ALERT

July 10, 2018

FASB ISSUES ACCOUNTING STANDARDS UPDATE ON STOCK COMPENSATION GRANTED TO NONEMPLOYEES

The Financial Accounting Standards Board (FASB) on June 20, 2018 issued Accounting Standards Update (ASU) 2018-07 which expands the scope of FASB Accounting Standards Codification (ASC) Topic 718 (Topic 718) to include stock compensation granted to nonemployees. Previously, Topic 718 applied only to stock compensation granted to employees as defined by common law and U.S. federal payroll tax principles, certain leased employees, and nonemployee members of a company's shareholder-elected board of directors. Stock compensation granted to nonemployees was subject to vesting date, as opposed to grant date, fair value principles that required companies to remeasure fair value at each reporting period until settlement for equity-classified awards. The expansion of Topic 718 to include nonemployees is a favorable development because it will simplify accounting by making most equity-classified awards subject to fixed grant date fair value principles, thereby eliminating the variable mark-to-market accounting.

ASU 2018-07 expands the scope of Topic 718 to include stock compensation granted in exchange for goods or services to be used or consumed in a company's operations from nonemployee service providers such as independent contractors, advisory board members, and employees and nonemployees of an equity method investment. It does not include stock compensation issued to a lender or investor in a financing transaction or as part of a contract accounted for under ASC Topic 606 dealing with revenue from contracts with customers.

With limited exceptions, companies are to apply the provisions of Topic 718 equally to all stock compensation granted to both employees and nonemployees. The exceptions from Topic 718 for nonemployees center around the period of time and pattern of cost recognition, and determination of stock price volatility and expected exercise term for stock options and stock appreciation rights (SARs) of a nonpublic company. Similar to service-vesting awards granted to employees, companies are to make an accounting policy election to either account for award forfeitures as they occur or estimate forfeitures and true-up based on actual experience. This policy election can be different than how the company accounts for awards to employees.

In regard to cost recognition for nonemployee awards, companies are to recognize compensation cost in the same period and in the same manner as if cash had been paid. As a result, if the nonemployee service provider does not provide goods or services ratably over the service period, compensation cost will be recognized in the same non-ratable manner. This will differ from employee awards which are recognized ratably over the service period, either on a straight line or accelerated accrual basis.

In regard to the determination of stock price volatility for nonemployee awards, nonpublic companies are to use the historical volatility of an appropriate industry sector index if it is not possible to estimate the expected volatility of its own stock price. This methodology should be applied consistently to both employee and nonemployee awards. In regard to the determination of expected exercise term for nonemployee awards, nonpublic companies are permitted on an award-by-award basis to elect to use the maximum contractual exercise term in lieu of the otherwise required expected exercise term of the award. If a nonpublic company uses the simplified method to calculate the expected exercise term for employee awards, it must also do so for nonemployee awards. In addition, nonpublic companies are required to change measurement of all liability-classified awards from fair value to intrinsic value if awards to employees are measured that way.

ASU 2018-07 provides that stock compensation granted to nonemployees remain subject to the provisions of ASC Topic 718 for the entire existence of the award, unless the award is subsequently modified after the goods or services are provided and the award is vested. The only exception is in the rare instance an award contains a convertible debt or equity feature. In that case, the award would be subject to other applicable accounting rules upon vesting. This is consistent with the treatment of awards granted to employees.

For public companies, ASU 2018-07 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within that fiscal year (that is, 2019 financial statements for calendar year companies). For nonpublic companies, ASU 2018-07 is effective for annual reporting periods beginning after December 15, 2019 (that is, 2020 financial statements for calendar year companies), and interim periods within fiscal years beginning after December 15, 2020 (that is, 2021 quarterly statements for calendar year companies). Early adoption is permitted, but no earlier than a company's adoption of ASC Topic 606. Upon adoption, companies should (1) remeasure the fair value of liability-classified awards that have not been settled and equity-classified awards for which a measurement date has not been established, and (2) recognize a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. There are no new disclosure requirements.

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General questions about this summary can be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by email at thomas.haines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com. A complete summary of Topic 718 can be found on our website at https://www.fwcook.com/content/documents/publications/07-10-18__ORIGINALLY_4-29-05__-_Accounting_for_Stock_Compensation_Under_FASB_ASC_Topic_718.pdf