

PCC Update: Nonemployee Share-Based Payments

APR 8: Webex

APR 11: Closed Meeting

APR 12: Open Meeting

April Meetings
Update on Current Approach



FINANCIAL
ACCOUNTING
STANDARDS BOARD

Objectives

- High-level review of key components of the employee model
- Review differences between employee and nonemployee models
- Examine particular issues with the nonemployee model
- Review recent outreach activities conducted
- Potential alternatives for addressing nonemployee share-based payments and staff recommendations

Key Components—Definitions

■ Employee:

- Concept → Grantee is an employee only if the grantor can establish that an employer-employee relationship exists under common law.

■ Grant Date:

- The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service.... The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares.

■ Requisite Service Period:

- The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement....Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

■ Service Inception Date:

- The date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date....

Key Components—Conditions

- **Service Condition:**
 - Concept → Requires the individual to remain employed by the company for a stated period of time to earn the right to the related equity instrument (i.e., to vest).
- **Performance Condition:**
 - Concept → Based on the operations or activities of the employer. The condition may relate to the performance of the entire company, a division, or an individual employee.
- **Market Condition:**
 - Concept → Exercisability or other terms may be dependent on achieving a specified stock price or a specified return on the stock price (e.g., price appreciation plus dividends).
- Generally, service and performance conditions affect attribution or recognition whereas market conditions affect grant date fair value. “Other” conditions do not convey an equity ownership.

Key Components—Classification

- Generally—Four key considerations to determining whether an award is *initially* liability or equity classified:
 - Does the award compel the employer to settle by transfer of cash or assets?
 - Can the employee compel the employer to settle by transferring cash or other assets?
 - Does an equity settlement alternative exist?
 - For options—are the shares underlying the options themselves classified as liabilities?
- **Note:** Awards can have dual indexation as long as the dual indexation is based on a service condition, a performance condition, or a market condition.

Classification “exceptions” are made for instruments issued as compensation.

Key Components—Attribution of Cost

- Specific definitions of service inception date, grant date, and requisite service determine the beginning and end of the period over which compensation cost will be recognized.
 - *Probability* considered for performance conditions
 - “And” “or” language determines length of requisite service.

- Service condition and graded vesting special consideration:
 - Accounting policy election for awards with service conditions and graded vesting features (straight line or accelerated tranche by tranche)
 - For awards with graded vesting and performance or market conditions, the graded vesting (i.e., accelerated) attribution approach is required.

Model Comparisons

Accounting Area	Nonemployee Model (Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees)	Employee Model (Topic 718, Compensation—Stock Compensation)
<p><i>Scope</i>—separate model for nonemployee awards</p> <p>For those areas not addressed under the nonemployee model (initial classification), it is acceptable to analogize to employee guidance.</p>	All transactions for acquiring goods and services outside of employee relationship	<p>Individuals over whom the entity has sufficient control to establish an employee-employer relationship</p> <p>Guidance focuses on the legal definition of an employee with specific exceptions (e.g., nonemployee directors)</p>
Measurement date (equity classified)	<p>Earlier of:</p> <p>(1) commitment is reached with the counterparty for performance.</p> <p>(2) counterparty performance is complete.</p> <p>Important note: Performance under a commitment considered probable only when a sufficient disincentive for nonperformance exists (practically → requirement rarely met).</p>	Grant date
Performance condition effect on recognition of compensation cost	If the performance condition is not satisfied, value award at lowest aggregate fair value (probability not relevant) → can result in an amount of <u>zero</u> .	When performance condition is probable of being achieved, recognize compensation cost.
Subsequent classification	Award subject to other Topics (i.e., Topic 815, Derivatives and Hedging) once performance is complete.	Award subject to other Topics (i.e., Topic 815) upon modification if grantee is no longer an employee.

Nonemployee Complexity

Fact Pattern:

ABC Corp. contracts with DEF Corp. to run a media campaign on behalf of ABC. In exchange, ABC will grant DEF 3,000 share warrants to purchase ABC shares. The media campaign begins at the contract date and runs for three months. The fair value of the share warrants is as follows →

Fair Value per Share Warrant	
Date contract signed	\$1.00
End of first month	\$1.25
End of second month	\$1.50
End of third month	\$2.00

Scenario 1

Facts: The contract states that DEF's performance is complete only at the conclusion of the campaign. Therefore, all of the share warrants vest at the end of the three-month campaign. The contract does not contain a performance commitment.

