continue to differ in valuing nonemployee and employee stock-based compensation. ASU 2018-07 includes an election, on an award-by-award basis, to use the contractual term as the expected term when estimating the fair value of a nonemployee award. Otherwise, an entity must apply the guidance in Topic 718 on estimating the expected term of a nonemployee award, which may result in a term less than the award's contractual term. This language is significantly different than the proposed guidance requiring entities to use the contractual term of a nonemployee's share option or similar instrument without allowing use of the expected term.

Conversely, a grantor of an *employee* award under Topic 718 will continue to determine the option or similar instrument's expected term. Due to these potential measurement input differences, however, the same award issued to a nonemployee and an employee may be valued at different amounts.

Spotlight on change: Term of share options

In practice, awards to consultants in exchange for services are often made under the same equity incentive plan as those with an entity's employees, using the same standard award agreement. Accordingly, upon termination of service to the entity, the option term truncates (e.g., the consultant may have 90 days upon termination of services to exercise the options or they expire). If an entity's nonemployee awards are nontransferable and truncate upon termination of services, entities may prefer to use the expected term as an input to the measurement of those awards (similar to employee awards under Topic 718). If the contractual term is used for these types of awards, the fair value of the option and the related compensation cost recognized would be larger.

Share-based compensation with performance conditions

A performance condition must relate to a nonemployee rendering service or delivering goods for a specified, implicitly or explicitly, period of time and achieving a specified performance target related to the grantor's own operations or activities. The updates in ASU 2018-07 supersede in its entirety the legacy guidance in Subtopic 505-50 on nonemployee performance obligations and replaces it with the employee share-based payment transaction model in Topic 718. When a compensation agreement dictates specific performance conditions, initial measurement includes an estimate of performance-based shares or share options expected to vest. The estimate is based on the probability that the performance condition will be achieved (the expected level of performance) and the fair value of each performance-based share or share option. Estimating performance-based shares expected to vest not only affects the award's initial measurement and determines the appropriate periods of compensation cost recognition (e.g., the vesting period), it may affect other inputs used in determining a share or share option's fair value in a pricing model (e.g., the exercise price and number of shares issued).

Only performance conditions probable of being met have an effect on determining the appropriate period and amount of compensation cost recognition. Hence, a grantor entity is required to reassess at each reporting date whether achievement of any performance condition is probable and adjust compensation cost accruals for changes in the probable outcome or the nonemployee's actual performance. Ultimately, the total amount of compensation cost recognized during the vesting period (when goods are delivered or services are rendered) should reflect the number of awards that actually vested based on the performance target at their grant date fair value. An example performance condition is one in which the number of options earned increases or the exercise price decreases if the grantee achieves a specific turn-around or delivery metric.

Spotlight on change: Performance conditions

Under legacy guidance in Subtopic 505-50, nonemployee share-based payment awards with performance conditions are measured at the lowest aggregate fair value, without considering the probability of the performance condition being achieved. Consequently, awards with even a remote chance of nonperformance, under legacy guidance, would likely result in a lowest aggregate value of zero (and continue to be remeasured at zero until all performance conditions are resolved). The new requirements for a granting entity to estimate achievement of a nonemployee's performance obligation and recognize compensation costs if achievement is probable will likely result in accelerated recognition of nonemployee compensation costs for contracts with performance conditions.

Forfeitures

A grantor should accrue nonemployee share-based payment costs over the vesting period. Vesting means the grantee's right to receive or retain equity shares, other equity instruments or assets under the award is no longer contingent on satisfaction of either a service condition or a performance condition. In its simplest form, vesting of nonemployee awards can viewed as *earned with no further performance required*.

Compensation cost to be recognized each period is dependent on the forfeiture policy the grantor chooses. Like employee share-based payment awards, an entity is required to make an entity-wide accounting policy election for all nonemployee share-based payment awards to either: (a) estimate the number of forfeitures expected to occur (that is, the number of awards expected to vest) or (b) recognize the effect of forfeitures in compensation cost as and when they occur.

