Simplified Accounting for Nonemployee Share-Based Payments

The Financial Accounting Standards Board (FASB) recently wrapped up a simplification project that substantially aligns employee and nonemployee share-based payment accounting. The changes will eliminate the need for a separate process for granting and tracking awards to nonemployees and employees and should reduce income statement volatility. The Accounting Standards Update (ASU) also provides additional relief to private companies. Under ASU 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, share-based payments for employees and nonemployees will be measured at fair value on the grant date of the stock payment. The amendments are not expected to result in practice changes for employee share-based payment awards.

This ASU supersedes Subtopic 505-50, *Equity—Equity-Based Payments to Non-Employees;* an entity should apply Topic 718 to nonemployee awards except for specific guidance on inputs to an option pricing model and the attribution of cost. For these items, nonemployee accounting approaches are unchanged from current practice.

Effective Dates **ASU 2018-07**	**Public Business Entities (PBE)**	**All Others**
	Annual and interim reporting periods beginning after December 15, 2018	Annual reporting periods beginning after December 15, 2019

Scope

The ASU applies to all companies that enter into share-based payment transactions for acquiring goods or services from nonemployees. The standard also includes awards granted by an investor to employees and nonemployees of an equity method investee for goods or services used or consumed in the investee's operations. Topic 718 does **not** apply to the following share-based payment transactions:

- Transactions that provide financing to the issuer
- Awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, *Revenue from Contracts with Customers.* However, share-based payments granted to a customer in exchange for a distinct good or service to be used or consumed in the grantor's own operations are accounted for under Accounting Standards Codification (ASC) 718

These scope exceptions were added to address potential structuring concerns. They ensure that instruments accounted for under Topic 718 are issued for goods or services used or consumed in a grantor's own operations and that transactions are not entered into to circumvent accounting classifications.

Key Changes

Overall Measurement Objective

An entity should be able to estimate the fair values of most share-based instruments on the grant date, regardless of whether the instruments are classified as equity or liability.

Under the ASU, nonemployee share-based transactions within Topic 718's scope will be measured by estimating the fair value of the equity instruments that the organization is obligated to issue when the goods have been delivered or the service has been rendered and any other conditions necessary to earn the right to benefit from the instruments have been satisfied. This means a reporting entity will be required to estimate, at the grant date, the equity instrument's fair value at the time of vesting.

Under existent standards, the general rule is to measure nonemployee share-based payment transactions at the fair value of the consideration received or the equity instrument issued, whichever is more reliably measurable. Entities either consider the cash value of goods or services received from the vendor as a reliable measure of fair value or, alternatively, objectively determine the fair value based on the cash value paid by the vendor's other customers. In practice, however, an organization's ability to estimate the **consideration's** fair value is often challenging and, hence, the guidance is changed to require measurement of the **equity instrument's** fair value.

Measurement Objective	
Current Generally Accepted Accounting Principles (GAAP)	ASU 2018-07
Nonemployee share-based payment awards are measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever can be more reliably measured.	Consistent with the accounting for equity-classified awards issued to employees, equity-classified nonemployee awards within Topic 718's scope will be measured at grant-date fair value.

Measurement Date

Like employee awards, a grantor should measure equity-classified nonemployee share-based payment awards at the grant date.

Under existent guidance, the measurement date for equity-classified nonemployee share-based payment awards is the earlier of the date a commitment for performance by the counterparty is reached or the date at which the counterparty's performance is complete.

Measurement Date	
Current GAAP	ASU 2018-07
The measurement date for equity-classified nonemployee share-based payment awards is the earlier of the date at which: ▪ A commitment for performance by the counterparty is reached ▪ The counterparty's performance is complete	Equity-classified nonemployee share-based payment awards are measured at the grant date. The definition of the term grant date is amended to generally state the date at which a grantor and grantee reach a mutual understanding of the key terms and conditions of a share-based payment award.

Performance Conditions

Nonemployee share-based payment awards with performance conditions are measured under existing standards at the lowest aggregate fair value, without considering the probability of resolving the performance condition. Consequently, those awards with even a remote chance of nonperformance could result in a lowest aggregate value of $0.

The ASU supersedes this guidance in its entirety and replaces it with the application of the employee share-based payment transaction model in Topic 718. When a nonemployee award agreement dictates specific performance conditions, the entity will estimate at the grant date the nonemployees' probability of satisfying the performance conditions. This determination affects the period over which the grantor will recognize costs (the vesting period) and each option's fair value (exercise price or number of shares dependent on the performance condition's achievement). Entities will adjust compensation cost for changes in the probable outcome of performance conditions.

Awards with Performance Conditions	
Current GAAP	ASU 2018-07
Nonemployee share-based payment awards with performance conditions are measured at the lowest aggregate fair value.	Consistent with the accounting for employee share-based payment awards, a company considers the probability of satisfying performance conditions when nonemployee share-based payment awards contain such conditions.

