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Accounting Standards Codification 718- Compensation- Stock Compensation

FOREWORD

Welcome to our **"Uniqus' ASC Insights Series: Guide to Accounting Standards,"** where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, this guide helps you navigate complex accounting scenarios and deepen your knowledge.

This is the tenth publication in our "Uniqus' ASC Insights Series: Guide to Accounting Standards," focusing on **"ASC 718, Compensation—Stock Compensation."** In this installment, we delve into the specifics of ASC 718, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners.

The primary objective of ASC 718 is to provide guidance on the principles and requirements for Stock-based compensation. ASC 718 specifically provides guidance on how companies should recognize, measure, and disclose the costs of share-based payment transactions with employees and non-employees. This guidance aims to ensure that share-based payment transaction costs are properly accounted for and disclosed in financial statements. This provides clarity, consistency, and transparency in financial reporting related to stock-based compensation.

We hope you enjoy reading this document and find this series valuable!

Thank you.

Yours faithfully

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PURPOSE

In today's era, most of entities especially the start-ups, are focusing on incentivizing employees and non-employee performance with equity or equity-linked awards (including stock options, restricted stock, restricted stock units (RSUs), stock appreciation rights (SARs), and other equity-based instruments) to align their compensation with an entity's operating performance and provide those holders with the opportunity to participate in future profits and/or equity appreciation of the entity.

ASC 718 addresses the financial accounting and reporting for a stock-based compensation transaction. The guidance in ASC 718, applies to various types of equity-based awards companies use to compensate their employees.

This publication provides an overview of the key accounting considerations and implementation matters relating to ASC 718. The technical views and accounting positions on the framework are constantly evolving.

We sincerely hope you find this quick reference guide informative in identifying and evaluating the issues related to Stock-based compensation. We will be happy to participate in any discussions required to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.

BACKGROUND

ASC 718 provides accounting guidance on share-based payment awards. It requires entities to use a fair-value-based measure when recognizing the cost associated with these awards in the financial statements. The primary objective of ASC 718 is for entities to recognize the cost of that compensation in their financial statements as the goods or services associated with the awards are provided.

Applicability of principles of ASC 718 is principally governed by the basis of award settlement. For a awards to be within the scope of ASC 718, terms of arrangement should require settlement in the entity's equity or settlement is based, at least in part, on the price of the entity's equity. An entity's conclusion related to whether an award is within the scope of ASC 718 significantly affects the amount of compensation cost recognized and when such cost is recognized in the financial statements.

These days, some of the non-public entities, such as limited partnerships, limited liability companies, or similar pass-through entities, grant special awards in the form of profits interests, for example, profits interest, which may entitle the interest holder to a portion of any distributions made, once senior interest holders obtain a specified return. Because profits interest holders only participate in future profits and/or equity appreciation and have no rights to the existing net assets of the partnership, it becomes difficult to determine whether a profits interest award should be accounted for as a share-based payment arrangement (Topic 718) or similar to a cash bonus or profit-sharing arrangement (Topic 710, Compensation—General, or other Topics).

An award that has the characteristics of an equity interest represents a substantive class of equity and should be accounted for under ASC 718; however, an award that is, in substance, a performance bonus or a profit-sharing arrangement would be accounted for in accordance with other guidance as applicable to employee arrangement such as ASC 710. In other words, profits interest awards may be akin to equity interests or profit sharing/bonus arrangements. In the absence of any authoritative guidance, judgment is required to make that assessment, which in practice, has resulted in diverse accounting for these awards.

SUMMARY OF TOPIC

1. Scope

ASC 718-10-15-3 provides guidance for the scope applicability of ASC 718 to stock compensation awards. As per the principles of ASC 718-10-15-3, if it is determined that an award (or the underlying security) has predominantly equity characteristics (even if junior to other classes of equity interests), it is subject to the scope of the ASC 718. In other words, if payment under the arrangement must be settled in or based, at least in part, on the price of the entity's shares or other equity instruments, the arrangement is in the scope of ASC 718.

ASC 718 applies to all transactions with employees or non-employees in which an entity receives goods or services to be used or consumed in the entity's own operations in exchange for share-based instruments. Common examples of share-based payment awards include stock options, SARs, restricted stock, and RSUs. Such awards also include liabilities incurred that (1) are indexed, in part, to the price of the entity's shares or other equity instruments or (2) require or may require settlement by issuing the entity's equity shares or other equity instruments.

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The following provides an indicative list of the factors that may be considered to determine whether an arrangement is a share-based arrangement **that should be accounted for under ASC Topic 718 or not.** The list is not all-inclusive-:

✓	✗

Primary indicators:
• The legal form of security is equity.
• Rights commensurate with an ownership interest in the Entity:
  ◦ Liquidation rights (Claims to the residual net assets of the entity upon dissolution or liquidation proportionate to other equity holders).
  ◦ Distributions proportionate to ownership interest (participation in the residual returns of the entity's net assets in a manner consistent with equity ownership).
  ◦ Participation in fair value fluctuations of the Entity.
• Retention of vested interests on termination of service.
Additional indicators which may also be considered when evaluating the substance of the arrangement:
• Initial investment required by the employee.
• Risk of loss of initial capital in the event of dissolution or liquidation of the company.
• Voting rights commensurate with ownership interest.
• Interest is transferable after vesting.
• Management's intent is to provide the employee with an equity ownership interest in the Entity.
• Existence of Pre-emptive rights (right to maintain their proportionate ownership through potential future issuances of common stock).
• Existence of right or the obligation to participate proportionately with the controlling shareholder's exit (sometimes referred to as drag-along or tag-along rights).
	• Rights to share in distributions tied to continued employment. In the event of termination of employment:
	  ◦ Automatic termination of any rights and/or return of units for no or nominal consideration.
	  ◦ Repurchase features (puts/calls) based on a formula (e.g., a fixed multiple of EBITDA).
	  ◦ A call option (option is with the entity) that provides for a fixed price or off-market (discounted) repurchase of the profits interest on cessation of employment.
	Note: The Entity's right to repurchase the profits interest at fair value is not considered an indicator of a profit sharing or deferred compensation plan.
	• Creditor-like features (e.g., fixed redemption date or a specified return).
	• Management's intent to provide a performance bonus by allowing employees to share in profits and distributions of the entity only during employment.
	• Profits interest used instead of cash bonuses for preferential tax treatment.

ASC 718 applies to share-based transactions; however, all share-based transactions cannot be considered within the scope of ASC 718. For share-based transactions to be within the scope of ASC 718, the following two conditions must be fulfilled:

(a) Share-based payment awards are issued **in exchange for goods or services**

(b) Such awards must be settled (or may require settlement) by issuing **the entity's equity shares or other equity instruments, or they must be indexed, at least in part, to the value of the entity's equity shares or other equity instruments.**

ASC 718 does not apply to equity or liability instruments issued in exchange for cash or other financial assets. The following are some examples of share-based transactions which are outside the scope of ASC 718:

- Equity instruments issued as consideration in a business combination
- Options or warrants issued for cash or other than for goods or services
- Detachable options or warrants issued in a financing transaction
- Share-based awards that are granted to employees or non-employees and settled in shares of an unrelated entity

2. Awards Granted- Employees Vs. Non-Employees

ASC 718 provides accounting principles related to recognition and measurement of Share-based payments granted to employees and non-employees. The guidance on non-employee awards is largely aligned with that on employee awards are subject to the following exceptions:

- **Attribution of compensation cost** — The compensation cost related to Share-based payments to employees is recognized over the service period, however in respect to share-based payments to non-employees ASC 718 does not prescribe the period(s) or the manner (i.e., capitalize or expense) in which nonemployee share-based payments will be recognized therefore in case of non-employees the costs are recognized in the same period and in the same manner in which the entity would, if it had paid cash for those goods or services.
- **Measurement principles** — Share-based payments to employees are measured based on the expected term of the award. In contrast, share-based payments to non-employees may be measured based on the expected term, or the entity can elect to use the contractual term as the expected term on an award-by-award basis.

Therefore, determining whether the grantee is an employee or non-employee is critical for accounting for the awards.

3. Classification of Awards

The awards classified as within the scope of ASC 718 need to be further assessed as to whether features of the award result in the "Liability" or "Equity" classification. Key factors, which should be considered for such classification assessment include:

- The legal form of the instrument (to be classified as equity, it must be considered legal equity of the partnership or LLC).
- Participation features such as voting rights, distribution rights, and liquidation rights (i.e., to be classified as equity, the instrument must participate in the residual returns of the entity's net assets in a manner consistent with equity ownership).
- Transferability of the instrument.
- Retention of vested interests upon termination of employment or when a nonemployee ceases to provide goods or services (liability classification is likely when vested interests are not retained upon termination).
- The settlement and repurchase features.

