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Technical Line

A closer look at an entity's accounting for sales of its shares in secondary market transactions

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What you need to know

- Secondary market transactions are a popular way for founders and employee shareholders of nonpublic entities to sell their shares before the entity is sold or goes public.
- These transactions can take a variety of forms and have accounting implications that may include the recognition of additional compensation cost and/or a change in classification of share-based payment awards.
- ASC 718 provides limited guidance on an entity's accounting for sales of its shares in secondary market transactions. Careful consideration of the facts and circumstances of each transaction is necessary to reach the appropriate accounting conclusion. Significant judgment is often required.

Overview

Secondary market transactions have become a popular way for holders of private company shares (e.g., employees, former employees or founders) to monetize the shares before the entity is sold or goes public. The transactions often involve direct purchases by the entity,[1] related parties[2] or other economic interest holders[3] of the entity or new investors, but secondary market transactions can also be executed on private exchanges.

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While this publication primarily discusses transactions in which employees are the sellers, the same considerations would apply to transactions involving nonemployees who received shares in exchange for providing goods or services to the entity.

Determining the appropriate accounting for secondary market transactions often requires significant judgment. Entities must consider their involvement in the transaction, the nature of the relationship between the buyer and seller, the transaction price and other facts and circumstances. For example, if the shares are purchased at a price above fair value on the transaction date, the entity may need to recognize the excess as compensation cost.

Further, if the transaction involves "immature" shares or options, the entity may need to reclassify both the shares or options that are sold and other outstanding awards with similar features from equity to liabilities depending on the facts and circumstances. Shares are considered immature if they haven't been held for six months or more from the date of exercise for options and the date of vesting for share awards.[4]

Entities also need to consider whether they are required to make disclosures about secondary market transactions. For example, entities should consider the requirements under Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation*, and ASC 850, *Related Party Disclosures*.

Accounting for secondary market transactions often requires significant judgment and careful consideration of the facts and circumstances.

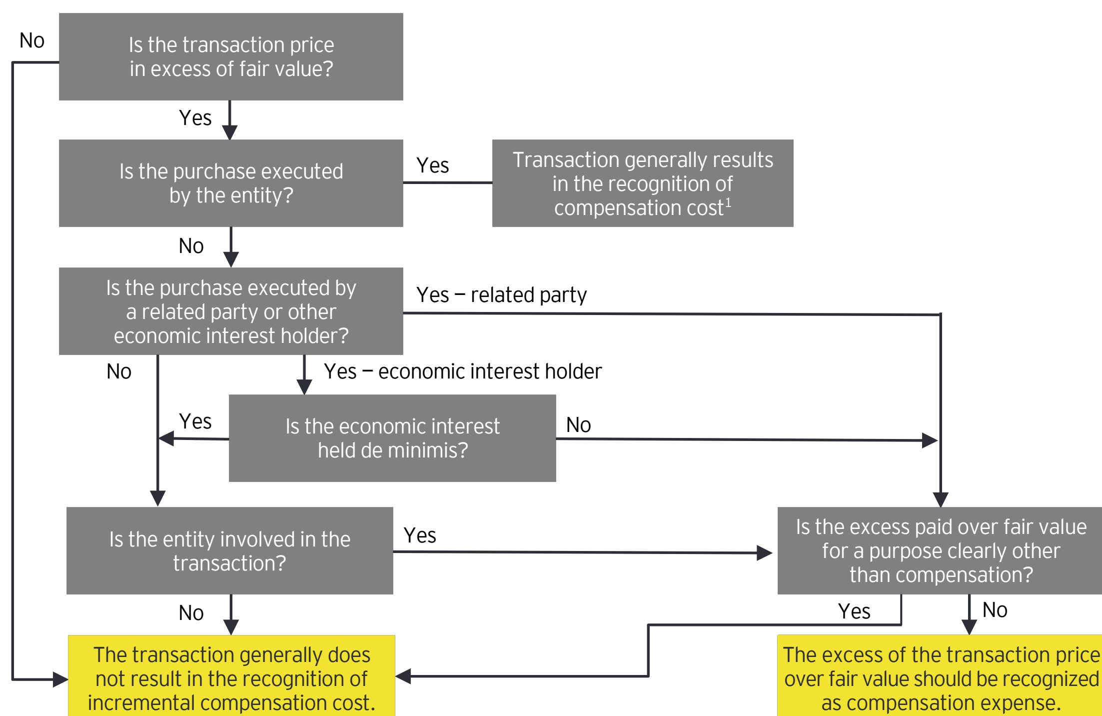
Further, an entity that files a registration statement for an initial public offering (IPO) or merger with a special purpose acquisition company (SPAC) with the Securities and Exchange Commission (SEC)[5] must also consider the SEC's related party disclosure requirements when directors, officers or certain other shareholders participate in the sale.[6]

The SEC staff may also ask the entity to explain or make disclosures about how secondary market transaction prices were factored into valuations of share-based payment awards made in the periods leading up to an IPO or merger with a SPAC. Due to the subjectivity involved in determining the value of shares of nonpublic entities, a primary concern of the SEC staff is whether a registrant has appropriately accounted for share-based compensation in the periods leading up to the transaction.

For details about the effect of secondary market transactions on share valuation, refer to the AIPCA Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*.

Determining whether to recognize compensation cost

The decision tree below depicts the key factors that entities should consider in assessing whether they are required to recognize compensation cost for secondary market transactions involving employees, former employees[7] or founders.[8] However, these factors are not all inclusive, and no one factor is determinative. An entity's facts and circumstances must be considered holistically to determine the appropriate accounting, and significant judgment is often required.