If a grantor estimates the number of forfeitures expected to occur (option [a]), it will base its initial compensation cost accruals on the estimated number of nonemployee share-based payment awards for which goods are expected to be delivered or services are expected to be rendered. If subsequent information indicates the forfeiture estimates should be changed, a grantor should recognize an adjustment to compensation cost in the current period for the cumulative effect on current and prior periods of the forfeiture estimate change. If a grantor recognizes the effect in compensation costs as forfeitures occur (option [b]), it should reverse previously recognized compensation costs in the period the award is forfeited. Under either method the adjustments made to the compensation cost should be recognized in the same manner as if the entity had paid cash.

Spotlight on change: Forfeiture election

The option to recognize the effect of forfeitures as they occur, if elected, will reduce the resources needed to estimate forfeitures on an ongoing basis. These benefits may be offset, however, by a less accurate reflection of periodic nonemployee share-based compensation costs and increased financial statement volatility.

Private company relief

The FASB has acknowledged that nonpublic entities without an active market, particularly development-stage entities, may be challenged in measuring the fair value of vendor and independent contractor arrangements. To address this, ASU 2018-07 expands the scope of certain of Topic 718's nonpublic valuation practical expedients applicable to employee share-based payment awards to include share-based compensation arrangements with nonemployees of nonpublic grantors. A nonpublic entity is defined in Topic 718 as an entity whose equity securities generally do not trade in a public market.

Pricing model input

Valuation models are used to estimate an award's fair value when observable market prices of identical or similar share options or similar equity or liability instruments of the entity are not available at the grant date. The models use various inputs to estimate the fair value by determining an amount at which equity or liability instruments with the same characteristics as the equity and liability instruments granted in a share-based payment transaction would be exchanged. A granting entity's share price and its expected volatility are among the requisite pricing model inputs. The exercise of judgment is often required for a nonpublic entity to estimate the expected volatility of its shares. It could, for example, use the average volatilities of otherwise similar public companies. Ultimately, the nonpublic entity may find it impractical to estimate the expected volatility of its share price, and therefore, unable to price its shares or share options using a fair value approach. When this happens, Topic 718 requires a nonpublic entity to substitute calculated value for fair value. Calculated values require use of the historical volatility of an appropriate industry sector index instead of the expected volatility of the nonpublic entity's share price. Valuation techniques and option pricing models are discussed further in ASC 718-10-55-13 through 55-49.

Use of the calculated value method is also allowed as a replacement valuation method for the fair value measurement of *employee* awards when it is impractical to estimate expected volatility. A nonpublic entity should use the calculated value method consistently between employee share-based transactions and nonemployee share-based transactions. Provisions of Topic 718 that apply to accounting for share options and similar instruments at fair value also apply to such instruments measured at calculated value.

Spotlight on change: Use of calculated value

Use of a fair value approach, as required under legacy guidance, is generally always preferable to a valuation technique using an index, as in the calculated value approach. Although the practical expedient is available, upon adoption of ASU 2018-07, a nonpublic entity is required to first make an assessment on whether it has sufficient data to assess its own historical volatility or that of similar public companies.

Liability-classified awards

Unchanged from legacy guidance, a grantor of nonemployee share-based payment awards should follow the requirements of Topic 718 to determine whether it should recognize a corresponding increase in equity or a liability for instruments granted. The measurement objective for liabilities incurred under share-based payment compensation arrangements is the same as the measurement objective for equity instruments under such arrangements. For awards classified as liabilities, companies are required to measure liability-classified awards at fair value (using the settlement date as the measurement date). However, for nonpublic companies, a simplification provision exists. A nonpublic entity is permitted to make a one-time policy election to switch from measuring liability-classified share-based payment awards at fair value to intrinsic value upon adoption of ASU 2018-07. Under the intrinsic value method, compensation cost is measured as the excess, if any, of the stock's quoted market price over the amount a grantee must pay to acquire the stock (an option's exercise price).