The classification assessment determines how the awards are accounted for and reported in the financial statements.

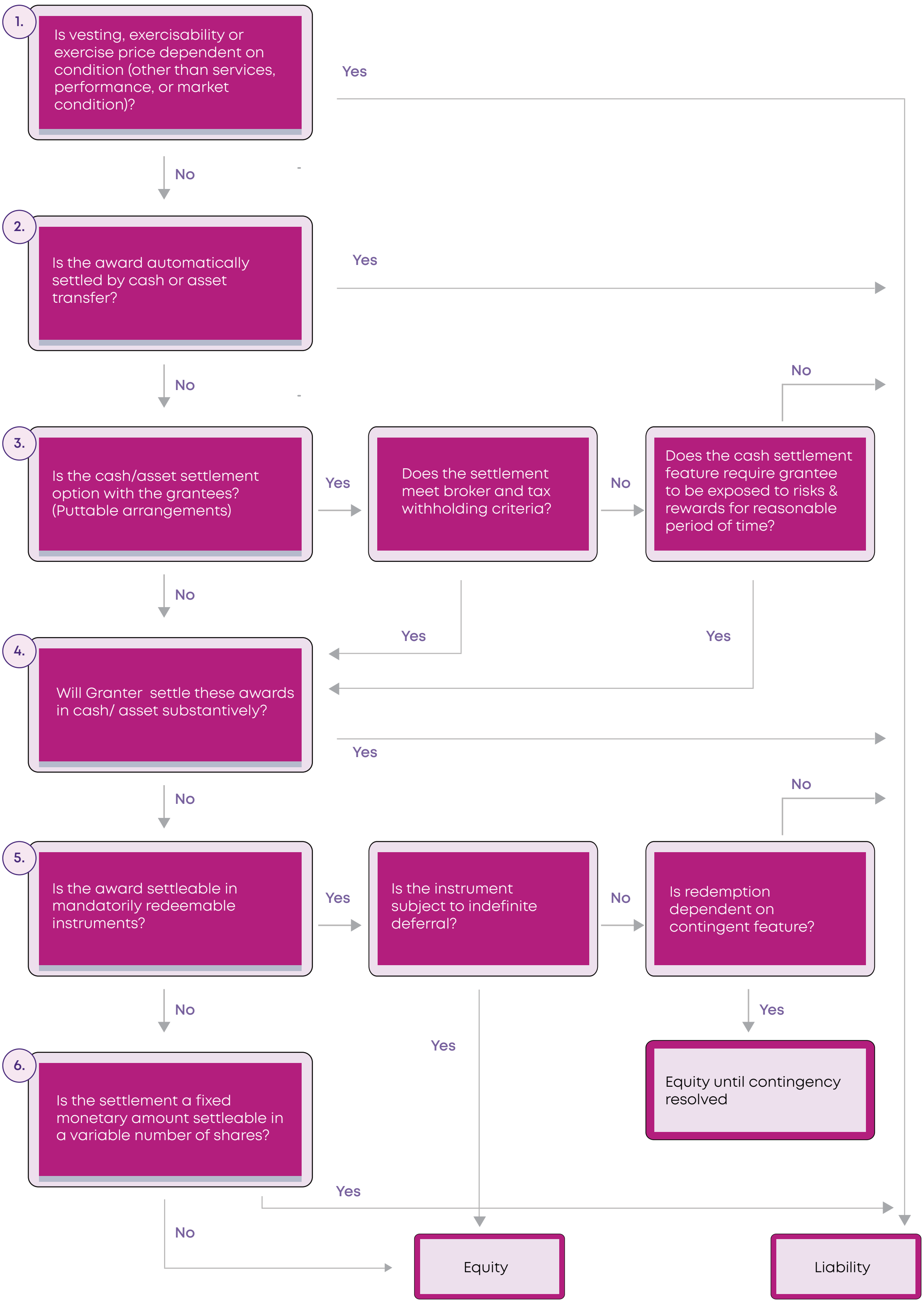
Classification of awards

Equity Classified Awards	Liability Classified Awards
a. Equity-classified awards include stock options and certain types of restricted stock. b. These awards are settled through the issuance of a fixed number of shares of the company's stock. c. The fair value of equity-classified awards is recognized as compensation expense over the vesting period, with adjustments for forfeitures. d. Equity-classified awards are measured at grant-date fair value and not re-measured. e. Awards are classified as equity when there are no conditions for mandatory redemption or cash settlements that would require classification as liabilities. f. Contingent cash-settlement features only affect classification if the event leading to cash settlement is probable and beyond the company's control.	a. Liability-classified awards include certain types of stock appreciation rights (SARs) and other instruments that may be settled in cash or the company's stock, at the option of the holder. b. Unlike equity-classified awards, liability-classified awards are marked to market each reporting period. c. Changes in the fair value of liability-classified awards are recognized in the income statement as compensation expense until the awards are settled. d. If an award's terms include a condition related to an external index (e.g., commodity price), it may be classified as a liability and is subject to fair value re-measurement due to the impact of non-standard conditions. e. Awards allowing cash settlement upon specific contingent events (e.g., a change in control or liquidation) can be liability-classified, depending on the likelihood of such events. When such contingencies are probable, the awards are classified as liabilities and updated to reflect fair value at each reporting date. f. Awards linked to mandatorily redeemable financial instruments are generally classified as liabilities leading to recognition of ongoing fair value changes.

Compensation cost to be recognized for awards within the scope of ASC 718 depends upon whether the awards are classified as equity or liabilities (i.e., a fair-value-based measure as of the grant date for most equity-classified awards versus a fair-value-based measure as of the end of each reporting period until settlement for liability-classified awards).

The following flow diagrams provide an overview of the determination of share-based awards as equity or liability.

Flow Chart– Equity or Liability Classification for an Award



1. Guidance	Implementation matters

• Stock-based awards wherein terms of vesting or exercisability or exercise price are subject to conditions (other than services, performance, or market condition), is classified as a liability and no further classification tests need be considered.
• Examples:
  • Award in which the exercise price is linked to the price of crude oil.
  • Award issued by oil and gas producers that vest based on increases in crude oil prices.
	• Stock-based awards wherein terms of vesting or exercisability or exercise price are subject to services, performance, or market condition, would be evaluated further for equity classification.
	• Award exercisable, if the entity's share price outperforms an index of share prices (e.g., the S&P 500) is a market condition Or Award wherein vesting is contingent upon a condition that growth in EPS outperforms the EPS growth of a group of peer entities is a performance condition. Such arrangements would be equity-classified for share award purposes if they otherwise qualify as equity-classified awards.

Under the circumstances wherein vesting is based on performance condition, requiring comparison of the entity's performance measure with the performance measure of a group of entities, the performance measure should be the same for e.g. If the award's vesting is based on the growth in the company's EPS during the requisite service period exceeding the growth in EPS for a group of peer companies for the same period the award shall meet the performance condition.

However, if awards vesting is based on a comparison of the growth in the company's EPS during the service period to the growth in the pretax income for a group of peer companies for the same period, does not represents the same performance measure (Company's EPS Vs. pretax income for a group) hence condition is neither a performance condition nor a service or market condition and the award would be liability-classified.

2. Guidance	Implementation matters

• Stock-based awards wherein terms of grant require an issuing entity to settle the award by transferring cash or other assets are generally classified as a liability.
• Examples:
  • Share appreciation right (SAR),
  • Phantom Stock Plan,
  • Cash performance units.
under which a grantor has an obligation to pay a grantee either on demand or at a specified date an amount of cash or other assets equivalent to the increase in the entity's share price from a specified level.
	• Stock-based awards wherein terms of grant permits grantees to net-share settle vested share options do not trigger liability classification, provided that the shares and share options cannot be put to the company for cash.
	• **Exceptions** to rule "Cash-Settled Awards are classified as Liability:
	  • Arrangements with the features permitting tax withholding settlement up to the employee's maximum individual statutory tax rate,
	  • Arrangements with the features permitting cash settlement arranged through a broker, and
	  • Arrangements with Put options allowing option holder to put back the shares issued back to the issuer as per the terms which causes grantee exposed to the market value of the shares for a reasonable period of time.