[1] As discussed below, a broad-based tender to all shareholders of a class of shares may result in the excess over fair value being considered a dividend.

Is the transaction price in excess of fair value?

ASC 718-10-20 defines fair value as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." When accounting for secondary market transactions in the scope of ASC 718, an entity cannot presume that the transaction price is fair value. Rather, the entity needs to determine whether the transaction price is fair value at the time of the purchase by applying the same valuation methodology it uses to determine fair value when it grants equity awards accounted for under ASC 718.[9]

Entities consider more inputs than just observable share prices in the secondary market to determine the fair value of their shares. As a result, investors may pay more than what the entity determines is the fair value if, for example, they negotiate a price that is commensurate with or at a slight discount from the price of the preferred shares, even though the common shares do not have the same liquidation preferences or other rights or features of the preferred shares.

If the transaction price exceeds fair value and the entity determines that the excess amount paid over fair value to the seller by or on behalf of the entity represents compensation, the entity must recognize the excess amount as compensation cost. Determining whether the excess over fair value represents compensation to the seller involves an analysis of the facts and circumstances of the transaction, including the involvement of the entity, the relationships between the buyer and seller and whether there is any indication that the excess amount is clearly for purposes other than compensation.

How we see it

Secondary market transactions executed in excess of fair value are presumed to be compensatory when the entity is directly repurchasing the shares from the seller. However, when the entity is not directly purchasing the shares, all of the facts and circumstances of each transaction, including the level of the entity's involvement in facilitating the transaction, must be considered holistically to determine the substance of the transaction.

If immature shares or options are purchased (regardless of the price), further analysis of the facts and circumstances of the transaction is needed to determine whether the entity needs to account for the transaction as a settlement or a modification that changes the classification of awards or shares from equity to liabilities. Refer to the *Determining whether a change in classification of share-based payment awards is necessary* section below for more information.

Is the purchase executed by the entity?

A common form of secondary market transaction is a direct repurchase of shares by the entity. As discussed in ASC 718-20-35-7, if the entity directly repurchases shares from its employees or former employees, "any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost."

However, if the entity issues a broad-based tender offer to all holders of a class of shares, the excess paid over fair value may represent a distribution to all shareholders. In reaching its conclusion, the entity needs to consider the facts and circumstances at the date the tender offer is made. Refer to the *Is the excess paid over fair value for a purpose clearly other than compensation?* section below for more information.

Is the purchase executed by a related party or other economic interest holder?

When the buyer in a secondary market transaction is a related party or other economic interest holder, it is generally presumed that the buyer is acting on behalf of the entity, even if the entity is not directly involved in the transaction. ASC 718-10-15-4 indicates that share-based payment transactions involving a related party or other holder of an economic interest in the entity are accounted for under ASC 718, unless the transfer is clearly for a purpose other than compensation for goods or services provided to the entity. Accordingly, the purchase of shares from employees, former employees or founders by a related party or other economic interest holder is treated for accounting purposes as if the entity repurchased the shares itself, and the entity recognizes compensation cost and a related capital contribution for any excess paid over the fair value of the shares.

Is the interest held de minimis?

The definition of an economic interest holder is broad and does not require a minimum level of ownership or any share ownership at all. However, the Financial Accounting Standards Board (FASB) acknowledged in Statement 123 (revised 2004) that a compensatory transaction most likely involves a holder of a significant economic interest.[10] Therefore, we believe that if an investor's economic interest is de minimis, this could be a factor that suggests that the buyer was acting independently rather than on behalf of the entity. We believe a de minimis investment must be an inconsequential ownership interest in the company to overcome the presumption that the transaction is compensatory.

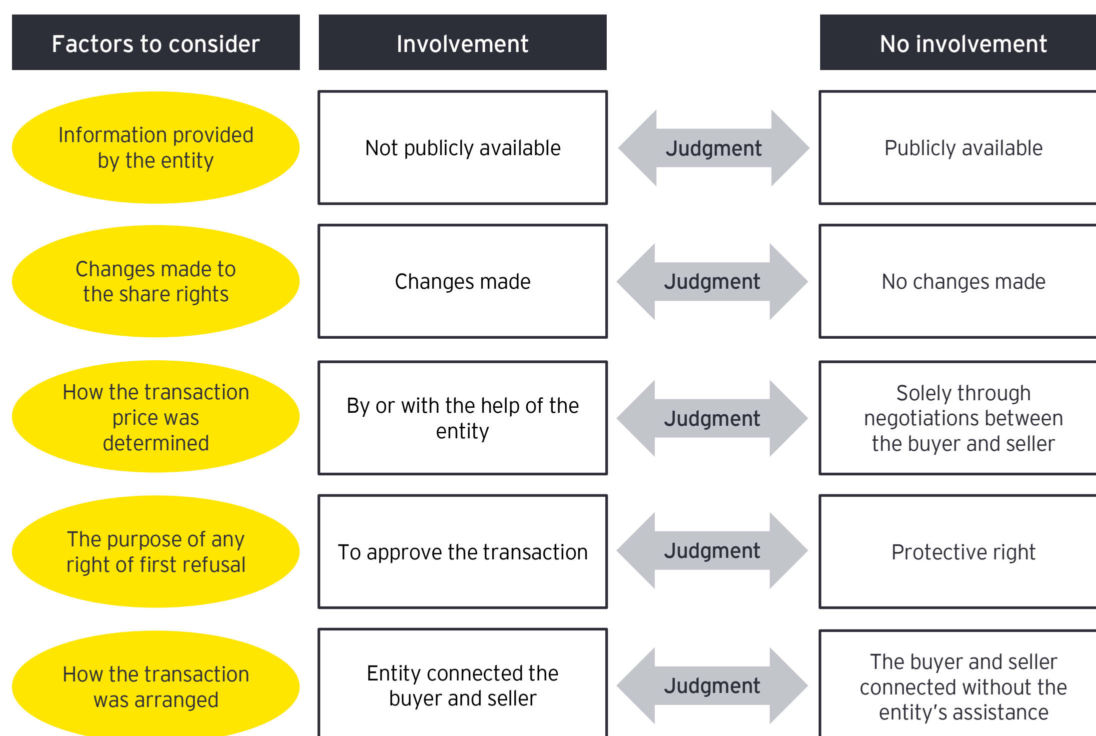
In addition to considering the ownership level in the assessment of whether an investor's economic interest is de minimis, a company should also consider other factors. For example, if the economic interest holder has a representative on the board of directors or observer rights, this may indicate that the economic interest is not de minimis.

