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FASB Proposes Clarifications to the Accounting for Share-Based Consideration Payable to a Customer

Overview

On September 30, 2024, the FASB issued a proposed ASU[1] that would clarify the guidance in both ASC 606[2] and ASC 718[3] on the accounting for share-based payment awards that are granted by an entity as consideration payable to its customer. The proposed ASU's purpose is to reduce diversity in practice and improve existing guidance, primarily by revising the definition of a "performance condition" and eliminating a forfeiture policy election specifically for service conditions associated with share-based consideration payable to a customer. In addition, the proposed ASU would clarify that the variable consideration constraint guidance in ASC 606 does not apply to share-based consideration payable to a customer regardless of whether an award's grant date has occurred. Comments on the proposal are due by November 14, 2024.

Background

In November 2023, the FASB received an agenda request to clarify certain aspects of the current guidance on an entity's accounting for share-based payment awards issued to a customer that are not in exchange for a distinct good or service. The agenda request focused primarily on awards that vest on the basis of customer purchases (or purchases by other parties that purchase the entity's goods or services from its customers) and noted that there is diversity in practice associated with whether these types of vesting conditions are performance conditions or service conditions and that this distinction affects how an entity accounts for the associated award.

1 FASB Proposed Accounting Standards Update (ASU), *Clarifications to Share-Based Consideration Payable to a Customer*.
2 FASB Accounting Standards Codification (ASC) Topic 606, *Revenue From Contracts With Customers*.
3 FASB Accounting Standards Codification Topic 718, *Compensation — Stock Compensation*.

Connecting the Dots

The amendments in ASU 2019-08[4] require that an entity apply the guidance in ASC 718 to measure and classify share-based consideration payable to a customer if such consideration is not in exchange for a distinct good or service. The entity then records the amount as a reduction of the transaction price in accordance with the presentation guidance in ASC 606 on consideration payable to a customer. ASU 2019-08 also requires an entity to determine whether any vesting conditions represent service conditions or performance conditions. As a result, this determination may affect when an entity recognizes amounts related to such awards (and, therefore, the entity's timing of revenue recognition). Specifically, an entity recognizes amounts related to an award that vests on the basis of a performance condition only if it is probable that the performance condition will be met (and, thus, it is probable that the award will vest). By contrast, an entity may initially recognize amounts related to an award that vests on the basis of a service condition even if it is not probable that the award will vest because the entity may elect, as an accounting policy for awards issued to nonemployees (including customers), to only account for the effects of forfeitures of such awards as they occur.

Given the lack of clarity in the current guidance, views have differed about whether to treat vesting conditions that are based on customer purchases (or purchases by other parties that purchase the entity's goods or services from its customers) as service conditions or performance conditions. The current definitions of "performance condition" and "service condition" in the ASC master glossary do not explicitly acknowledge share-based payment awards issued to customers or awards that vest on the basis of the grantee's purchases of goods or services from the grantor.

When these vesting conditions are treated as service conditions and an entity elects to account for the effects of forfeitures as they occur, there can be a delay in revenue recognition for transactions that include the grant of awards for which vesting is not probable. Certain stakeholders have indicated that such a delay can diminish the usefulness of an entity's reported revenue information. For example, in this scenario, an entity would (1) initially reduce revenue for amounts related to an award that the entity does not expect will vest and (2) subsequently recognize revenue when the unvested award ultimately expires, which could conceivably occur in a reporting period after the entity has already satisfied the related performance obligation.

In response to the agenda request, the FASB staff conducted research and outreach with various stakeholders. At its June 12, 2024, meeting, the Board approved the addition of a project on this topic to its technical agenda, made tentative decisions about various proposals presented by the FASB staff, and instructed the staff to draft the proposed ASU.