Share-based payment arrangements wherein the term of settlement includes a combination of cash and stock. In such a case it is appropriate to account for these arrangements as two separate awards, an equity-classified share option award and a liability-classified cash-settled award.

For example, an entity may grant 1000 share options to an employee and also commit to make an additional cash payment equal to a 20% of the value of the options when exercised.

Such an award is intended to cover the taxes due when the share options are exercised (i.e., a tax gross-up or top-off payment). These awards can be viewed as two awards:

(i) an award of 1000 equity-classified share options; and

(ii) an award of cash-settled share options that will be liability-classified.

3.

Guidance	Implementation matters
• In the case of Puttable award arrangements wherein terms of arrangement permit the holder of the puttable share award to put the shares back to the issuing entity, the awards would be liability-classified if- • the arrangement permits the holder to put the shares obtained upon exercise: **without being exposed to the risks and rewards of the shares for a reasonable period of time from the date the goods are delivered, or the services are rendered and the shares are issued** OR • it is likely that the entity will prevent the holder from being exposed to the economic risks and rewards of shares for a reasonable period of time.	• Award arrangements wherein the grantee is provided with a put option allowing the holder of puttable shares to put the shares back to the issuing entity at its then fair value; the grantee would bear risk and reward of ownership. In such a case the award shall be classified as equity provided the repurchase right is delayed until the grantee has held shares for a reasonable period of time (at least 6 months). On the other hand, if shares are not required to be held for reasonable period of time, it shall be liability-classified until reasonable period of time elapses post that same shall be equity classified.

For award arrangements wherein the grantee is provided with Put option, the classification assessment is primarily based on the principles of determination repurchase price at which grantee/ holder of shares can put back the shares to the Company.

- For the awards wherein there exist fixed repurchase price or Formula Repurchase Price, a grantee would not bear the risks and rewards of ownership, hence these are classified as Liability.
- For awards wherein repurchase price is linked to fair value it may be classified as equity provided shares are held by holder for reasonable period of time.

4.

Guidance	Implementation matters
• Stock awards wherein terms of arrangement consist of either a share option or a cash-settled SAR, and the choice of settlement is the entities. In such case the grantor's past practice of settling awards with multiple settlement alternatives may affect the classification of the awards. Under such circumstances if the entity usually settles in cash, it's past practice would result in a liability classification for the award.	• The repeated choice of cash settlement by the grantor may establish a past practice by the grantor that affects the substantive terms of the award when determining the classification for accounting purposes.

5.

Guidance	Implementation matters
• As per ASC 718, share awards are classified as liabilities if the underlying shares are classified as liabilities. • Share awards to be settled by issue of mandatorily redeemable financial instruments classified as a liability as per the principles of ASC 480 shall be classified as liabilities.	• As per ASC 480, shares embodying an unconditional obligation (i.e., an obligation that is required to be executed) requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or on an event certain to occur shall be considered as mandatorily redeemable. In other words, because of past transactions, the instruments contain a requirement to transfer assets of the entity at a future date, and the issuing entity does not have the discretion to avoid that transfer. • A mandatorily redeemable share is classified as a liability unless redemption is required to occur only on the liquidation or termination.

Financial instruments wherein terms of issue provide the conditional obligation to redeem the instrument (i.e., it requires the transfer of assets based on an event not certain to occur), **it is only considered mandatorily redeemable and, therefore, a liability, once that event occurs,** the condition is resolved, or the event becomes certain to occur. Until then it is classified as Equity. Share awards related to such instruments also would be equity-classified while the underlying instruments are equity-classified unless the awards fail to meet other requirements for equity classification as per the principles of ASC 718.

6.

Guidance	Implementation matters
• Stock awards wherein terms of arrangement provide for share-settleable for a fixed monetary amount is liability-classified. because the award does not expose the holder to gains and losses in the fair value of an equity share in the same way as outright share ownership.	• An employee is granted an award that will vest over a five-year period. If the employee completes that service period, he will receive $1,000,000 worth of company shares. The award will be settled in shares of common stock, and the number of shares will be calculated by dividing the $1,000,000 by the fair value of the shares on the vesting date. • Because the award does not expose the holder to gains and losses in the fair value of an equity share in the same way as outright share ownership, therefore award shall be classified as liability.

4. Modification of Awards

Modifying share-based payment awards involves changes to the terms or conditions of existing awards. These changes can affect the recognition and measurement of compensation costs, potentially altering total expenses. Modification accounting should be applied by an entity when there is a modification of an award unless there is no change in the following terms because of modification:

- Fair value (or calculated value or intrinsic value, for entities that use either of those methods);
- Vesting conditions of the award; and
- The classification as either a liability or equity instrument.

Example of Modifications to an award:

Requiring modification accounting	Does not require modification accounting
• Repricing of share options that results in a change in value of those share options. • Changes in service, performance, or market condition. • Changes in the terms of award that change the classification from equity to liability or vice versa; and • Accelerated vesting provision added to the plan in contemplation of an event, under which the awards are immediately vested if the related event occurs.	• Administrative changes, e.g., company or plan name changes; and • Changes in statutory tax withholdings that do not affect the classification of the award.

Modification of the terms or conditions of equity-classified award resulting in the change in fair value or vesting conditions or the classification is construed as an exchange of the original award for a new award. In substance, the issuer is deemed to have repurchased the original instrument by issuing a new instrument of equal or greater value, resulting in incurrence of incremental cost for any incremental value. The incremental cost is determined as follows-:

1. **Pre-Modification Fair Value:** Determine the value of the award immediately before the modification.
2. **Post-Modification Fair Value:** Determine the value of the award immediately after the modification.
3. **Incremental Cost:** The difference between the pre- and post-modification values is recognized as additional compensation cost.

For vested awards, Incremental cost is recognized immediately; however, for unvested awards, the incremental cost is recognized ratably over the remaining vesting term of the award. Therefore, the total remaining compensation cost (i.e., Unrecognized compensation cost on the original award at the date of the modification and Incremental cost related to the modification) of an unvested award (i.e., the requisite service has not yet been completed) is recognized ratably over the remaining vesting term of the award.

Key Considerations related to different types of Modifications

1. Modifications resulting in Change in Vesting Condition

Modification of the terms of award resulting in change in vesting conditions does not affect an award's per share or per share option fair value. However, a modification to the vesting terms may impact the total amount of compensation cost to be recognized thereby requiring assessment of modification accounting. The Four Types of Modifications Affecting Vesting Conditions are detailed as follows:

Modification Type	Description	Accounting Treatment
Type I: Probable-to-Probable	When an award is initially expected to vest, it is still expected to vest after the modification, with no change in the likelihood of meeting the vesting condition and no change in fair value.	For modifications that only change vesting conditions total compensation cost is unchanged for all awards, as there is no additional value upon modification.
Type II: Probable-to-Not Probable *Note-: It is generally believed that Type II modifications will be rare*	When an award initially expected to vest (probable) is modified so that it is no longer expected to vest (not probable).	Record compensation cost if the award ultimately (1) vests under the original terms or (2) would have vested under the modified terms
Type III: Not Probable-to-Probable	When an award initially considered unlikely to vest is modified and becomes probable to vest.	• Calculate cumulative compensation cost based on the fair value of the modified award at the modification date. • Recognize the cost over the remaining service period of the employee or non-employee vesting period.
Type IV: Not Probable-to-Not Probable	When an award was not expected to vest before and after the modification.	• No additional compensation cost was recognized initially at the time of modification. • If probability changes in the future and vesting becomes likely, recognize compensation cost using the modified date fair value.

Following are the examples of all the above modification types:

Modification Type	Examples
Type I: Probable-to-Probable	On January 1, 20X1, Entity Y grants 1,000 equity-classified employee stock options, each with a grant-date fair value of $9. The options vest if Entity Y achieves a cumulative net income greater than $5 million over a four-year period. Since the options are initially expected to vest, Entity Y begins recognizing compensation costs on a straight-line basis over the four-year service period. For the first three years (20X1, 20X2, and 20X3), Entity Y records $2,250 in compensation costs annually. *Journal Entry:* December 31, 20X1, 20X2, and 20X3 Compensation cost 2,250 To APIC 2,250 (To record compensation cost for each of the years ended December 31, 20X1, 20X2, and 20X3.) On January 1, 20X4, Entity Y modifies the performance condition to lower the net income target to $4.5 million, providing additional retention incentives to employees. The modification does not change other terms of the options, and the fair value-based measure remains the same before and after the modification. As a result, no incremental compensation cost is recorded. If the modified performance condition is met, Entity Y will record total compensation cost of $9,000 (1,000 options × $9 grant-date fair value) over the vesting period. For the year 20X4, Entity Y recognizes $2,250 in compensation cost, consistent with prior years. *Journal Entry: December 31, 20X4* Compensation cost 2,250 To APIC 2,250 *(To record compensation cost for the year ended December 31, 20X4.)*

Modification Type	Examples
Type II: Probable-to-Not Probable	Entity T grants 1,000 at-the-money employee share options with a contractual term of 10 years to each of 10 employees in the sales department. All share options vest at the end of three years (cliff vesting), which is an explicit service (and requisite service) period of three years. 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. For simplicity, this Example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Based on historical sales patterns and expectations related to the future, the 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. On January 1, 20X7, 102,000 units of product A were 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 canceled nor settled as a result of the cash bonus program. The cash bonus program would be accounted for using the same accounting as 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, the 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: 0** 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.