If it is determined that the buyer's economic interest is de minimis, the entity must still determine whether it was involved in the transaction before reaching a conclusion about whether the excess amount paid over fair value is compensation.

Is the entity involved in the transaction between the buyer and seller?

If the entity is not repurchasing the shares directly but the transaction price is in excess of fair value, the entity needs to consider its level of involvement in the transaction between the buyer and the seller to determine whether the excess amount paid is compensation.

The graphic below depicts some of the key factors that should be considered when determining the level of the entity's involvement in the transaction.



If an entity facilitates the transaction or the transaction is executed by a related party or other economic interest holder, there is a presumption that consideration paid in excess of fair value represents compensation.

When an entity facilitates the transaction between a buyer and a seller, it is presumed that the transaction is in the scope of ASC 718. Any excess paid over fair value represents compensation to be recognized by the entity, unless the facts and circumstances indicate that the excess paid over fair value was clearly for purposes other than compensation.

Examples of an entity being involved in the transaction include:

- Connecting the buyers and sellers (e.g., providing a list of equity holders to potential buyers)
- Determining which buyers or sellers can participate in a purchase
- Dictating the number of shares that can be sold
- Negotiating or suggesting a price
- Agreeing to change the rights of the shares to be sold
- Deferring the receipt of the exercise price due from the seller until the sale has occurred
- Creating a company policy that favors certain investors when waiving the right of first refusal
- Providing information that is not publicly available or paying the costs of the transaction

If the transaction involves a large number of shares (or a large number of sellers), that may also indicate that the entity facilitated the transaction (e.g., a new investor that wants to purchase a large number of shares may need the entity to assist with identifying shareholders interested in selling).

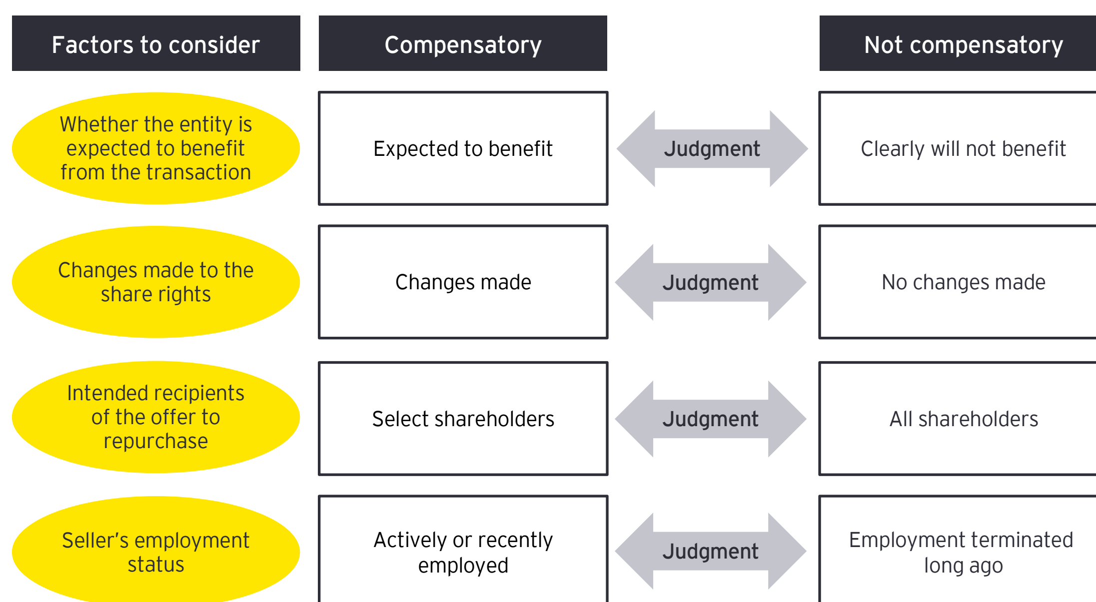
In addition, if the seller (or buyer) is an employee or former employee who left recently, the individual's level of seniority is an important consideration. Senior executives are generally presumed to be acting on behalf of the entity, which would indicate that the entity is indirectly facilitating the transaction. Further, the seller or buyer's seniority could indicate that the

transaction price was established based on information that was not publicly available. That's because individuals in executive positions would likely have access to confidential information that a lower-level employee (or former employee) would not have. Therefore, if executives are involved in a secondary market transaction, it is difficult to separate their involvement as shareholders from their role as representatives of the entity, and it is presumed that the entity facilitated the transaction for the purpose of compensation.