Classification Reassessment

Vested nonemployee awards would follow the Topic 718 post-vesting classification assessment requirements (liability versus equity). An entity will not reassess an equity-classified award after initial classification so long as the award is not modified after the nonemployee vests in the award—the good has been delivered, the service has been rendered, any other conditions necessary to earn the right to benefit from the instruments have been satisfied—and the nonemployee is no longer providing the entity goods or services.

Under existent guidance, an entity granting nonemployee awards will generally analyze—upon vesting of the award—the equity instrument's terms to determine whether it meets the definition of a derivative instrument and is within the scope of Topic 815, *Derivatives and Hedging*.

Classification Reassessment of Certain Equity-Classified Awards	
Current GAAP	ASU 2018-07
In general, the classification of equity-classified nonemployee share-based payment awards is subject to other GAAP, *e.g.*, Topic 815, *Derivatives and Hedging*, once the good has been delivered or the service has been rendered and any other conditions necessary to earn the right to benefit from the instruments have been satisfied. This often results in the need to reassess the classification of such awards.	In general, the classification of equity-classified nonemployee share-based payment awards will continue to be subject to the requirements of Topic 718 unless modified after: ▪ The good has been delivered and/or service has been rendered ▪ Any other conditions necessary to earn the right to benefit from the instruments have been satisfied ▪ The nonemployee is no longer providing goods or services This eliminates the requirement to reassess classification of such awards upon vesting.

Continued Differences in Employee & Nonemployee Share-Based Payments

While the previous accounting models are mostly converged, two areas will differ in valuing nonemployee and employee stock-based compensation. For these items, nonemployee accounting approaches are unchanged from current practice.

Pricing Model Input – Expected Term

Current guidance in ASC 505-50 requires the nonemployee award's contractual term to be used in a pricing model. Under ASU 2018-07, the contractual term can be used as the expected term on an award-by-award basis. Nonpublic entities are provided additional relief (see next section).

When a nonpublic entity chooses to measure a nonemployee share-based payment award by estimating its expected term and applies the intrinsic value practical expedient, it must apply the practical expedient to all similar nonemployee awards. However, a nonpublic entity may still elect—on an award-by-award basis—to use the contractual term as the expected term.

Grantors of an employee award under ASC 718 will continue to determine the award's expected term. FASB found that because employee share options generally are nontransferable, employees often exercise their options before the end of the options' contractual term. Nonemployee options typically do not have the same restrictions on transfer after vesting. Accordingly, valuations could differ for the same award issued to a nonemployee and an employee.

Attribution of Compensation Cost

Attribution of compensation cost is the period over which share-based payment awards vest and the pattern of cost recognition over that period. The superseded guidance in ASC 505 was carried forward into ASU 2018-07, which requires entities to recognize compensation cost for nonemployee awards in the same period and in the same manner, *i.e.*, capitalize or expense, they would if they paid cash for the goods or services. The total amount of compensation cost recognized for share-based payment awards to nonemployees shall be based on the number of instruments for which a good has been delivered or a service has been rendered. To determine the amount of compensation cost to be recognized in each period, an entity shall make an entitywide accounting policy election for all nonemployee share-based payment awards to do either of the following:

- Estimate the number of forfeitures expected to occur. The entity shall base initial accruals of compensation cost on the estimated number of nonemployee share-based payment awards for which a good is expected to be delivered or a service is expected to be rendered. The entity shall revise that estimate if subsequent information indicates the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimates shall be recognized in compensation cost in the period of the change.
- Recognize the effect of forfeitures in compensation cost when they occur. Previously recognized compensation cost for a nonemployee share-based payment award shall be reversed in the period that the award is forfeited.

The 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.

Private Company Relief

FASB acknowledges nonpublic entities without an active market may be challenged in measuring vendor and independent contractor arrangements. Topic 718 provides the following valuation alternatives for nonpublic entities, generally defined in Topic 718 as entities whose equity securities do not trade in a public market.

Using Calculated Values as Expected Volatility Inputs

Valuation models are used to estimate an award's fair value when observable market prices of identical or similar share options or similar instruments are not available at the grant date. In valuation models, entities use their share prices to estimate share volatility, a required model input. Nonpublic entities may find estimating their share price volatility impractical, essentially barring them from using a valuation approach. In these circumstances, Topic 718 allows a nonpublic entity to substitute calculated values as valuation inputs for expected volatilities. 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. The same practical expedient is offered for employee share-based payment awards.

*Nonpublic entities must use the same volatility accounting policy for **both** employees and nonemployees share-based transactions.*

Calculated Value	
Current GAAP	ASU 2018-07
Inputs to the valuation of equity share options and similar instruments issued to nonemployees include an estimate of the expected volatility.	Historical volatility of an appropriate industry-sector index is used by nonpublic entities for expected volatilities as inputs to the valuation of share options and similar instruments issued to nonemployees when it is not practicable for the nonpublic entity to simulate the expected volatility of its share price.