Modification Type	Examples
Type II: Probable-to-Not Probable	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 a 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 *(Source-: Excerpt from ASC 718-20-55-109; 55-113 through 55-115)*
Type III: Not Probable-to-Probable	On January 1, 20X1, Entity X grants 1,000 equity-classified at-the-money employee stock options, each with a grant-date fair value of $9. The options vest if Entity X achieves a cumulative net income greater than $5 million over a four-year period. Believing it probable that the performance condition will be met, Entity X begins recognizing compensation costs on a straight-line basis over the service period. For the years 20X1 and 20X2, Entity X records $2,250 in annual compensation costs. Journal Entries: December 31, 20X1 and 20X2 Compensation cost 2,250 To APIC 2,250 *(To record compensation cost for the years ended December 31, 20X1 and 20X2.)* By December 31, 20X3, based on financial performance, Entity X no longer considers it probable that the performance condition will be met. Consequently, it reverses the $4,500 of previously recognized compensation costs, reducing the cumulative recognized compensation cost to zero. Journal Entry: December 31, 20X3 APIC 4,500 To Compensation cost 4,500 *(To reverse previously recognized compensation cost.)* On January 1, 20X4, Entity X modifies the performance condition to reestablish retention incentives, lowering the cumulative net income target to $3 million. The fair value of the modified award at the modification date is $12. Since it was improbable the original options would vest, Entity X bases compensation cost on the modification-date fair value. Entity X recognizes a total compensation cost of $12,000 (1,000 options × $12 fair value) over the remaining one year of service, recording the full amount in 20X4. *Journal Entry: December 31, 20X4* Compensation cost 12,000 To APIC 12,000 *(To record compensation cost for the year ended December 31, 20X4.)*

Modification Type	Examples
Type IV: Not Probable-to-Not Probable	On January 1, 20X1, Entity Z grants 1,000 equity-classified employee stock options with a grant-date fair value of $9. The options vest only if: **1. Performance Condition:** Entity Z achieves cumulative net income greater than $5 million over four years. **2. Performance Condition:** Entity Z completes an IPO. Entity Z believes the net income target will be met but considers the IPO improbable (as IPOs are typically not considered probable until completed). As a result, no compensation cost is recognized. On January 1, 20X4, due to deteriorating financial performance, Entity Z modifies the net income condition, lowering the cumulative target to $4 million. The modification does not change any other terms of the options. The fair value of the modified award at the modification date is $12. However, since the IPO is still improbable, no compensation cost is recognized (0 options expected to vest × $12 modification-date fair value). If both the modified net income target ($4 million) and the IPO are subsequently achieved, the options will vest. At that point, Entity Z will recognize a compensation cost of $12,000 (1,000 options × $12 modification-date fair value). *Journal Entry: -* Compensation cost 12,000 To APIC 12,000 *(To record compensation cost for the fully vested options.)*

2. Modifications resulting in Change in fair value

Entity may modify the terms of awards granted to the grantee, resulting in a change in its exercise price or extending the contractual terms. Modification resulting in a change in the exercise price or a change in the contractual term (thereby changing the remaining expected term of the share option) affects the per share option fair value of the award. The following summarizes key accounting considerations related to a change in fair value -:

Modification of “Exercise Price”

Lowered Exercise Price

Increases fair value; recognize incremental fair value as additional cost.

Increased Exercise Price

Reduces fair value but does not decrease previously recognized cost.

Modification of “Contractual term”

If the Vesting Period Increases

a. Involves extending the requisite service period.

b. Result in incremental compensation cost if the fair value of the modified award exceeds the fair value of the original award immediately before the modification.

c. Compensation Cost is recognized over the extended service period.

If the Vesting Period Decreases

a. Often referred to as “acceleration of vesting.”

b. Compensation Cost is immediately recognized upon the acceleration of vesting.

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Comparison with IFRS

Illustrative example- Modification of unvested share options with cliff vesting terms

On January 1, 2021, XYZ Inc. grants 3,000 share options with an exercise price of $20 per share option (the current share price). The awards cliff vest after three years of service. The grant-date fair value is $6 per share option. XYZ's policy is to account for forfeitures when they occur. During 2021 no forfeitures are expected or occur, so XYZ recognizes compensation cost of $6,000 (3,000 share options × $6 × 1/3).

On January 1, 2022, XYZ Inc. reduced the exercise price of the share options to $10, which equals the share price at the date of the modification. No other terms or conditions of the award are changed. The fair value of the modified award is $3.50 per share option and the fair value of the original award at the date of the modification is $2.00 per share option.

As the fair value of the award is not the same immediately before and after the change of the award, the entity accounts for the effect of the modification on January 1, 2022. The compensation cost recognized over the remaining employee requisite service period after the modification of the award (and assuming there are no forfeitures) is computed as follows:

Fair value of modified share option at January 1, 2022	$3.50
Less: Fair value of original share option at January 1, 2022	$2.00
Incremental compensation cost per share option	$1.50
Number of unvested awards modified	3,000
Incremental compensation cost to be recognized	**$4,500**
Unrecognized compensation cost on original award at the date of the modification (3,000 share options × $6 × 2/3)	$12,000
Total remaining compensation cost to be recognized	**$16,500**

The remaining compensation cost of $16,500 is recognized ratably over 2022 and 2023 (the remaining employee requisite service period).

Illustrative example- Impact of Modification on vested and unvested share options with graded vesting terms

On January 1, 2021, XYZ Inc. grants 3,000 share options with an exercise price of $20 per share option (the current share price). The options contain a graded vesting schedule (i.e., 1/3 of the options vest at the end of each year of service). In accordance with the accounting policy, election to choose between straight-line or graded vesting attribution, XYZ Inc. records compensation cost on a straight-line basis over the total requisite service period for the entire award. The grant-date fair value is $6 per share option. XYZ's policy is to account for forfeitures when they occur. During 2021, no forfeitures are expected to occur, so XYZ recognizes a compensation cost of $6,000 (3,000 share options × $6 × 1/3).

On January 1, 2022, XYZ Inc. reduced the exercise price of the share options to $10, which equals the share price at the modification date. No other terms or conditions of the award are changed. The fair value of the modified award is $3.50 per share option and the fair value of the original award at the date of the modification is $2.00 per share option.

As the award's fair value is not the same immediately before and after the change to the award, the entity accounts for the effect of the modification on January 1, 2022. The compensation cost recognized over the remaining employee requisite service period after the modification of the award (and assuming there are no forfeitures) is computed as follows:

Fair value of modified share option at January 1, 2022	$3.50
Less: Fair value of original share option at January 1, 2022	$2.00
Incremental compensation cost per share option	$1.50
Number of unvested awards modified	3,000
Incremental compensation cost to be recognized	**$4,500**
Unrecognized compensation cost on original award at the date of the modification (3,000 share options × $6 × 2/3)	$12,000
Total remaining compensation cost to be recognized	**$16,500**

XYZ Inc. records $1,500 of incremental compensation cost immediately because 1/3 of the options have vested. The remaining $3,000 ($4,500 less the $1,500 recognized) of incremental compensation cost, along with the $12,000 of compensation cost associated with the modified unvested awards, is recognized ratably over 2022 and 2023 (the remaining employee requisite service period).

3. Modifications resulting in Change in Classification

Classification modification	Key Considerations
Equity-classified award modified to liability-classified award	The modification resulting in change in classification from equity to liability will result in cumulative compensation cost equal to the greater of: a. the grant-date fair value of the original equity-classified award or b. the fair value of the modified liability-classified award when it is settled
Liability-classified award modified to Equity-classified award	• Fair value of the award at the date of the modification becomes its measurement basis from that point forward. • In this case, cumulative compensation cost can be less than the award's grant-date fair value if, at the date of the modification, the fair value of the liability-classified award is less than its grant-date fair value.