Is the excess paid over fair value for a purpose clearly other than compensation?

Entities that are not directly purchasing shares may not intend to compensate employees or former employees in a secondary market transaction. However, when the transaction involves a related party or other economic interest holder or when the entity is involved in the transaction, significant judgment and careful consideration of the facts and circumstances is needed to determine whether a transaction is clearly for a purpose other than compensation.

The below graphic depicts some of the factors that an entity should consider in its assessment.



In determining whether the presumption of compensation can be overcome and the excess of the transaction price over the fair value of the shares is clearly related to something other than to compensate the seller, consideration should be given to whether the entity is directly or indirectly expected to benefit from the transaction. For example, the secondary market transaction may benefit the entity if the transaction incentivizes current employees by allowing them to monetize existing awards or settles an informal agreement with a recently terminated employee. Transactions that benefit the entity are presumed to be entered into on behalf of or at the direction of the entity and would generally be considered compensatory absent other evidence to the contrary.

The seller's employment status is another factor to be considered in the analysis. There is a presumption that a purchase of shares from a current or former employee for consideration in excess of fair value by a buyer acting on behalf of the entity relates to compensation for current or past services. However, if the seller has not been employed by the entity for some time, this may be an indicator that the excess paid over fair value is not compensatory, but the characteristics of the buyer (as discussed above) and other factors must also be taken into consideration.

Similarly, the entity should consider who is receiving the offer to purchase shares. If the same offer is extended to all holders of a class of shares and the holders of that class of shares are sufficiently broad such that the offer doesn't primarily target employees, former employees

or founders, this could suggest that the intent of the transaction was not compensation. This may be the case when a broad-based tender offer is designed for the buyer to obtain a desired number of shares or when the excess consideration represents a control premium (e.g., significant influence or control is achieved through the transaction). In these cases, the excess over fair value may represent a distribution to all shareholders.[11]

The nature of the relationship between the buyer and seller should also be considered. If the relationship between the parties is a close, personal relationship (e.g., a familial relationship), this could indicate that the buyer is paying more than fair value out of generosity (e.g., to provide a gift to the seller from the buyer)[12] rather than to compensate the seller. ASC 718 also cites as an example of a transaction that is clearly for a purpose other than compensation a transaction that is intended to settle an obligation that is unrelated to the goods or services to be used or consumed in an entity's own operations.[13] While an entity may be able to overcome the presumption that both of these types of transactions are compensatory, we believe that these situations are rare and that it would be difficult to demonstrate that the excess over fair value is "clearly for a purpose other than compensation for goods and services."

The entity should also consider whether its intent is to compensate the seller. However, the lack of intent to compensate the seller is not determinative in the analysis. Instead, the entity must understand all of the facts and circumstances about the transaction to determine the appropriate accounting treatment.

A lack of intent to compensate is not determinative in the analysis of whether a secondary market transaction is compensatory.

Illustrations

The following examples illustrate factors that need to be assessed to determine whether the excess paid over fair value in a secondary market transaction is considered compensation. The illustrations do not address all factors that might need to be evaluated. As noted above, all facts and circumstances should be considered holistically to determine the substance of the transaction, and no one factor is determinative.

Illustration 1 — Secondary market purchase by a new investor

Investor A, a new investor, enters into a transaction to purchase shares from current and former employees of Entity KEM at an amount in excess of fair value. Investor A contacts the current and former employees through a third-party marketplace where employees are able to sell their shares. Entity KEM has no involvement other than waiving its right of first refusal to purchase the shares. Assume that the shares being purchased do not represent a large number of shares, and there is no other business purpose for the transaction other than for Investor A to obtain an ownership interest in Entity KEM.

Entity KEM concludes that the transaction is ***non-compensatory***.

In reaching its conclusion, Entity KEM considered the following factors:

- Investor A is not a related party or other economic interest holder before the transaction.
- Entity KEM's involvement in the transaction was minimal. Investor A initiated the transaction through a third-party marketplace, and the only action taken by Entity KEM was to waive its right of first refusal (a protective right), permitting the transaction to take place.
- The number of shares purchased was small, and therefore, there is no evidence to suggest that Entity KEM was involved in facilitating the transaction. If the transaction involved a larger number of shares, further analysis would be needed to determine the substance of the transaction and whether the amount paid in excess of fair value represented compensation.

Illustration 2 — Secondary market purchase by an existing investor that owns a de minimis interest in the entity

Investor B, an economic interest holder in Entity KEM, enters into a transaction to purchase a small number of common shares from Entity KEM's employees for an amount in excess of fair value. Investor B contacted the employees and made the offer to purchase the shares through a business networking site.

Investor B currently owns 1% of the outstanding shares of Entity KEM and does not have a board seat or observer rights. In addition, Investor B does not have any additional economic interest in or relationship with Entity KEM. Investor B did not receive any information from Entity KEM other than information available to all shareholders. Investor B set the offer price as 10% less than the per-share price that Entity KEM received in its last round of preferred financing.

Several lower-level employees decide to accept the offer, and Entity KEM waives its right of first refusal, permitting the transactions to take place. There is no other business purpose for the transaction other than for Investor B to increase its ownership interest in Entity KEM.

Entity KEM determines that the transaction is ***non-compensatory***.

In reaching this conclusion, Entity KEM considered the following factors:

- Based on Investor B's existing ownership interest in Entity KEM and the lack of influence and other economic interest or relationship, Entity KEM determined that Investor B's interest was de minimis.
- Entity KEM's involvement in the transaction was limited to waiving its right of first refusal (a protective right).
- The sellers were lower-level employees, and therefore, there is no indication that Entity KEM facilitated the transaction.
- The number of shares purchased was small, and therefore, there is no evidence to suggest that Entity KEM was involved in facilitating the transaction (as may be the case if the transaction involved a larger number of shares).