Like the guidance in Topic 718 for *employees*, regardless of the election to use intrinsic value, liability-classified awards must be remeasured at each reporting date through the date of exercise or other settlement.

Attribution of compensation costs

The attribution of compensation cost, the period over which nonemployee share-based compensation vests and for which costs (asset or expense) are recognized, occurs as goods are delivered or services are rendered. The total amount of compensation cost for share-based payment awards to nonemployees is based on the number of financial instruments for which goods have been delivered or services have been received. A grantor of nonemployee share-based compensation should continue using legacy guidance (incorporated into Topic 718) to recognize compensation costs (or reverse previous recognition) in the same period(s) and in the same manner as if it had paid cash for the goods or services instead of paying with or using equity instruments. Conversely, compensation cost for an award of share-based *employee* compensation will continue to be recognized over the requisite service period—the period during which an employee is required to provide service in exchange for an award, which often is the vesting period.

The grantor entity's forfeiture policy and estimate of the probability of achievement of a performance condition affects the attribution of costs. These practices and policies, along with fair value measurement and pricing model input decisions, require significant management judgment. Specific guidance is included in Topic 718 on how to attribute and recognize compensation costs and numerous examples have been amended to clarify which portions of the examples could be applicable to nonemployee share-based payment transactions. The examples cover various accounting aspects of compensation cost attribution, including situations in which an award vests upon meeting performance and service conditions and how to account for forfeitures and award reclassifications, among other implementation matters.

Spotlight on change: Attribution of compensation costs

Grantors with nonemployee share-based compensation and employee share-based compensation arrangements should not be alarmed if periodic compensation cost recognized for the same award issued to an employee and a nonemployee differs. Nonemployee awards have different attribution requirements than employee awards. Additionally, valuation amounts may differ as the contractual term of share options and similar instruments may be required when valuing nonemployee share-based transactions, versus the expected term for employees.

Subsequent classification and measurement

Once subject to the initial recognition and measurement guidance in ASC 718, an instrument continues to be subject to that guidance throughout the life of the instrument, except in situations where the instrument's terms are modified after a nonemployee vests and is no longer providing goods or services. This includes the requirement to change the classification of a share-based financial instrument from equity to liability due to a change in probable settlement outcome. Further guidance is provided in ASC 718-10-35-9 through ASC 718-10-35-15. Freestanding financial instruments issued under a share-based payment arrangement no longer subject to the requirements of Topic 718 (e.g., due to certain modifications of the arrangement's terms after a nonemployee has vested in the award and is no longer providing services) should be accounted for under other topics (e.g., as liabilities under ASC Topic 480, *Distinguishing Liabilities from Equity*, or under other applicable ASC topics).

ASC 718-20-35 provides guidance on the subsequent measurement of awards classified as equity. Items addressed include, but are not limited to, subsequent measurement of awards measured at intrinsic value, awards with contingent features, award term or condition modifications, short-term inducements, award repurchase or cancellation, or cancellation and replacement. Notwithstanding these particular circumstances, a granting entity should adjust compensation cost for a reporting period upon the occurrence of changes in probability estimates pertaining to satisfaction of performance conditions and changes in forfeiture estimates, or actual occurrences of performance or forfeiture. Subsequent measurement guidance and illustrations are provided in ASC 718-20-55.

ASC 718-30-35 provides guidance on the subsequent measurement of liabilities incurred in a share-based payment arrangement.

Spotlight on change: Classification reassessment

Under the legacy guidance in Subtopic 505-50, a grantor of nonemployee share-based compensation is required to analyze, upon vesting of an award, an equity instrument's terms to determine whether it is a liability pursuant to Topic 480 or meets the definition of a derivative instrument and is within the scope of Topic 815, *Derivatives and Hedging* (as well as potentially under the scope of other ASC topics). Hence, the grantor may have been required to recognize subsequent changes in fair value of its share-based commitments (due to market value changes) because of the application of the guidance in Topic 480 or Subtopic 815-40. It is likely that the classification of some nonemployee awards would not have changed after the awards vested had the amendments in the ASU been in place at the time those awards did vest. Upon adoption of ASU 2018-07, an entity that applied the legacy guidance in Subtopic 505-50 would revert certain liability-classified nonemployee awards to equity classification.