5. Profits interest awards

Certain entities provide employees or non-employees with profits interest awards to align compensation with an entity's operating performance and allow those holders to participate in future profits and/or equity appreciation of the entity. The term profits interest is not defined in GAAP. Still, it differentiates those interests from capital interests held by investors that provide those holders with rights to the existing net assets in a partnership or similar entity (for instance, a limited liability company [LLC]). Because profits interest holders only participate in future profits and/or equity appreciation and have no rights to the existing net assets of the partnership, it becomes difficult to determine whether a profits interest award should be accounted for as a share-based payment arrangement (Topic 718) or similar to a cash bonus or profit-sharing arrangement (Topic 710, Compensation—General, or other Topics).

Correct accounting depends upon the correct classification of awards. While these awards' legal and economic forms can vary, they should be accounted for based on their substance. An award that has the characteristics of an equity interest represents a substantive class of equity and should be accounted for under ASC 718; however, an award that is, in substance, a performance bonus or a profit-sharing arrangement would be accounted for in accordance with other guidance as applicable to employee arrangement such as ASC 710. In other words, profits interest awards may be akin to equity interests or profit sharing/bonus arrangements. In the absence of any authoritative guidance, judgment is required to make that assessment, which in practice, has resulted in diverse accounting for these awards.

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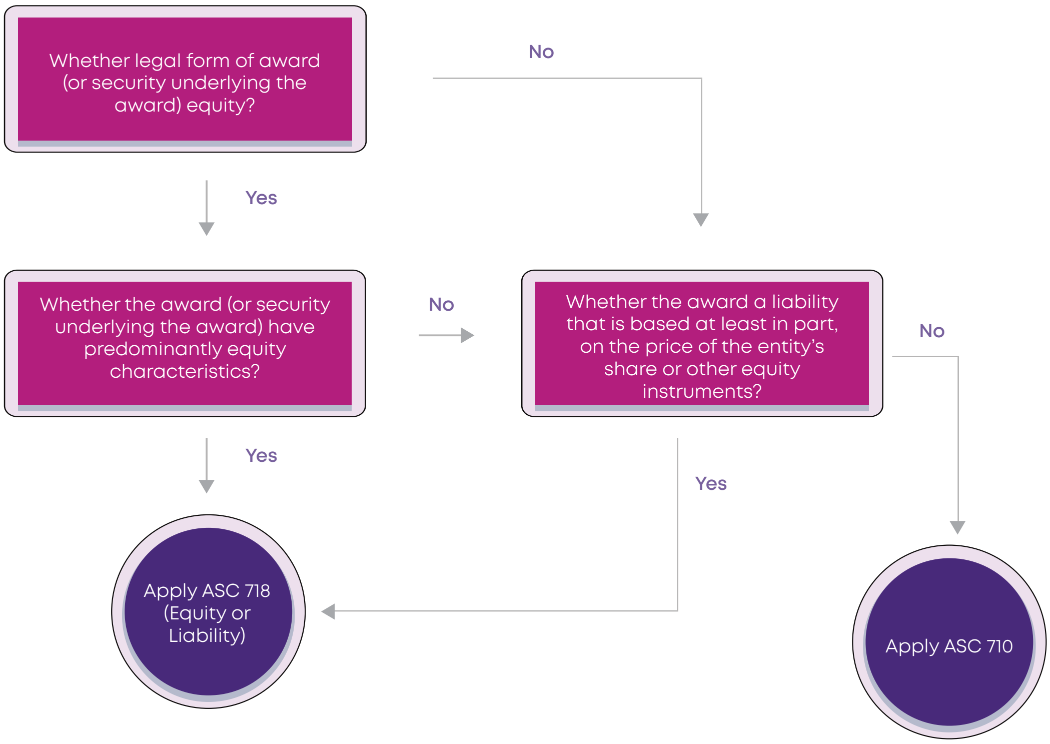
Following flow diagram summaries, the steps for classification assessment of profit interest awards as a share-based payment arrangement (Topic 718) or similar to a cash bonus or profit-sharing arrangement (Topic 710, Compensation—General, or other Topics).:



Recognition and measurement principles of profits interest awards

Nature of Awards	Recognition and measurement principles
a. Profits interest awards classified as Employee Stock awards ***(ASC 718)*** (i) Classified as Equity	• Measure the fair value of the award on the grant date. • Recognize compensation costs over the requisite service period. • No adjustment for subsequent changes in fair value
(ii) Classified as Liability.	• Measure the fair value of the award on the grant date. • Recognize compensation costs over the requisite service period. • Remeasure the fair value of the award each reporting period until the award is settled. • True up compensation cost for each reporting period for changes in fair value pro-rated for the portion of the requisite service period rendered. • Once vested (i.e., the requisite service period is complete), immediately recognize compensation cost for any changes in fair value. That remeasurement process con-tinues until settlement.

Nature of Awards	Recognition and measurement principles
b. Profits Interest Award that is, in sub stance, a profit-sharing arrangement or performance bonus ***(ASC 810)***	Recognizing the liability and compensation cost as per the guidance of the deferred compensation plan; • The present value of the obligation is fully accrued at the date the employee attains full eligibility for benefits. • If substantive future service is not required, the cost is generally required to be ac-crued at the grant date rather than over the remaining employment or service period. • If, however, the future payments require future services, then the charge to income would be based on the services rendered through the balance sheet date.

FASB, in its efforts to improve the operability of the guidance in ASC 718-10-15-3, issued ASU 2024-01 adding examples to illustrate the scope application of ASC 718. The illustrative example includes four fact patterns to demonstrate how an entity would apply the scope guidance in paragraph 718-10-15-3 to determine whether profits interest awards should be accounted for in accordance with ASC 718.

To learn more about requirements, implementation matters, and key considerations of amendments made by FASB to Topic 718 through Accounting Standard Update ASU 2024-01, refer to our recent publication titled, FASB's Guidance on applicability of ASC 718 to Profits Interest and Similar Awards (Topic 718).

6. Group Awards Accounting

Parent companies often grant share-based payment awards (such as stock options or restricted stock) to employees or non-employees of a subsidiary. Similarly, a subsidiary may also grant share-based payments to employees or non-employees of the parent company or of other subsidiaries within the consolidated group. Accounting for share-based payment awards exchanged within a group of companies—such as between a parent and its subsidiaries or among subsidiaries in a consolidated group—can be a complex issue in practice. Many practitioners struggle with this, especially regarding recognizing the expense and handling intercompany eliminations.

When stock-based awards, such as stock options or restricted stock units (RSUs), are issued, the treatment for a holding company and its subsidiaries will depend on whether the awards are granted by the parent or the subsidiary and how those expenses are reflected in the consolidated financial statements. The following simplifies the guidance for stock-based compensation under ASC 718

A Parent is a company with two consolidated subsidiaries, Subsidiary M and Subsidiary N. During the year, the following stock-based compensation is granted:-

Scenarios	Parent's Consolidated Financial Statements (CFS)	Subsidiary M's Separate Financial Statements (SFS)	Subsidiary N's Separate Financial Statements (SFS)
Scenario 1: Parent grants equity in Parent to Sub M's employees	· Stock compensation accounting shall be applied in CFS as per the principles of ASC 718. · Employees of a subsidiary are considered employees of the parent in CFS to apply ASC 718. · Awards would be measured at fair value on the grant date and accounted for as awards granted to an employee, as defined by ASC 718.	· In SFS, awards would be accounted for under ASC 718, recognizing compensation cost at grant date fair value. · If no consideration is charged by the parent for awards granted to the subsidiary employees, the value of the awards granted to Sub M's employees would be considered a capital contribution from Parent.	N/A
Scenario 2: Sub M grants equity in Sub M to Parent's employees	· Stock compensation accounting shall be applied in CFS as per the principles of ASC 718. · Awards of subsidiary equity represent equity (non-controlling interest) in the consolidated entity.	· Equity granted to the employees of a parent without any consideration shall be recognized as a dividend to the Parent at fair value on the grant date with a corresponding amount as equity.	N/A