Main Provisions of the Proposed ASU

Revision of the Term "Performance Condition"

The proposed guidance would revise the ASC master glossary definition of "performance condition." Specifically, for share-based consideration payable to a customer,[5] the revised definition would specify conditions (including vesting conditions) that are based on a customer's purchases of goods or services from an entity. The revised definition would also include performance targets based on purchases made by other parties that purchase the entity's goods or services from its customers (i.e., purchases made by an entity's customer's customer).

[4] FASB Accounting Standards Update No. 2019-08, *Codification Improvements — Share-Based Consideration Payable to a Customer*.

[5] As specified in the proposed ASU, share-based consideration payable to a customer would encompass "the same instruments as share-based payment arrangements" (as defined in the ASC master glossary) but the grantee would not need to be a supplier of goods or services to the grantor.

Under the proposed ASU, the ASC master glossary definition of "performance condition" would be revised to add the following:

> 2. For share-based consideration payable to a customer that is not in exchange for a distinct good or service (or that is in exchange for a distinct good or service and can result in a reduction of the transaction price in accordance with paragraph 606-10-32-26), a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
>   a. Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's (the customer's) performance related to the grantor's own operations (or activities)
>   b. The grantee's purchase of the grantor's goods or services from either the grantor or the grantor's customers
>   c. A purchase of the grantor's goods or services from either the grantee or the grantee's customers.
>
> The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer.

As indicated in the revised definition above, a performance condition would explicitly include any condition related to achieving a specified performance target that is defined by reference to a grantee's purchases of the grantor's goods or services from the grantor or the grantor's customers or a purchase of the grantor's goods or services from the grantee or the grantee's customers. Therefore, under the proposed ASU, a vesting condition that is based on a specified volume or specified monetary amount "of goods or services [purchased from the grantor] (including over a specified period of time)" would be a performance condition. The revised definition would also include such targets on the basis of purchases of an entity's goods or services by a customer's customer and reflects the FASB's decision that awards that vest upon direct customer purchases and those that vest upon purchases made by a customer's customer are similar and therefore do not warrant different accounting treatment.[6]

Example

Share-Based Sales Incentive Contingent on Cumulative Purchases

On January 1, 20X1, Entity A executes a one-year master supply agreement (MSA) to sell and deliver widgets to Customer B. Customer B agrees to pay A $1,000 for each widget purchased under the MSA. Entity A includes the following terms in the MSA:

- Customer B will earn 1,000 shares of A's common stock if or when B purchases five widgets within one year of the MSA's execution.
- Customer A's payment of shares to B is not in exchange for distinct goods or services.
- Customer A determines that this payment represents share-based consideration payable to a customer and that it is equity-classified in accordance with the guidance in ASC 718.

Entity A concludes that the terms of the MSA are sufficient to establish a grant date for the share-based consideration in accordance with the guidance in ASC 718. Entity A measures the share-based consideration issued to B on January 1, 20X1, because a grant date exists for the share-based consideration in accordance with the criteria in ASC 718. The grant-date fair-value-based measure is $1 per share.

[6] Paragraph BC14 of the proposed ASU states that "[a]lthough not defined in the amendments in this proposed Update, the Board expects that the term *purchases* would be interpreted broadly. For example, performance targets based on (a) payments by a grantee in connection with a grantee's purchase of goods and services from the grantor, (b) delivery of purchased goods or services by the grantor to the grantee, or (c) the grantor, upon inception of a contract, committing to provide goods or services to the grantee in exchange for consideration would be considered performance conditions for the purpose of applying the proposed definition."

Example (continued)

Entity A concludes that the share-based consideration payable to B includes a performance condition because the shares issuable to B vest on the basis of a condition related to B's (i.e., the grantee's) purchase of goods from A (the grantor).[7] Accordingly, A estimates the probable outcome of the performance condition and concludes that it is not probable that B will purchase five widgets within one year of the MSA's execution. As a result, A (1) does not recognize any reduction in transaction price because it is not probable that the share-based consideration payable to B will vest and (2) does not apply the guidance on constraining estimates of variable consideration under ASC 606.

