



On the Radar

Share-Based Payment Awards

To incentivize employee performance and align the interests of employees and shareholders, entities often grant share-based payment awards — including stock options, restricted stock, restricted stock units, stock appreciation rights, and other equity-based instruments — in exchange for services. To a lesser extent, entities also grant such awards to compensate vendors for goods and services or as sales incentives to customers.

ASC 718 provides the accounting guidance on share-based payment awards, which requires entities to use a fair-value-based measure when recognizing the cost associated with these awards in the financial statements. Some of the more challenging aspects of applying this guidance are highlighted below.

Scope

An entity must first determine whether an award is within the scope of ASC 718 or is, in substance, a bonus or profit-sharing arrangement. ASC 718 applies to awards that require or may require settlement in the equity of the entity or whose 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 can significantly affect the amount of compensation cost recognized and when such cost is recognized in the financial statements.

Nonpublic limited partnerships, limited liability companies, and other pass-through entities often establish special classes of equity, referred to as profits interests. These special equity classes often have distribution



thresholds or hurdles related to amounts that must be paid to other classes of equity before the grantee of the profits interest can receive distributions. On the grant date, an award may have zero liquidation value for tax purposes but a fair value for financial reporting purposes.

While the features of a profits interest award can vary, such an award should be accounted for on the basis of its substance. If the award has the characteristics of an equity interest, it 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 as such in accordance with other U.S. GAAP (e.g., typically ASC 710 for employee arrangements).

There are several characteristics to consider when determining whether an instrument is within the scope of ASC 718. To be a substantive class of equity, the profits interest must be legal form equity. An entity would also consider whether the instrument’s holder can retain a vested interest in an award if the holder stops providing goods or services to the company. In determining whether a repurchase feature allows the grantee to retain a vested interest, an entity would assess whether the repurchase price of that repurchase feature is consistent with the fair value of the award. Other characteristics of the award (e.g., claim to residual assets of the entity upon liquidation, substantive net assets underlying the interest, and distribution rights after vesting) could also be relevant to the entity’s conclusion.

On May 11, 2023, the FASB issued a proposed ASU that would clarify U.S. GAAP by adding an illustrative example to help entities determine whether a profits interest or similar award should be accounted for under ASC 718. Comments on the proposed ASU were due July 10, 2023. Stakeholders should monitor the FASB’s deliberations for developments related to the proposal.

Classification

If an entity concludes that an award is within the scope of ASC 718, it must then determine whether that award will be recognized within equity or as a liability. Equity-classified awards are generally measured as of the grant date and, in the absence of any modifications, the total amount of compensation cost to be recognized is fixed at the grant-date measurement amount. By contrast, liability-classified awards must be remeasured to fair value as of every reporting period until settled. Accordingly, if the value of an entity’s shares increases before the liability is settled, the total recognized compensation cost of a liability-classified award will also increase.

Determining the classification of a share-based payment award can be challenging. While classifying a cash-settled award as a liability may seem straightforward, other awards may contain features and conditions that entities must analyze further. Examples of questions to consider in the determination of the classification of an award include the following:

- Can the grantee of the award choose the method of settlement (i.e., shares or cash)?
- Can the entity be forced to settle the award in cash or other assets of the entity?
- Does the entity have a past practice of settling the award in cash even though the written terms of the award state that it will be settled in shares of the entity?
- Does the award specify a fixed dollar amount that is settled in a variable number of shares of the entity?
- Is the award indexed to something other than a service, market, or performance condition?
- Do the awards include repurchase features (i.e., grantee put rights and entity call rights)?
 - Can the repurchase feature be exercised immediately upon vesting?
 - Is the repurchase price an amount other than the fair value of the award on the purchase date (i.e., fixed price or formula price)?
 - Is the exercise of the repurchase feature contingent on a specified event?
- Is the underlying share of an option award classified as a liability?

Some of these questions typically only pertain to nonpublic entities. For example, nonpublic entities often include repurchase features to remain closely held or may choose to settle the award in cash to provide liquidity to the grantee for shares that are not actively traded.