Scenarios	Parent's Consolidated Financial Statements (CFS)	Subsidiary M's Separate Financial Statements (SFS)	Subsidiary N's Separate Financial Statements (SFS)
Scenario 3: Sub M grants options to purchase Sub M's shares to employees of Sub N	Same treatment as Scenario 2.	Subsidiary M accounts for them as if: 1. they were issued to the parent and 2. the parent then issued them to N. Subsidiary M measures the awards at their fair-value-based measure as of the grant date and recognizes that amount as a dividend from itself to the par-ent; it recognizes a corresponding amount as equity.	The grant of Sub M's options to the employees of Sub N would generally be considered awards based on the equity of another entity. Under this view, the awards would be accounted for in accordance with ASC 815 with the change in fair value measured each reporting period and recognized as compensation cost. As the awards are provided to Sub N by Parent (through Parent's direction of Sub M to issue the awards), the change in fair value would be considered a capital contribution and recognized as an increase or decrease in Parent's equity in Sub N's SFS.
Scenario 4: Parent grants awards indexed to the price of Parent's stock that can be settled, at the employee's direction, in cash (by Parent) to employees of Sub M.	· Stock compensation accounting shall be applied in CFS as per the principles of ASC 718. · Since the awards allow for cash settlement at the employee's election, they would be liability-classified in Parent's CFS. · Accordingly, the Parent remeasured the awards each reporting period until final settlement.	· The awards would be accounted for as employee awards under ASC 718. The impact of remeasuring the awards each reporting period should be reflected in Sub M's SFS, generally as compensation cost with an offsetting entry to contributed capital. · Sub M would generally not record a liability as it is not legally obligated to make the payment.	N/A

7. Business Combination

In connection with a business combination, the acquirer may agree to assume existing stock-based compensation arrangements with employees of the acquiree or may establish new stock-based compensation arrangements to compensate those employees for post-combination services. These arrangements may involve cash payments to the employees or the exchange (or settlement) of stock-based awards. These replacement awards, in many cases, include the same terms and conditions as the original awards and are intended to keep the employees of the acquiree "whole" (i.e., preserve the value of the original awards at the acquisition date) after the acquisition. In other situations, the acquirer may change the terms of the stock-based awards, often to provide an incentive to key employees to remain with the combined entity.

ASC 718 does not provide specific guidance on accounting for awards exchanged in a business combination. However, ASC 805, Business Combinations, does include specific guidance on this subject.

ASC 805-30-30-9 notes that the acquirer is obligated to replace the acquiree's share-based payment awards "if the acquiree or its grantees have the ability to enforce replacement." It further indicates that the acquirer is obligated to replace the awards if replacement is required by (1) the terms of the acquisition agreement, (2) the terms of the acquiree's awards, or (3) applicable laws or regulations.

Replacement of Acquiree Awards:

- When an acquirer replaces the share-based payment awards of the acquiree, it is essential to determine whether these awards are part of the consideration for the acquisition of business to be recognized as a business combination transaction or it relate to a business combination event to be recognized as future compensation cost in post business combination financial statements.
- Replacement awards are measured at their fair value at the acquisition date. The portion attributable to pre-combination service is accounted for as part of the purchase price (equity), while the portion attributable to future service is recognized as post-combination compensation expense over the requisite service period.

Following flow diagram illustrates the steps in an entity's determination of the amount to recognize as consideration transferred in a business combination and as post-combination compensation cost.

Is the acquirer obligated to replace the acquiree's awards?

Yes

Include all or a portion of thefair-value-based measure of the acquirer's replacement awards in the consideration transferred. The portion not included in the consideration transferred is included in post combination compensation cost.

Step 1: Calculate the fair-value-based measure of the acquirer's replacement awards and the acquiree's awards being replaced as of the acquisition date.

Step 2: If the fair-value-based measure of the replacement awards is greater than the fair value-based measure of the replaced awards as of the acquisition date, attribute the difference to post combination compensation cost in accordance with ASC 718.

Step 3: Calculate the portion of the acquisition date fair-value-based measure of the replacement awards that should be attributed to consideration transferred (i.e., pre combination vesting) and the portion of the fair-value-based measure that should be attributed to post combination compensation cost (i.e., post combination vesting).

No

If replacement awards are issued, generally account for the entire award as post combination compensation cost.

The portion of the replacement share-based payment awards that is attributable to pre combination vesting, and therefore included in the consideration transferred, is calculated as follows:

Amount included in consideration transferred	Acquisition-date fair-value-based measure of the acquiree's replaced awards **x** Ratio of the pre-combination vesting to the greater of (1) the total vesting period* or (2) the original vesting period of the acquiree's replaced awards. **** Total vesting period=** Vesting period for the acquiree's replaced awards completed before the acquisition date + Post combination vesting period, if any, for the acquirer's replacement awards.*
Post combination compensation cost	Acquisition-date fair-value-based measure of the ac-quiree's replaced awards (-) Amount attributable to pre-combination vesting (+) Incremental fair-value-based measure of the acquirer's replacement awards in excess of the fair-value-based measure of the acquiree's replaced awards as of the acquisition date (if any)

Illustrative Example: Acquirer Replacement of Employee Awards

Case A: No Post combination Vesting Required; All Requisite Service Rendered

Case B: Post combination Vesting Required; All Requisite Service Rendered

Case C: Post combination Vesting Required, Incomplete Pre combination Service

Case D: No Post combination Vesting, Incomplete Pre combination Service

	Case A	Case B	Case C	Case D
Scenario	Acquirer issues replacement awards valued at $110 for Target awards valued at $100.	Replacement awards valued at $100 require an additional year of service post-acquisition. Original awards had a four-year service requirement.	Replacement awards worth $100 require one year of post combination service, with employees only completing two of four required years before the acquisition.	Replacement awards valued at $100 require no further service post-acquisition, and two years of a four-year service requirement had been completed before the acquisition.
Facts	No post-combination vesting is needed. All required service for the original Target awards was rendered before the acquisition date.	Target employees already completed four years of service. New awards require one more year of service.	Original awards had a four-year service requirement. Two years of service already rendered by the acquisition date.	Awards do not require any remaining service post-acquisition.

	Case A	Case B	Case C	Case D
Analysis	**Pre combination Vesting:** $100 is included in the consideration transferred. **Post combination:** The additional $10 is recognized as immediate compensation cost.	**Total Service Period:** 5 years (4 pre-combination + 1 post combination). **Pre combination Vesting:** $80 is included in the acquisition cost, calculated as $100 × (4 ÷ 5). **Post combination:** $20 is recognized as post combination compensation cost	**Total Service Period:** Adjusted to 3 years (2 pre-combination + 1 post-combination). **Pre combination Vesting:** $50 calculated as $100 × (2 ÷ 4). **Post combination:** $50 recognized as compensation cost post-acquisition	**Pre combination Vesting:** $50 as $100 × (2 ÷ 4). **Post combination:** Remaining $50 recognized immediately as compensation.
Conclusion	Entire pre combination portion ($100) is part of acquisition cost; excess ($10) is expensed.	$80 considered transferred value, and $20 expensed over the post combination period.	Half of the award value ($50) is acquisition consideration, and the other half ($50) is a post combination expense.	$50 treated as transferred value, and $50 is expensed immediately.

Key Takeaways:

- **Pre combination Vesting** is included in the acquisition cost based on the completed portion of service.
- **Post combination Compensation** Cost depends on unrendered service periods and whether vesting requirements remain post-acquisition.

KEY ISSUES/CONSIDERATIONS

Issue 1: "Spring-Loaded" Share-Based Compensation Transactions and Valuation Adjustments

"Spring-loaded" share-based compensation refers to a scenario where a company grants stock options or other equity-based compensation to employees right **before** a material event is expected to cause a significant increase in the company's stock price, such as a positive earnings announcement, acquisition, or other market-moving event.

The SEC has noted instances where companies grant share-based compensation while in possession of positive material non-public information. In response, the SEC issued Staff Accounting Bulletin: 120 (SAB 120) to provide interpretive guidance for public companies engaged in share-based payment transactions under such circumstances. SAB 120 offers additional guidance for estimating the fair value of share-based payment transactions in accordance with Topic 718, focusing on determining the current price of the underlying share and estimating the expected volatility of the share price over the expected term when material non-public information is involved.

According to ASC 718-10-30-6, companies must estimate the fair value of the equity instrument as of the grant date. In the case of spring-loaded stock options, the market price of the underlying shares may not reflect the impact of material non-public information. Consequently, the fair value of such options on the grant date would not capture the effect of a potential positive price movement in the underlying shares.

Management is typically required to develop estimates related to (i) the volatility of the underlying share price, (ii) the expected term of the option, and (iii) the determination of the current price of the underlying share. The SEC staff emphasizes that adjustments to the market price and volatility of the underlying share involve significant company management judgment.

