To the Point
FASB – final guidance

FASB simplifies the accounting for share-based payments to nonemployees

What you need to know

- The FASB issued final guidance aligning the measurement and classification guidance for share-based payments to nonemployees with the guidance for share-based payments to employees, with certain exceptions.

- Under the guidance, the measurement of equity-classified nonemployee awards will be fixed at the grant date, which may lower their cost and reduce volatility in the income statement.

- The guidance allows nonpublic entities to account for nonemployee awards using certain practical expedients that are already available for employee awards, but the same accounting policies must be used for awards to both employees and nonemployees.

- The guidance is effective for PBEs in annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective in annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. Early adoption is permitted, including in an interim period, but not before an entity adopts the new revenue guidance.

Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-07¹ to simplify the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees, with certain exceptions.
The new guidance expands the scope of Accounting Standards Codification (ASC) 718 to include share-based payments granted to nonemployees in exchange for goods or services used or consumed in an entity’s own operations and supersedes the guidance in ASC 505-50.

The FASB launched the project in response to requests it received in its post-implementation review of Statement No. 123(R), Share-Based Payment.

**Key considerations**

The ASU aligns much of the guidance on measuring and classifying nonemployee awards with that of awards to employees. The key changes from ASC 505-50 are:

- Equity-classified nonemployee awards are measured on the grant date, rather than on the earlier of (1) the performance commitment date or (2) the date at which the nonemployee’s performance is complete.

- Awards to nonemployees are measured by estimating the fair value of the equity instruments to be issued, rather than the fair value of the goods or services received or the fair value of the equity instruments issued, whichever can be measured more reliably.

- During the vesting period, nonemployee awards that contain a performance condition that affects the quantity or other terms (e.g., exercise price) of the award are measured based on the outcome that is probable. This differs from the guidance in ASC 505-50 that requires these types of awards to be measured at the lowest aggregate fair value within a range of possible outcomes.

- Entities may use the expected term to measure nonemployee awards or elect to use the contractual term as the expected term, on an award-by-award basis. This differs from the guidance in ASC 505-50 that requires the use of the contractual term.

- Nonpublic entities that measure their liability-classified employee awards using intrinsic value must also measure liability-classified nonemployee awards using intrinsic value. This differs from the guidance in ASC 505-50 that requires liability-classified awards to be measured at fair value.

- Entities are required to reassess the classification of a nonemployee award (i.e., equity or debt) under other US GAAP (e.g., ASC 815) only if it is modified after it vests and the nonemployee is no longer providing goods or services, rather than once performance is complete and the award vests.

**How we see it**

- Under the new guidance, the cost for nonemployee awards may be lower and less volatile than under current US GAAP because the measurement generally will occur earlier and will be fixed at the grant date. For these reasons, entities may want to early adopt the new guidance.

- Management will need to have historical information about exercise behavior for a similar grantee group to use the expected term to measure a nonemployee award.

**Scope of the new guidance**

The guidance applies to nonemployee awards issued in exchange for goods or services used or consumed in an entity’s own operations and to 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. It does not apply to instruments issued to a lender or investor in a
financing (e.g., in a capital raising) transaction. It also does not apply to equity instruments granted when selling goods or services to customers in the scope of ASC 606, *Revenue from Contracts with Customers*. However, the guidance states that 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 ASC 718.

**Recognition of compensation cost**

The ASU retains today’s cost attribution (i.e., recognition) guidance, 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, but it moves the guidance to ASC 718. As a result, if the nonemployee does not provide goods or services ratably over the vesting period, the timing of recognition for nonemployee awards will continue to differ from the timing of recognition for employee awards (which are recognized ratably over the service period).

The guidance requires entities to make an accounting policy election to either account for forfeitures of nonemployee awards as they occur or estimate forfeitures and adjust the estimate when it is likely to change. This is similar to the accounting policy election for employee awards the FASB provided in ASU 2016-09. The new guidance allows an entity to make separate accounting policy elections for employee and nonemployee awards. For example, an entity may elect to estimate forfeitures of employee awards but account for forfeitures of nonemployee awards as they occur.

**Key changes at a glance**

The following table summarizes what’s changing and the key areas in which the new guidance aligns with the accounting for employee awards and areas where differences will remain:

<table>
<thead>
<tr>
<th>Share-based payments to nonemployees</th>
<th>Share-based payments to employees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Before ASU 2018-07</strong></td>
<td><strong>After ASU 2018-07</strong></td>
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<tr>
<td>Measurement date for equity-classified awards</td>
<td>Earlier of performance commitment date or date performance is complete</td>
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<td>Measurement date for liability-classified awards</td>
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<td>Term used for measurement</td>
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<td>Recognition</td>
<td>In the same period and in the same manner the entity would if it paid cash for goods or services</td>
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<td>Post-vesting classification</td>
<td>Assessed when performance is complete</td>
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**Nonpublic entity practical expedients**

The new guidance allows nonpublic entities to use the following practical expedients that are available for employee awards when accounting for awards to nonemployees, but it requires entities to use the same accounting policies for awards to both employees and nonemployees:

- Nonpublic entities can use the midpoint between the vesting date and the contractual term as the expected term for certain awards with service or performance conditions (even if they use the contractual term to value other nonemployee awards).
Nonpublic entities can determine the calculated value using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity’s share price if it is not practicable to estimate the latter.

How we see it

- The use of the calculated value is not a free choice.
- If a nonpublic entity is able to identify an appropriate industry sector index to use the calculated-value method and can extract from that index similar entities on which to base an estimate of its own volatility, it would be required to use the fair value-based method. When identifying similar public entities in an industry sector index, a nonpublic entity should consider each entity’s stage in its life cycle, size, financial leverage, products and other characteristics.

Transition and effective date

Entities will apply the new guidance to equity-classified nonemployee awards for which a measurement date has not been established and liability-classified nonemployee awards that have not been settled as of the date of adoption by recognizing a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption. Assets that include nonemployee share-based payment costs, such as work-in-process inventory and construction-in-process, will be remeasured at the adoption date. However, assets that have been completed (e.g., finished goods inventory, equipment that has been placed into service and depreciation has begun) would not be remeasured.

There are no new disclosure requirements.

The guidance is effective for public business entities (PBEs) in annual periods beginning after 15 December 2018, and interim periods within those annual periods. For all other entities, it is effective in annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. Early adoption is permitted, including in an interim period for which financial statements have not been issued (PBEs) or made available for issuance (non-PBEs), but not before an entity adopts ASC 606.

Endnotes:

1. ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting.
2. ASC 718, Compensation – Stock Compensation.
3. ASC 505-50, Equity-Based Payments to Non-Employees.
4. As described in ASC 505-50-30-12.
5. We believe that practice generally interprets the term “probable” to represent a greater than 70% likelihood that an event will occur.
6. ASC 815, Derivatives and Hedging.
7. ASU 2016-09, Improvements to Employee Share-Based Payment Accounting.
8. See ASC 718 for the definition of a nonpublic entity.