Illustration 3 — Secondary market purchase by an existing investor that owns more than a de minimis interest in the entity

Investor C recently purchased preferred shares from Entity KEM and owns 3% of the entity. Investor C wants to increase its ownership interest to 10% by acquiring common shares from Entity KEM. Entity KEM agrees to identify specific, current employees who collectively own sufficient common share holdings and provide their information to Investor C.

Investor C offers to pay the same price for the common shares held by the employees as it did for the preferred stock it recently purchased from Entity KEM. The preferred shares were issued at a premium over the fair value of the common shares due to the liquidation preference and other rights attached to the preferred shares.

Entity KEM determines that the transaction is ***compensatory***.

In reaching this conclusion, Entity KEM considered the following factors:

- Investor C is an economic interest holder, and its current 3% ownership interest in Entity KEM is determined to be more than de minimis.

- Entity KEM assisted in facilitating the transaction. Entity KEM selected individuals whose holdings were sufficient to accommodate the number of additional common shares that Investor C wanted to purchase.

Pursuant to ASC 718-10-15-4, the transaction was not clearly for a purpose other than to compensate for services provided by the employees to Entity KEM. Therefore, the presumption that the transaction was compensatory was not overcome. The substance of the transaction is that the economic interest holder makes a capital contribution to Entity KEM of the excess amount paid over fair value, and the payment to the employees is in exchange for services rendered to Entity KEM, which recognizes the excess as compensation cost in accordance with ASC 718.

Illustration 4 — Secondary market purchase by a new investor with no involvement of the entity

Investor D, a new investor, enters into a transaction to purchase shares at amounts in excess of fair value directly from a former executive of Entity KEM, who retired five years earlier.*

The primary objective of this transaction is for the former executive to diversify her personal investments. She initiated the transaction after she became aware, through a third-party agent, that Investor D had been looking to invest in Entity KEM. Entity KEM had no involvement in the transaction other than to waive its right of first refusal.

The former employee no longer has the ability to influence management and was not provided any financial or other information. She does not have any ongoing disputes with the entity or unsettled compensation arrangements and has not been involved with Entity KEM since her retirement.

Entity KEM determines that this transaction is ***non-compensatory***.

In reaching this conclusion, Entity KEM considered the following factors:

- The seller is a former employee who left Entity KEM several years ago, and Entity KEM was under no obligation to assist the seller in divesting her holdings.
- The former executive only had entity information available to all shareholders (Entity KEM did not provide additional financial information).
- Neither the buyer nor seller have influence over Entity KEM.
- The transaction was not initiated or facilitated by Entity KEM. It was initiated by the seller through a third-party agent.

While a price in excess of fair value paid to purchase shares from a former employee who was part of upper-level management may suggest that an element of compensation is present, Entity KEM concluded that in this case, the presumption was overcome and the transaction was not compensatory.

* There is no bright line for determining the number of years following an employee's separation that would lead an entity to conclude that the transaction was non-compensatory. As discussed throughout this publication, all of the facts and circumstances of each transaction must be considered holistically to determine their substance.

Illustration 5 — Secondary market purchase by a new investor with direct involvement by the entity

Investor E had previously expressed an interest in acquiring shares in Entity KEM but is not currently a shareholder. Certain members of management agreed to sell a portion of their shares, which Investor E agreed to purchase at amounts in excess of fair value. As part of the transaction, Entity KEM waived its right of first refusal and provided Investor E with financial information that is not available to other shareholders. The members of management who agreed to sell a portion of their shares did not have a preexisting relationship with Investor E.

Entity KEM determines that this transaction is ***compensatory***.

In reaching this conclusion, Entity KEM considered the following factors:

- The sellers are current employees and, as members of management, are deemed to have facilitated the transaction on behalf of Entity KEM. In addition, Entity KEM provided financial information to Investor E that was not available to other shareholders.
- Entity KEM will benefit from the amount in excess of fair value that was paid to the members of management because allowing them to monetize share-based payment awards incentivizes them to continue providing service.

Because of the involvement of both Entity KEM and the members of management in the transaction, Entity KEM determines that it facilitated the transaction, and therefore, the excess paid over fair value should be recognized as compensation cost.

Regardless of whether transactions are executed at fair value, entities must consider whether a pattern of purchasing immature shares has been established.

Illustration 6 — Secondary market purchase by an existing investor with changes to the underlying shares

Investor F, an existing investor, wants to increase its ownership interest in Entity KEM, an entity with two classes of common stock, Class A and Class B. The two classes of shares have the same economic rights except that Class A has voting rights and Class B does not. Investor F owns Class A shares while employees typically own Class B shares, because share-based payment awards to employees are in Class B shares.

Investor F initiates the transaction by contacting key executives of Entity KEM directly with an offer to purchase their Class B shares. Entity KEM agrees to change the rights associated with the shares being transacted and to convert them to Class A shares. Investor F pays the employees an amount equal to the fair value of the Class A shares, which exceeds the fair value of the Class B shares that the employees previously held.

Entity KEM determines that this transaction is ***compensatory***.

A key factor considered in reaching this conclusion is that Entity KEM agreed to change the rights of the shares (something the investor and employees could not do on their own). Entity KEM also provided value to the employees by agreeing to convert their shares to a different class upon the consummation of the transaction. As a result, Entity KEM determines that the excess paid over fair value should be recognized as compensation cost.