Secondary Transactions

When a nonpublic entity repurchases common shares from its employees at an amount greater than the estimated fair value of the shares at the time of the transaction, the excess of the purchase price over the fair value of the common shares generally represents employee compensation. In addition, investors (e.g., private equity or venture capital investors) may purchase shares held by current or former employees of an entity because such investors want to acquire or increase their stake in that entity or provide liquidity to the entity's employees. Any consideration paid in excess of the fair value of the shares is presumed to be compensation cost and an in-substance equity contribution that must be recognized by the reporting entity.

A nonpublic company should carefully evaluate secondary transactions when determining the fair value of its common shares. Often, an entity may conclude that a secondary transaction includes a compensatory element that must be recognized even when there are also indicators that the secondary transaction was conducted at fair value. In such situations, an entity should consider whether to give some weight to that transaction when determining the fair value of the common shares.

Clawbacks

On October 26, 2022, the SEC issued a [final rule](#) aimed at ensuring that executive officers do not receive “excess compensation” if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements. Such restatements would include those correcting an error that “is material to the previously issued financial statements” (a “Big R” restatement) or “would result in a material misstatement if the error were corrected in or left uncorrected in the current period” (a “little r” restatement).

The final rule requires issuers to “claw back” excess compensation for the three fiscal years before the determination of a restatement regardless of whether an executive officer¹ had any involvement in the restatement. The final rule also requires an issuer to disclose its recovery policy in an exhibit to its annual report and to include new checkboxes on the cover page of its annual report to indicate whether the financial statements “reflect correction of an error to previously issued financial statements and whether [such] corrections are restatements that required a recovery analysis.” Additional disclosures are required in the proxy statement or annual report when a clawback occurs. Such disclosures include the date of the restatement, the amount of excess compensation to be clawed back, and any amounts outstanding that have not yet been clawed back.

On June 9, 2023, the SEC approved amendments filed by the New York Stock Exchange and Nasdaq that revise the date by which listed companies must comply with the final rule's requirements. Under the approved amendments, the effective date of the new clawback requirements is October 2, 2023, and the official compliance date for public companies is December 1, 2023, which is the date by which public companies must have a clawback policy that complies with the requirements of the respective exchange.

Cheap Stock

Since private companies often heavily rely on equity grants to compensate their employees, it is critical for such entities to proactively address potential issues that may emerge during the IPO process related to their equity plan. As an entity prepares for an IPO, the SEC staff often focuses on “cheap stock”² issues. The staff is interested in the rationale for any difference between the fair value measurements of the underlying common

¹ Compared with the recovery provisions of Section 304 of the Sarbanes-Oxley Act of 2002 that (1) are triggered when an accounting restatement results from an issuer's misconduct and (2) only apply to CEOs and CFOs, the final rule's scope includes a broader list of executive officers, including former executive officers.

² Cheap stock refers to issuances of equity securities before an IPO in which the value of the shares is below the IPO price.

stock of share-based payment awards issued within the past year and the anticipated IPO price. In addition, the staff will challenge valuations that are significantly lower than prices paid by investors in recent acquisitions of similar stock. If the differences cannot be reconciled, a nonpublic entity may be required to record a cheap-stock charge. Such a charge could be material and, in some cases, lead to a restatement of the financial statements.

Waiting to consider cheap stock issues until after the SEC raises related questions may delay a declaration that an IPO registration statement is effective.

When the estimated fair value of an entity's stock is significantly below the anticipated IPO price, the entity should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO. To perform this reconciliation, the entity would take into account, among other things, intervening events and changes in assumptions that justify the change in fair value. The SEC staff has frequently inquired about a registrant's pre-IPO valuations. Specifically, during the registration statement process, the SEC staff may ask an entity to (1) reconcile its recent fair value measurements with the anticipated IPO price (including significant intervening events); (2) describe its valuation methods; (3) justify its significant valuation assumptions, including the weight given to operating the business both under and in the absence of an IPO; and (4) discuss the weight it gives to secondary transactions.

Deloitte's Roadmap *Share-Based Payment Awards* provides a comprehensive discussion of the accounting guidance on share-based payment arrangements in ASC 718.

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