Intrinsic Value

FASB permits private companies to make an accounting policy election to measure all liability-classified employee awards at fair value or intrinsic value. Because employee and nonemployee awards are economically similar, ASU 2018-07 extends this election to nonemployee awards.

In certain circumstances where the award terms are very complex, Topic 718 acknowledges it may not be possible for grantors to estimate an award's fair value. The ASU provides a practical expedient for nonpublic entities unable to reasonably estimate an option's grant date fair value, generally because of the award's complexity. In these situations, the private company 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 the excess, if any, of the stock's quoted market price at the grant date or other measurement date over the amount an employee must pay to acquire the stock.

Entities electing to measure at intrinsic value would continue to use this method for liability-classified instruments even if it subsequently concludes it is possible to reasonably estimate the instrument's fair value.

*Nonpublic entities must use the same accounting policy for **both** employees and nonemployees share-based transactions.*

Intrinsic Value	
Current GAAP	ASU 2018-07
Entities are required to measure liability-classified nonemployee share-based payment awards at fair value.	A nonpublic entity can make a one-time election to switch from measuring liability-classified nonemployee share-based payment awards at fair value to intrinsic value. Regardless of the election, liability-classified awards would be subject to remeasurement until exercise.

Expected Term

As noted above, all entities can elect on an **award-by-award** basis to use the expected term as the contractual term when estimating the fair value of a nonemployee award. In addition, the ASU expands an existing practical expedient on expected term to include nonemployee awards. If an award meets certain criteria, a nonpublic entity may make an **entitywide** accounting policy election to estimate the expected term as follows:

- If vesting is only dependent on a service condition, a nonpublic entity shall estimate the expected term as the midpoint between the employee's requisite service period or the nonemployee's vesting period and the award's contractual term
- If vesting is dependent on satisfying a performance condition, a nonpublic entity first would determine whether the performance condition is probable of being achieved:
    - If probable, the estimated expected term would be the midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term
    - If not probable, the estimated expected term would be either:
        - The contractual term for an implied service period
        - The midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term for explicit requisite service periods

Awards must meet the following conditions to be eligible for this entitywide practical expedient:

- The award is granted at the money
- The grantee only has a limited time to exercise the award—typically 30 to 90 days—if the grantee no longer provides goods or terminates service after vesting
- The grantee can only exercise the award—it cannot be sold or hedged
- The award does not include a market condition

If elected, a nonpublic entity must apply the practical expedient for **all** nonemployee awards that have all the characteristics noted above. However, a nonpublic entity may still elect—on an award-by-award basis—to use the contractual term as the expected term to estimate an award's fair value on grant date.

Disclosures

Under current GAAP, entities are required to separately disclose information related to share-based payment transactions to the extent the disclosures are important to understanding the transactions' effects on the financial statements. FASB decided not to add separate disclosures specific to nonemployee share-based payment transactions. Instead, an entity will need to consider whether providing separate information about nonemployee share-based payment transactions is required to achieve reporting objectives. In general, when differences in the characteristics of the awards make separate disclosure important to understanding the entity's use of share-based payment transactions, nonemployee awards should be separately disclosed. For example, separate disclosure of weighted average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price could be important. It also could be important to segregate the number of options not yet exercisable into those that will become exercisable based solely on fulfilling a service condition and those for which a performance condition must be met for the options to become exercisable. It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

Transition

Entities will use a modified retrospective approach in adopting these amendments. A company only should remeasure liability-classified awards that have not been settled by the adoption date and equity-classified awards for which a measurement date has not been established through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. A company is required to measure these unsettled liability-classified nonemployee awards at fair value as of the adoption date. This requirement would not apply to vested equity-classified awards. FASB retained the requirement to measure equity-classified awards by estimating the fair value of the equity instruments that an entity is obligated to issue. The company must **not** remeasure assets that are completed. For example, finished goods inventory or equipment that has begun amortization should not be remeasured upon transition.

Nonpublic entities must apply the guidance on calculated value prospectively to all awards that are measured at fair value after the effective date. With a prospective adoption, a nonpublic entity would not incur the cost to determine a cumulative-effect adjustment to the previous estimate for the value of an option or similar instrument using a practical expedient that FASB decided should result in a reasonable estimate that is not significantly different from fair value.

Disclosures required at transition include the nature of and reason for the change in accounting principle and, if applicable, quantitative information about the cumulative effect of the change on retained earnings or other components of equity.

Effective Date

These amendments are effective for PBEs for fiscal years beginning after December 15, 2018, and interim periods therein. For all other companies, the changes are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early adoption is permitted but no earlier than a company's adoption of ASC 606, the new revenue recognition guidance.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com