The SEC staff also expects management to disclose its accounting policies regarding adjustments to the closing price, the method used to determine the adjustment amount, and any significant assumptions applied in making such adjustments.

Facts: Company D, a public entity, entered into a significant contract with a customer after market close and subsequently awarded non-routine share options to its executives. These awards, approved by the Board in anticipation of the contract, were granted before the next trading day when the share price was expected to rise significantly due to the announcement. Company D's accounting policy consistently uses the closing share price on the grant date to estimate the fair value of share options.

Should Company D adjust the closing share price to determine the current share price for estimating the fair value of the share options?

Analysis: The SEC staff advises that before granting such awards, Company D should evaluate its alignment with internal policies, shareholder-approved compensation plans, governance standards, and legal requirements. Additionally, the staff emphasizes the need for robust corporate governance and effective financial reporting controls. In this scenario, using the unadjusted closing share price would not meet the fair value measurement objective of ASC Topic 718, as it would not provide an unbiased estimate reflecting marketplace conditions at the grant time. An adjustment to the closing price is necessary to account for the impact of the material contract.

Issue 2: Determination of Grant date

Determining the **grant date** is a critical issue in accounting for share-based compensation. It affects when and how compensation expense is recognized, the calculation of fair value, and the overall accuracy of financial reporting.

The grant date is determined when the grantor and grantee mutually understand the award's key terms and conditions and obtain all necessary approvals (e.g., board or shareholder). The grant date reflects the point at which the grantee begins to benefit from or be affected by changes in the grantor's equity price. Key considerations include Approval Requirements, Clarity of Terms, Eligibility, and Uncertainty in Terms.

Below are some key considerations related to determination of grant date: -

Key Considerations	Implementation matters
(a) Approval condition Grant date for Share-based payment awards which are subject to approval by an entity's shareholders, board of directors, can be determined **based on such an approval unless approval is perfunctory or administrative in nature.**	• Grantee's formal acceptance to terms and conditions of awards are generally not determinative to grant date unless a grantee is in a position to negotiate the key terms and conditions of its awards, in which case a grant date cannot occur until both grantor and grantee agree on those terms and conditions.

Illustrative example:

- On January 1, 2021, Entity X's management approved the issuance of 5,000 shares of restricted stock to an executive (all terms are known and communicated to the executive) in accordance with Entity X's executive stock incentive plan.
- The terms of the plan require X's board of directors to approve all individual awards, and management does not control the board. However, on the basis of past practice, it is reasonably likely that the board will approve the award.
- The board meets on April 1, 2021, and approves the award. Therefore, if all other conditions for establishing a grant date have been met, the grant date would be April 1, 2021.
- Note that even though it is likely that approval will be granted, this does not affect the determination of whether an approval is perfunctory and, therefore, of whether a grant date can be established before such approval is obtained. Rather, the approval in this example would not be considered perfunctory because management does not control the outcome of the board's vote.

Key Considerations	Implementation matters
(b) Unknown Conditions • Employee share awards which contain a performance condition or market condition whose achievement depends on future events that are not within the control of the issuing entity the grant date can be established, provided **the performance condition or market condition must be objectively determinable and nondiscretionary.**	• **Performance Conditions:** Under the circumstances in which performance conditions are subjective or discretionary (e.g., individual performance ratings without objective criteria), the grant date cannot be established until subjectivity is resolved. • **Market Conditions:** Under the circumstances in which market conditions are clearly defined and objectively measurable (e.g., stock price thresholds), a grant date may still be established even if some inputs are unknown at issuance

Illustrative example:

- On January 1, 2021, XYZ Inc. issues 10,000 shares of restricted stock to its employees. The shares will vest in 25 percent increments (tranches) each year over the next four years if XYZ's actual earnings for each year exceed its annual budgeted earnings by 10 percent (i.e., a graded vesting schedule). XYZ Inc. set its annual budget in November of the previous year.
- In this scenario, on January 1, 2021, a grant date can be established for only 2,500 of the shares, assuming all other conditions for establishing a grant date have been met.
- A grant date cannot be established for the remaining 7500 shares because the performance conditions for the shares have not been established yet. The grant dates for those shares will occur once XYZ's annual budget for the appropriate year has been established and the employee is aware of the performance target (or the performance target is communicated to the employee within a "relatively short time period" thereafter).

- The grant dates will most likely be as follows:

Tranche of shares	**Likely Grant date**
First tranche of 2,500 shares	January 1, 2021
Second tranche of 2,500 shares	November 2021
Third tranche of 2,500 shares	November 2022
Fourth tranche of 2,500 shares.	November 2023

Illustrative example:

- On October 1, 2021, Entity PQR issued RSUs to Employee M. The RSUs will vest in 1,000 shares of common stock if (1) PQR's stock price increases 15 percent from January 1, 2022, to December 31, 2022, and (2) M is still employed on December 31, 2022.
- As of October 1, 2021, M understands what stock price increase must be achieved to earn the award relative to the stock price as of January 1, 2022. Accordingly, on October 1, 2021, a grant date may be established even if the stock price on January 1, 2022, is unknown when the RSUs are issued because the market condition is objectively determinable and nondiscretionary.

Key Considerations	Implementation matters
(c) Unknown Exercise Price • A grant date cannot be established until the exercise price of an award is known if the price depends on future conditions or dates. • The exercise price must be determined and communicated so that the grantor and grantee can reach a mutual understanding of the award's terms.	• If the terms of the award specify that the exercise price is set based on the stock price on a future date, the grant date is delayed until that price is finalized. • However, a grant date can be established: • When the exercise price is tied to current prices with clear parameters (e.g., a discount or cap), as the terms are objectively determinable or • When the exercise price is based on current market conditions and determined using objective parameters (e.g., a percentage discount on the stock price or a pre-set formula). In such case the parameters allow the exercise price to be predictable, even if the exact amount is not known immediately.

Illustrative example:

- On January 1, 2021, Entity P issues 10,000 employee stock options that vest at the end of one year of service (cliff vesting). All terms of the options are known except for the exercise price, which is set equal to the lower of the market price of P's shares on January 1, 2021, or its market price on December 31, 2021 (i.e., the employee is given a look-back option).
- As per the facts of the given case, a grant date can be established for January 1, 2021, if all other conditions for establishing a grant date have also been met, even though the ultimate exercise price is not known, since it cannot be greater than the current market price of P's shares.
- In this case, the relationship between the exercise price and the current market price of P's shares constitutes a sufficient basis for understanding both the compensatory and the equity relationships established by the award. While the employee may not be adversely affected by any decreases in P's share price, the employee will begin to benefit from subsequent increases in the price of P's shares.

Key Considerations	Implementation matters
(d) Discretionary Provisions • The establishment of a grant date may be hindered if an entity retains discretionary authority to adjust key terms or conditions of share-based payment awards. Such discretion introduces uncertainty about whether a mutual understanding of the award's terms exists between the grantor and the grantee.	• Negative discretion provisions, which allow the entity to reduce the number of awards granted based on specific criteria, require careful evaluation. Factors like past use of discretion, management's intent, and communication with grantees play a role in determining whether such provisions introduce uncertainty that precludes the establishment of a grant date.

Illustrative example:

- An employee is awarded 100 shares of restricted stock on January 1, 2021. The shares vest on the basis of a service condition and a performance condition. While both the service and performance conditions have been specified, management retains the discretion to increase or decrease the number of shares that vest by up to 25 percent on the basis of the entity's performance.
- Management has not provided guidance on what performance criteria would trigger the use of discretion. Furthermore, management has previously exercised discretion provisions for similar share-based payment awards granted to employees.
- The discretion provision will not affect the entity's ability to establish a grant date for the 75 percent of shares that are not subject to the discretion provision and, if all the other criteria for establishing a grant date have been met, a grant date has been established on January 1, 2021, for these 75 shares. However, for the remaining 25 percent of shares subject to the discretion provision, these 25 shares do not have the same terms and conditions as the other 75 shares.
- Thus, the entity should separately evaluate the 25 shares subject to the discretion provision to determine whether the discretion provision for those shares affects the entity's ability to establish a grant date (i.e., a grant date has most likely not been established for the 25 shares).

Issue 3: Clawback Features

A clawback feature requires the grantee to return share options, shares, or realized gains under specific conditions, often without compensation or adjusted for amounts paid. These provisions are typically triggered upon departure, particularly to discourage employees from joining competitors. Clawback features are not factored into the grant-date fair value of the award; instead, they are accounted for only if the contingent event occurs. However, such features can influence the grantee's exercise behavior, potentially affecting valuation assumptions like the expected term. For instance, awards with reload features might have shorter expected terms, leading to a lower grant-date fair value. Entities should evaluate the impact of clawback or reload features on relevant valuation assumptions when determining fair value.