Disclosures

Topic 718 is amended to explicitly include minimum disclosure requirements for nonemployee share-based arrangements. The requirements are similar to those required in the legacy guidance in Subtopic 505-50, which specified that disclosures similar to those in ASC 718-10-50 be provided. That is, the disclosure requirements remain numerous and judgment is required, particularly for situations in which a grantor entity has multiple share-based payment arrangements. Entities are required to separately disclose information related to different types of awards (including nonemployee versus employee) to the extent the disclosures are important to understanding the entity's use of share-based compensation and the transactions' effects on the financial statements. Separate disclosures are generally expected for different types of awards and awards with different characteristics. For example, separating disclosures for awards with unexercised options into those with service conditions, performance conditions or both, separating disclosures for awards classified as equity and those classified as liabilities, or separating award disclosures based on whether the option's exercise price is fixed or indexed may be important to financial statement users.

Transition

Entities are required to measure unsettled nonemployee awards at fair value as of the adoption date, except vested equity-classified awards. The transition provisions are simplified from those in the 2017 proposed amendments, which would have required entities to measure all (vested and unvested) outstanding awards at fair value as of the grant date and adjust the basis of the related assets. Instead, no entity is allowed to retrospectively adjust the basis of completed assets (for example, finished goods inventory or equipment that has begun amortization) that include nonemployee share-based payment costs at transition. The amendments should be applied on a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption. Special transition provisions are required for nonpublic entities measuring financial instruments at calculated value, as discussed in the following paragraphs.

Upon adoption, an entity should reevaluate the classification of nonemployee awards initially classified as equity before completion of performance and subsequently reclassified to liabilities upon performance completion (e.g., because of other guidance, such as Topic 815 on derivatives and hedging). In preparing the cumulative effect adjustment, only unsettled liability-classified awards that were previously classified as equity awards as of the effective date should be assessed.

In the first interim and annual period of adoption, an entity should disclose: (a) the nature of and reason for the change in accounting principle and (b) if applicable, quantitative information about the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the period of adoption.

Upon adoption of ASU 2018-07, each entity should make an entity-wide accounting policy election to recognize the effect of forfeitures in compensation cost when they occur or to estimate the number of forfeitures expected to occur. The election is made separately for nonemployee and employee share-based compensation.

Nonpublic entities, upon adoption of ASU 2018-07, are required to:

- Make an assessment on whether it has sufficient data to assess its own historical volatility or that of a similar public company. If the calculated value practical expedient is utilized, the nonpublic entity would apply the approach prospectively to all awards measured at fair value after the effective date. As discussed earlier under the section, “Private company relief: Pricing model input,” use of calculated value should be consistently applied for employee and nonemployee share-based payment transactions, and all provisions in Topic 718 applying to equity share options and similar instruments at fair value also apply to calculated value.
- Make an accounting policy decision on whether to change the measurement of all of its unsettled liability-classified nonemployee awards from fair value to intrinsic value. (A nonpublic entity would make an accounting policy election to change its measurement of all liability-classified *employee* awards from fair value to intrinsic value upon adoption of the amendments in ASU 2016-09, *Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.*) A nonpublic entity is not required to evaluate whether the change is preferable under Topic 250, *Accounting Changes and Error Corrections*, provided such election is made upon adoption of ASU 2018-07 on its effective date.

Conclusion

Entities should begin preparing to implement the new standard, as transitioning under the modified retrospective basis requires an analysis of all unsettled liability-classified awards and all nonvested equity-classified awards as of the beginning of the adoption period. For further guidance, contact your RSM professional.

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