Determining whether a change in classification of share-based payment awards is necessary

The sale of immature shares or options in secondary market transactions requires an entity to reassess the classification of share-based payment awards, regardless of whether the purchase price exceeds fair value.

When an offer is made to settle equity awards for cash or other assets, the entity must determine whether the purchase should be accounted for as a settlement or a modification that changes the classification of the awards from equity to liabilities. If the transaction qualifies to be accounted for as a short-term inducement, it is accounted for as a settlement, and no reclassification of the shares from equity to a liability is required. However, if a pattern of repurchasing immature shares or options has been established, it may have changed the substantive terms of the plan. Therefore, the entity will have to determine whether it substantively has a liability plan (requiring liability classification for some or all of its immature shares/options) or a contingent liability plan (requiring liability classification for some or all of its immature shares/options when a contingent event triggering repurchase becomes probable of occurring).

Short-term inducements

An inducement is an offer by the entity[14] to its grantees that encourages them to accept the entity's offer to modify, replace, settle or repurchase existing awards. A short-term inducement is defined in ASC 718-20-20 as an offer to modify an award that an award holder may subscribe to for a limited period of time.

While the FASB has provided little guidance on how to determine whether an inducement is short term or long term beyond the glossary definition, based on past practices with respect to offers to cancel and replace options, we generally do not expect the offer period for a short-term inducement to extend beyond a few months. That is because we would not expect the offer period to extend beyond the period sufficient to both:

- Allow the grantee to receive, consider and accept the offer
- Comply with any offering period specified in applicable securities laws

Pursuant to ASC 718-20-35-5, short-term inducements are accounted for as modifications only for award holders who accept the inducement offer. Therefore, the modification occurs on the date the inducement is accepted. However, the FASB stated that it did not intend for a short-term inducement that is deemed to be a settlement (i.e., for those who accept the offer) to affect the classification of the award (e.g., change the award from an equity instrument to a liability instrument).[15] Accordingly, if an entity's short-term inducement to repurchase shares is accepted, the award would continue to be equity classified until the transaction is settled.

If the offer price exceeds the fair value of the shares, the entity would need to perform an analysis (described in the *Determining whether to recognize compensation cost* section above) to determine whether, based on the facts and circumstances of the transaction, the excess represented compensation cost.

Determining whether an offer meets the criteria to be classified as a short-term inducement requires careful consideration of the facts and circumstances.

How we see it

Entities must apply judgment to determine whether the short-term inducement guidance can be applied to secondary market transactions. While the guidance does not limit how often an entity can account for offers as short-term inducements, an entity that establishes a pattern of offering short-term inducements to cash settle immature shares or options may have a substantive liability that would require liability classification of some or all of the immature shares or options.

The example below illustrates the assessment of these factors and the accounting for a repurchase transaction that an entity has determined to be a short-term inducement.

Illustration 7 — Accounting for a short-term inducement when the transaction price is in excess of fair value

Entity KEM has issued options to its employees that vest based on completing a service period. On 30 June 20X2, Entity KEM enters into an agreement with a new investor to sell preferred shares, and the entity simultaneously offers to repurchase 10% of each employee's vested options. Assume the following:

- This is the first time that Entity KEM has purchased options from its employees (i.e., there is no history of repurchase transactions).
- Employees have one month from the offer date to accept, and the repurchase is executed at the end of the one-month offer period.
- Employees accept the repurchase offer for 360 options.
- The fair value of each option on 31 July 20X2 is $10. The options are repurchased at $15 each.

Entity KEM determined that the repurchase transaction represents a settlement under the short-term inducement guidance. In reaching this conclusion, Entity KEM considered that the offer was open for a "limited period of time" (i.e., one month) and that this was the first time it had made an offer to repurchase options.

In addition, Entity KEM concluded that the excess of the purchase price over the fair value of the shares represented compensation cost. That's because the transaction was a direct purchase made by Entity KEM, and the offer was only extended to employees, not to all shareholders, making the nature of the transaction compensatory.

Upon settlement (31 July 20X2), Entity KEM makes the following journal entry:

	Dr.	Cr.
Dr. Additional paid-in capital	$ 3,600	
Dr. Compensation cost	$ 1,800	
Cr. Cash		$ 5,400

Entry to recognize the cash paid to settle the share options (360 options x $15) and record the compensation cost that represents the excess of the transaction price over fair value at the settlement date (360 options x ($15 - $10)).

The same accounting would apply if the offer had been made by a related party or other economic interest holder of an entity or if the entity had facilitated the transaction. However, upon settlement, the entity would record a capital contribution instead of a cash payment because the payment was made directly by the related party or economic interest holder.

Substantive liabilities

Pursuant to ASC 718-10-25-15, the accounting for an award of a share-based payment reflects the terms of the award and any related arrangements. An entity's past practice of operating a plan may indicate that the substantive terms are different from those described in the written plan.

Accordingly, an important factor to consider when assessing the accounting effects of repurchases of employee, former employee or founder awards is whether the entity has established a pattern of repurchasing immature shares or options.[16] When immature shares or options are repurchased or cash settled, grantees are prevented from bearing the risks and rewards of share ownership for a reasonable period of time (i.e., six months or more). When an

entity has established a pattern of repurchasing awards, it may have changed the substantive terms of share-based payment awards to include a cash settlement feature, which would require the entity to account for its options and immature shares as liabilities.