Accounting: ABC would record a total 3-month marketing expense of \$6,000 ($3,000 \times \2).

Journal Entries

Fair Value (FV) end of first month	3750
Dr. Mkt. Expense	1250
Cr. APIC	1250

FV end of second month	4500
Dr. Mkt. Expense	1750
Cr. APIC	1750

FV end of third month	6000
Dr. Mkt. Expense	3000
Cr. APIC	3000

Scenario 2

Facts: The contract states that 1,000 share warrants vest at the end of each month. The contract does not contain a performance commitment.

Accounting: ABC would record a total 3-month marketing expense of \$4,750 [$(1,000 \times \$1.25) + (1,000 \times \$1.50) + (1,000 \times \$2.00)$].

Journal Entries

FV end of first month	3750
Dr. Mkt. Expense	1250
Cr. APIC	1250

FV end of second month	4250
Dr. Mkt. Expense	1583
Cr. APIC	1583

FV end of third month	4750
Dr. Mkt. Expense	1917
Cr. APIC	1917

Total and month-to-month expenses differ based on vesting structure

Nonemployee Complexity Effect

Fact Pattern:

- Equity award with identical terms and conditions granted to employee and nonemployee beginning of 2014.
- Awards stipulate 2 years service, and entity's revenue in 2015 exceeds \$10 million.
- At grant date, entity concludes that it is probable to exceed revenue of \$10 million in 2015.
- No provisions in the contract constitute a significantly large disincentive for nonperformance (i.e., there is no performance commitment) → measurement date for nonemployee occurs when performance is complete.

Other Information	
Grant Date	1/1/14
Grant Date Fair Value	\$1,000
Fair Value End of 2015 (Contractor Performance Complete)	\$800

Accounting - Employee Award

2014	
Dr. Comp. Expense	500
Cr. APIC	500

2015	
Dr. Comp. Expense	500
Cr. APIC	500

Accounting - Contractor Award

2014	
No entry - possible no shares issued and \$0 is the lowest aggregate FV	

2015	
Dr. Comp. Expense	800
Cr. APIC	800

Staff approach aims to align the models; eliminating differences

Differences in model primarily driven by measurement date differences.

“Lowest Aggregate Fair Value” can result in \$0 expense recognition.

Outreach

■ Prevalence

- Decrease in use, because of the volatility created
- Primarily in smaller public companies with lack of cash, pre-initial public offering, and early life cycle or private companies
- Public company data indicate industries primarily broadly include technology, biotech, and some externally managed real estate investment trusts → although can be any industry
- Primarily issued for services, with a few instances of volume incentives; did not see instances of issuances for goods
- Typically issue plain vanilla awards to nonemployees; not uncommon for awards to be the same as those to employees.

■ Structuring

- Structuring limited
- No performance commitments seen, because of high hurdle
- Instances of \$0 compensation cost recognized, given “lowest aggregate fair value”.

Outreach (cont'd)

■ Challenges

- Calculation of fair value most often cited
- Confusion as to why nonemployees are accounted for differently, because in many instances they are providing the same services as employees
- Challenges reconciling “lowest aggregate fair value” with recognition of cost as if paying cash
- Few instances of companies being unaware of separate model, causing problems after the fact (reasons vary: resources, accounting not intuitive, placement in Accounting Standards Codification).

■ Opportunities for improvement

- Measuring fair value once is the significant improvement most often cited.
- Defining “employee-like services” may address many of the issues that exist; however, there are difficulties with this option.
- Address probability for performance conditions under the model → most accounting includes a notion of probability.
- Move model to the 700 Topics of the Accounting Standards Codification.

Potential Alternatives Presented to Board

- **Alternative A:** Address performance conditions within the nonemployee model potentially replacing the notion of “lowest aggregate fair value” with a probability assessment.
 - Considerations → narrow in scope and will likely not address several concerns expressed by stakeholders.
- **Alternative B:** Increase the scope of Topic 718 to include transactions with employees and “others providing similar services”.
 - Considerations → significant difficulties with defining “employee-like services.” Could result in replacing existing complexity with different complexity.
- **Alternative C (Staff Recommendation):** Align the models for nonemployee and employee share-based payments under GAAP
 - Considerations
 - Grant-date fair value → final expense does not equal award fair value.
 - Cost attribution → provide guidance beyond “as if paid in cash”.
 - Subsequent accounting for nonemployee awards → concerns with “structuring” opportunities.

Current focus of staff research

Questions?