Throughout 20X1, A must continually assess the probability that the performance condition will be met. If at any point during the year it becomes probable that the shares issuable to B will vest on the basis of B's expected purchases, A would (1) reduce the transaction price by $1,000 (1,000 shares expected to vest × $1 grant-date fair-value-based measure) and (2) recognize this reduction in transaction price in conjunction with its recognition of the related revenue, which may potentially include an immediate reversal of some amount of revenue already recognized under the MSA during the period in which A did not think it was probable that the shares would vest.

Elimination of Forfeiture Policy Election

Under the proposed revision to the ASC master glossary definition of "performance condition," fewer awards issued to customers would be expected to have service conditions. However, the proposed ASU would also amend the guidance in ASC 718-10-35-1D on service conditions in share-based payment arrangements that permits entities to elect a policy of recognizing the effect of forfeitures when they occur. The amendment would eliminate that policy election for share-based consideration payable to a customer that is not in exchange for distinct goods or services. Thus, for service conditions associated with share-based consideration payable to a customer, entities would be required to estimate the number of forfeitures expected to occur.

Connecting the Dots

In the proposed ASU's Basis for Conclusions, the Board explains that it considered an alternative approach to the proposed ASU in which it would not amend the definition of performance condition but would merely eliminate an entity's ability to elect an accounting policy of recognizing the effect of forfeitures as they occur (and thereby require entities to estimate the number of forfeitures expected to occur) for service conditions associated with share-based consideration payable to a customer that is not in exchange for distinct goods or services. Under this approach, entities would need to estimate the number of awards expected to vest regardless of their conclusion about whether a vesting condition is a service condition or a performance condition, which would have achieved the same objective as the guidance in the proposed ASU (i.e., improving an entity's estimate of transaction price in a contract with a customer) without an amendment to the current definition of either service condition or performance condition.

However, the Board ultimately decided to amend the definition of "performance condition" because of its concern about the consequences of failing to address underlying issues associated with the definition's lack of clarity. The Board noted that one such consequence is related to differences in how awards with service conditions and awards with performance conditions are incorporated into the calculation of diluted earnings per share (EPS). Accordingly, by amending the definition of "performance condition," the proposed ASU would not only improve an entity's estimate of transaction price in a contract with a customer that includes share-based consideration payable to a customer but also address diversity in practice in other areas of U.S. GAAP in which entities need to distinguish between service conditions and performance conditions for share-based consideration payable to a customer.

[7] This conclusion is based on the revised definition of "performance condition" in the proposed ASU. Entity A, therefore, would not necessarily reach the same conclusion under current authoritative GAAP.

For further discussion of the impact of service conditions and performance conditions in the calculation of EPS for share-based payment awards, see Section 7.1 of Deloitte's Roadmap *Earnings per Share*.

The proposed ASU also includes a request for feedback on whether entities should be permitted, upon transition to the new guidance, to make a one-time change to their forfeiture policy for nonemployee awards if they previously elected to estimate forfeitures for such awards.

Variable Consideration Constraint Guidance

The proposed ASU would also clarify that the guidance on constraining estimates of variable consideration in ASC 606 "should not be applied to share-based consideration payable to a customer that is measured and classified under Topic 718." The Board is aware of the current diversity in practice that has resulted from an absence of guidance that clearly describes the extent to which the variable consideration requirements in ASC 606 (which includes the constraint) apply to share-based consideration payable to a customer.

Effective Date and Transition

Effective Date

The Board will determine the effective date after considering stakeholder feedback on the proposed ASU.

Transition

Entities would be able to apply the ASU's amendments on either a modified retrospective or retrospective basis. Under the modified retrospective approach, an entity would recognize a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption and would not recast any comparative periods presented. Under the retrospective approach, an entity would recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the earliest period presented. Under either approach, an entity would apply the amendments in this proposed ASU as of the date of initial application to all arrangements for share-based consideration payable to a customer.

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