Clawback features are accounted for if and when the contingent event occurs by recognizing the consideration received from the former grantee in the appropriate balance sheet account (treasury stock if the entity receives its shares back) and a credit in the income statement. **The amount of consideration recognized is equal to the lesser of:**

a. recognized compensation cost related to the share-based payment arrangement that contains the contingent feature, or

b. the fair value of the consideration received.

Example: - Accounting for a Clawback Feature

On January 1, 2025, when the market price of its shares is $20 per share, ABC Corp. grants its CEO an award of 100,000 share options that vest on the completion of five years of service. The exercise price of the share option is $20, and the grant-date fair value of each share option is estimated to be $10. However, the award specifies that in the event of the employee's departure and subsequent employment by a direct competitor within three years after vesting, the share options, shares, or their cash equivalent on the date of employment by the direct competitor must be returned to ABC for no consideration to the former employee (a clawback feature).

Because the grant-date fair value of the award ignores the contingent clawback feature, the value at grant date would be $1,000,000 (100,000 × $10).

Assume that the CEO's share options vest and within two years of vesting (but before any of the share options have been exercised), the CEO leaves ABC and is hired as an employee of a direct competitor of ABC. The former CEO is required to return the 100,000 share options. At the time the share options are returned, they have a fair value of $1,600,000.

Answer:

At the date the award is clawed back, the following entry would be recorded to recognize the lesser of the recognized compensation cost ($1,000,000) or the fair value of share options received as a result of the clawback feature ($1,600,000):

Paid-in-capital-share options 1,000,000

To Other income (compensation cost) 1,000,000

Example 2: Accounting for a Clawback Feature When the Value of Shares or Share Options Clawed Back Is Below the Compensation Cost

Assume the same facts as in above example, except that the value of the share options surrendered by the CEO is only $700,000.

Answer:

At the date the award is clawed back, the following entry would be recorded to recognize the lesser of the recognized compensation cost ($1,000,000) or the fair value of share options received as a result of the clawback feature ($700,000).

Paid-in-capital-share options 1,000,000

To Other income (compensation cost) 700,000

To Paid-in-capital surrender share options 300,000

COMPARISON WITH IFRS

ASC 718, Compensation—Stock Compensation under U.S. Generally Accepted Accounting Principles (GAAP), and IFRS 2, Share-based payment under International Financial Reporting Standards (IFRS), both the standards provide guidance on Stock-based compensation accounting. Both accounting frameworks share the same principles-based approach and are largely converged. However, there are some key differences in the application of those principles, as summarized below:

Subject	ASC 718	IFRS 2
Forfeitures of awards with service condition	• Entity may make an entity-wide accounting policy election to either: • estimate forfeitures expected to occur OR • account for forfeitures when they occur.	• An entity is required to estimate forfeitures expected to occur. Unlike USGAAP, there exists no accounting policy choice to account for forfeiture when they occur.
Graded vesting awards with only service condition	• An accounting policy election is made to treat graded vesting awards as either a single award (straight-line cost recognition) or, in substance, multiple awards for both recognition and measurement.	• Such awards must be recognized only as in-substance multiple awards (i.e., on an accelerated basis). Unlike USGAAP, there exists no accounting policy choice of straight-line cost recognition.

Subject	ASC 718	IFRS 2
Recognition of payroll taxes	• Payroll tax liabilities related to share-based payment awards should be recognized on the date on which the measurement and payment of the tax are triggered (e.g., upon exercise or vesting).	• Payroll taxes related to a stock-based compensation plan are expensed by an entity in the income statement when it recognizes the related expense.
Measurement of equity-settled awards	• The measurement date is generally when the equity-classified award are granted.	• Share-based payment awards issued to nonemployees in exchange for goods or for services that are not similar to employee services are measured as of the date the entity obtains the goods, or the counterparty renders the service. • The awards should be measured on the basis of the fair value of the goods or services received unless that fair value cannot be estimated reliably. • If the entity cannot estimate reliably the fair value of the goods or services received, the entity should measure their value by reference to the fair value of the equity instruments granted. However, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.

Subject	ASC 718	IFRS 2
Service inception date that precedes the grant date	• Certain criteria must be met for the service inception date to precede the grant date, which would result in the recognition of compensation cost before the grant date.	• Compensation cost may be recognized earlier than grant date under circumstance wherein the grant date occurs after the grantee begins providing service. Unlike USGAAP there exist no explicit criteria to be met.
Classification of awards with "other" conditions	• A share-based payment award that can be repurchased for cash at fair value is not classified as a liability if the grantee bears the risks and rewards of equity share ownership for a reasonable period of time. (defined as a period of at least six months).	• A share-based payment award that can be redeemed for cash at fair value at the employee's option must be classified, at least in part, as a liability. • There is no exception for a grantee that bears the risks and rewards of share ownership for a reasonable period of time.
Classification of awards with "other" conditions	• Awards with conditions indexed to something other than a market, performance, or service condition must be classified as liabilities, and the additional condition should be reflected in the award's fair value.	• Awards with conditions that are indexed to something other than a market, performance, or service condition may be classified as equity if there is no obligation to settle the awards in cash, and the additional condition should be reflected in the award's fair value as a non-vesting condition.
Classification of net-share- settled awards with statutory tax withholding obligations	• A net share settlement feature for statutory tax withholding purposes wherein the amount withheld exceeds, the number needed to settle the employee's tax obligation, the entire award is classified as a liability.	• A net share settlement feature wherein the number of equity shares withheld exceeds, the number needed to settle the employee's tax obligation, only the excess is accounted for as a liability.

Subject	ASC 718	IFRS 2
Performance targets satisfied after the requisite service period	• Performance conditions that can be met after the requisite service period or non-employee's vesting period are treated as vesting conditions. Therefore, the performance conditions are not directly reflected in an award's fair value-based measure.	• Performance conditions that can be met after the requisite service period are treated as non-vesting conditions. Therefore, the performance condition is directly reflected in the award's fair-value-based measure.
Share-based payment awards with a performance condition based on the occurrence of a liquidity event (e.g., IPO or change in control)	• A liquidity event such as a change in control or an IPO is generally not considered probable (i.e., a future event is likely to occur) until it occurs. Accordingly, an entity generally does not recognize compensation cost related to awards that vest upon a change in control or an IPO until the event occurs.	• For awards in which a liquidity event such as a change in control or an IPO is assessed as a performance condition, compensation cost is recognized if and when the liquidity event is expected to occur which is evidenced once plans are well advanced.
Modification accounting for awards for which vesting is improbable but becomes probable (i.e., improbable to probable modifications)	• Compensation cost is recognized on the basis of the modified award's fair-value-based measure as of the modification date.	• Compensation cost is recognized on the basis of the grant-date fair-value-based measure of the original award plus the incremental value of the modified award on the modification date.

Subject	ASC 718	IFRS 2
Modification accounting for awards that change from liability-classified to equity-classified	• Upon modification, the liability is reclassified to equity. • If the fair-value-based measure of the modified award is less than the fair value-based measure of the liability at the time of the modification the difference is deemed to be a capital contribution and recognized in equity. • If the fair-value-based measure of the modified award is greater than the fair-value based measure of the liability at the time of the modification, the excess is generally recognized as compensation cost over the remaining employee's requisite service period or non-employee's vesting period.	• Upon modification, the existing liability is derecognized. • The fair value-based measure of the equity awards on the modification date is recognized in equity on the basis of which goods or services have been received (i.e., on the basis of the vesting period that has lapsed). • Any difference between the liability derecognized and the amount recognized in equity is reflected immediately in the income statement
Accounting for income tax effects	• For awards that ordinarily give rise to a tax deduction under existing tax law, deferred taxes are computed on the basis of compensation expense that is recognized for financial reporting purposes. • Tax benefits in excess of or less than the related DTA are recognized in the income statement in the period in which the amount of the deduction is determined (typically when an award vests or, in the case of options, is exercised or expires).	• For awards that ordinarily give rise to a tax deduction, deferred taxes are computed on the basis of the hypothetical tax deduction for the share-based payment award corresponding to the percentage earned to date (i.e., the intrinsic value of the award on the reporting date multiplied by the percentage vested). • Recognition of deferred taxes could be recorded through either profit or loss, or equity.

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