How we see it

Determining whether a pattern of repurchasing immature shares or unexercised options has been established often involves significant judgment. An assessment of the frequency of the repurchase transactions, the circumstances under which the repurchase transactions have occurred and the expectations of the grantees should be considered in concluding whether the substantive terms of the share-based payment plan have changed and immature shares and/or outstanding options represent in-substance liabilities.

As discussed in the *Short-term inducements* section above, a repurchase transaction may qualify to be accounted for as a settlement under the short-term inducement guidance.

However, when a pattern of cash settling awards has been established through offers to repurchase immature shares or options, some or all of an entity's immature shares and options would be classified as liabilities (i.e., modification accounting would be applied to change the classification from equity to a liability), even though cash settlement is not explicitly provided for in the plan. The liability-classified awards would be subsequently remeasured at fair value each reporting period until the awards are settled or the shares mature.

When a modification changes the classification of an award from equity to a liability, an entity generally includes in its measurement of compensation cost on the modification date any increase in the fair value of the award between the grant date and the modification date. This is because when accounting for liability-classified awards, entities must remeasure the award at each reporting period and reflect any change in fair value in compensation cost.[17] This differs from the accounting for a settlement of the award pursuant to a short-term inducement offer that does not change classification of the award and results in the recognition of additional compensation cost for the excess of the settlement amount over the fair value of the award on the settlement date, as seen in Illustration 7 above (unless the transaction is clearly for a purpose other than compensation).

For further details regarding accounting for modifications that change the classification of an award from equity to a liability, refer to section 8.6.1 of our Financial reporting developments (FRD) publication, ***Share-based payment***.

Contingent repurchases

An entity that establishes a pattern of offering to repurchase immature shares and options upon the occurrence of a specific event (e.g., when there is a preferred round of financing bringing in new capital to the entity, when employees are involuntarily terminated) is effectively creating an in-substance contingent liability plan. That is, the entity is creating an expectation among grantees that cash settlement will occur whenever the triggering event occurs, even though the terms of the plan don't allow share repurchases upon the contingent event. In this case, we believe the guidance on contingent call features in Issue 23(b) of EITF 00-23[18] would be applied to determine the classification of the immature shares and options.

Under EITF 00-23, the entity must assess whether it is probable that the contingent event will occur and that the grantor will offer to repurchase the immature shares or options. When an entity has established a pattern of repurchasing immature shares or options upon the occurrence of a contingent event, the entity only needs to assess whether it is probable that the contingent event will occur while the shares are immature or before the options expire or have been exercised.

If it is not probable that the contingent event will occur while the shares are immature or the options are unexercised, the award is classified as equity as long as no other features require liability classification. If it becomes probable that the contingent event will occur, this change is accounted for as a modification that changes the classification of immature shares or options from equity to liabilities, as discussed in the *Substantive liabilities* section above, and the reclassified liability is marked to fair value at each reporting period.

Once the shares mature or the contingency lapses, modification accounting that changes the classification of the shares from liabilities to equity is applied. Gains or losses previously recognized while the shares were classified as liabilities are not reversed. For further details regarding accounting for modifications that change the classification of an award from a liability to equity, refer to section 8.6.2 of our FRD, ***Share-based payment***.

How we see it

While the term "probable" is generally interpreted to mean a likelihood of greater than 70% that an event will occur, we believe that a contingent event that is an IPO or a change in control or other liquidity event can be considered probable only when it occurs.

The example below illustrates the accounting for a repurchase transaction triggered by a contingent event.

Illustration 8 — Accounting for a repurchase transaction triggered by a contingent event when the transaction price is in excess of fair value

Assume the same facts as in Illustration 7, in which Entity KEM made its first employee share repurchase on 31 July 20X2. Then assume that, on 31 December 20X3, Entity KEM obtained another preferred round of financing and offered again to repurchase 10% of vested employee options, which it accounted for as a short-term inducement (consistent with the first transaction).

After the second repurchase, Entity KEM determined that its pattern of repurchasing employee options had set the expectation that it will continue to offer to repurchase 10% of vested employee options each time additional capital is obtained through a round of preferred financing. That is, Entity KEM determined that it had an in-substance contingent liability plan. However, at that time, it determined that raising another round of financing was not probable, and therefore, the outstanding options did not require liability classification.

On 1 April 20X4, Entity KEM entered into an agreement for another round of preferred financing. Based on the entity's facts and circumstances, the entity concluded that the contingent event would not be probable of occurring until the transaction closed. On 30 April 20X4, Entity KEM completed the preferred round of financing. At this time, Entity KEM determined that it has a liability to repurchase 10% of employees' vested options. Then, as expected, in conjunction with the preferred round of financing, Entity KEM offered to repurchase 10% of the vested options from all employees for $18 each. Assume the following on 30 April 20X4:

- The fair value of each option is $13.
- The previously recognized compensation cost for each option is $4.[19]
- 10% of vested options is 500 options (i.e., the maximum number of options that would be eligible to be repurchased).
- Employees have one month from the offer date to accept, and the repurchase is executed at the end of the one-month offer period.

Therefore, on 30 April 20X4, Entity KEM makes the following journal entry:

Dr. Compensation cost	$ 7,000	
Dr. Additional paid-in capital	$ 2,000	
Cr. Share-based payment liability		$ 9,000

Entry to recognize the maximum liability (500 options x $18 offer price) and the compensation cost for the excess of the offer price over the amount previously recognized (500 options x ($18 offer price - $4 previously recognized compensation)).

Employees accept the repurchase offer for 400 options. Upon settlement (30 May 20X4), Entity KEM makes the following journal entries:

Dr. Share-based payment liability	$ 7,200	
Cr. Cash		$ 7,200

Entry to recognize the cash paid to settle the options (400 options x $18) and derecognize the liability for the options repurchased.

Dr. Share-based payment liability	$ 1,800	
Cr. Additional paid-in capital		$ 1,800

Entry to derecognize the liability for the options that were not repurchased (100 options x $18) and reclassify the amounts back to equity since the contingency has lapsed.

The outstanding options will remain equity classified until it becomes probable that another contingent event triggering repurchase will occur, but the additional compensation cost that was recorded for these options at the time the offer was made is not to be reversed.

It would not have been appropriate for the entity in the illustration above to reclassify all outstanding options from equity to liabilities when the contingent event became probable because the entity's past practice indicates that the employees expect that the entity will offer to repurchase only 10% of the vested options. In reaching its conclusion about the number of vested options that should be reclassified, the entity would need to consider the facts and circumstances known at the time it entered into the preferred financing arrangement and continue to assess for appropriateness.

Accordingly, once the contingent event becomes probable of occurring, the entity reclassifies a portion of its vested options from equity to a liability measured at fair value. However, in the illustration above, since the offer was made in conjunction with the preferred financing agreement at an amount above fair value, the liability must be recorded at the offer price. The liability recorded represents the settlement value for the maximum number of options that could be tendered from employees. The entity recognizes the difference between the offer price and the compensation cost previously recognized as compensation cost when recording the liability. For employees who accept the entity's offer to repurchase the options, the liability is relieved when the settlement occurs. The remaining options that are not repurchased are reclassified from liabilities back to equity since the contingency has lapsed and the entity no longer has an in-substance liability. The entity does not reverse any previously recognized compensation cost.

Similarly, a related party or other economic interest holder of the entity may establish a pattern of offering to purchase immature shares from employees, or the entity may establish a pattern of facilitating the purchase of immature shares from employees by new investors. We believe the accounting described above applies in these situations, and these transactions should be accounted for as if the entity had made the offer.

Endnotes:

[1] This publication addresses the accounting for secondary market transactions from the perspective of the entity that issued the shares or granted the share-based payment awards that are being sold.

[2] Refer to ASC 850-10-20 for the definition of a related party.

[3] ASC 718-10-20 defines an economic interest in an entity as "any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics or equity, liabilities or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses."

[4] As discussed in ASC 718-10-25-9, shares are immature if the grantee has not been subject to the risks and rewards of share ownership for a reasonable period (i.e., six months or more). Therefore, shares are mature six months or more from the date of exercise (for options) or the date of vesting (for share awards). Options are never mature.

[5] Entities that submit an IPO registration statement for nonpublic or confidential review with the SEC must also consider the SEC's related party disclosure requirements when directors, officers or certain other shareholders participate in the sale.

[6] Item 404(a) of Regulation S-K.

[7] ASC 718-10-35-10 states that an award "issued to an employee in exchange for past or future services that is subject to initial recognition and measurement guidance of [ASC 718] shall continue to be subject to the recognition and measurement provisions of [ASC 718] throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee."

[8] While founders' shares are not in the scope of ASC 718, under ASC 505-30-30-2 through 30-4, any excess of the purchase price over fair value paid for these shares must similarly be assessed to determine the nature of the excess and, therefore, whether it represents compensation to the seller. Accordingly, we believe the factors to consider are consistent with those considered when ASC 718 awards are repurchased from employees or former employees.

[9] The AICPA *Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation* provides a non-authoritative framework for valuation specialists and preparers of financial statements to estimate the fair value of share-based payments issued by nonpublic entities.

[10] As stated in paragraphs B109 through B110 of the Basis for Conclusions of Statement 123(R), *Share-Based Payment*, the FASB broadened the requirement that an entity account for transfers between its economic interest holders and employees but said such a transfer is most likely to be made by a major shareholder or another holder of a significant economic interest in an entity.

[11] When shares are purchased in a secondary market transaction by a related party or other economic interest holder, the guidance in ASC 505-30-30-4 may be applied if there is a broad-based tender executed at a purchase price in excess of fair value because the substance of the transaction would be the same as if the entity had executed the transaction.

[12] While the concept of generosity is discussed in AICPA Accounting Interpretation AIN-AP25, *Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25*, which has been superseded, we believe that the guidance may still be relevant to the analysis of whether the excess paid over fair value in a secondary market transaction is clearly for a purpose other than compensation for goods or services.

[13] ASC 718-10-15-4.

[14] An offer from a related party or other economic interest holder of an entity is accounted for as if the inducement had been offered by the entity. An offer from a new investor, when facilitated by the entity, is also accounted for as if the inducement had been offered by the entity.

[15] Background of FASB Staff Position FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R).

[16] The nature of past repurchase transactions must be considered to determine whether an equity instrument is an in-substance liability.

[17] Cumulative compensation cost cannot be less than the grant-date fair value of the original award plus any incremental compensation cost associated with the modification.

[18] Because the accounting for contingent call features is not comprehensively addressed in ASC 718, the concepts in earlier accounting literature (EITF 00-23) are applied in practice since FAS 123(R) (the predecessor to ASC 718) was not meant to change practice when it was issued.

[19] When employees or former employees have outstanding awards with various original grant-date fair values and an entity is offering to purchase only a portion of the awards, we believe the entity should identify the awards to be reclassified to liabilities using a systematic and rational approach and apply that approach consistently. For example, the entity may assume that the oldest awards will be sold first or average all the grant-date fair values for each employee or former employee's vested awards to determine the previously recognized compensation cost.

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