BDO Dunwoody LLP
Chartered Accountants
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Inside

Accounting for Stock-Based Transactions

The Canadian Institute of Chartered Accountants (CICA) accounting Handbook Section on stock-based compensation and other stock-based payments (Section 3870) establishes recognition, measurement, and disclosure requirements for stock-based transactions.

Is your enterprise affected?

To determine if your enterprise is affected by these rules, answer the following questions:

		YES	NO
1.	Does your enterprise have stock-based transactions with:		
	• Employees of your enterprise?	☐	☐
	• Employees of a parent company or subsidiary?	☐	☐
	• Employees of a subsidiary of your parent company (i.e., sister subsidiary)?	☐	☐
	• Employees of investee companies (equity-accounted affiliates)?	☐	☐
	• *Non-employee directors?*	☐	☐
	• Non-employees?	☐	☐
2.	*If you answered "yes" to any part of question 1, do your enterprise's stock-based transactions include:*		
	• *Granting shares of your enterprise's stock?*	☐	☐
	• Granting stock appreciation rights?	☐	☐
	• Granting stock options?	☐	☐
	• Incurring liabilities (or cash payments) based on the price of your enterprise's stock?	☐	☐
	• Granting stock-based payments based on the stock of an affiliated enterprise (for example, parent, subsidiary, or sister subsidiary)?	☐	☐

Appendices

If you answered “yes” to any part of questions 1 and 2, your enterprise is impacted by the rules for stock-based compensation and other stock-based payments. As indicated by the questions, the rules apply to stock-based transactions in which your enterprise grants shares of stock, stock options, other equity instruments, or incurs liabilities based on the price of equity instruments in transactions with employees and non-employees. For example, suppose your enterprise sets up a stock-based compensation plan that grants 1,000 shares of common stock to your chief executive officer (CEO) as a bonus for increasing the enterprise’s market share of its principal product to 75 per cent. This type of stock-based compensation plan would fall under these rules.

Who must apply the Section and when?

Public enterprises, co-operative enterprises, deposit taking institutions and life insurance enterprises should already apply Section 3870, as portions have been applicable since 2002, and the remainder of the Section became applicable in 2004.

For all other enterprises, since 2003 Section 3870 has applied to the following stock-based transactions:

- non-employee transactions;
- awards settled in cash or other assets;
- stock appreciation rights to be settled in stock or other equity instruments; and
- any award modified which, as a result of the modification, would be included in either of the previous categories.

For all other awards, Section 3870 is applicable to fiscal years beginning on or after January 1, 2005.

Practically speaking, for private enterprises December 31, 2005 is the first year for which the entire Section 3870 is applicable.

This section is not subject to a differential reporting exemption.

How are stock-based transactions categorized?

Stock-based transactions fall into three groups:

- Non-compensatory employee transactions – These are transactions in which employees are allowed to purchase shares at a discount from the prevailing market price, thereby having an ownership interest in the enterprise in which they work. Section 3870 states that employee stock purchase plans must satisfy all of the following conditions to be considered non-compensatory:
    - substantially all full-time employees are allowed to participate in the plan on an equitable basis;
    - the discount from the market price is considered reasonable (a discount of 5 per cent or less is considered reasonable without justification);
    - employees are permitted a short period of time (less than 31 days) to enroll in these plans; and
    - the purchase price of the stock is based solely on the stock’s market price at the date of purchase.
- Compensatory employee transactions - These are stock-based transactions that are intended to compensate employees for current performance or provide an incentive for future performance. Stock-based transactions which do not qualify as non-compensatory employee transactions are considered compensatory employee transactions.
- Non-employee transactions - These are transactions with individuals (or other entities) with whom an enterprise does not have an employer-employee relationship.

Who are employees and non-employees?

Section 3870 defines employees as individuals over whom an enterprise exercises or has the right to exercise sufficient control to establish an employer-employee relationship as determined by law. This includes:

- *individuals an enterprise represents as employees (for example, individuals given T4 slips);*
- *individuals with lease or co-employment agreements between the enterprise (lessee) and another enterprise (lessor) that satisfy certain conditions[1]; and*
- *directors compensated for services as directors.*

Individuals or enterprises that do not belong to the above categories are non-employees. These include:

- *individuals who provide services (in a non-elected capacity) to an enterprise and are not represented as employees, including independent consultants who do not meet the criteria for leased individuals;*
- *non-employee directors compensated for services outside their role as a director;*
- *non-related enterprises providing goods or services; and*
- *non-related enterprises that are granted equity instruments or stock-based payments (for example, charitable organizations).*

What are the requirements of the Section?

As previously mentioned, the Section establishes measurement, recognition and disclosure standards for stock-based transactions. In general, these standards are based on the written terms of the transactions. However, if the substantive terms of stock-based transactions differ from the written terms, the accounting for such transactions is based on the substantive terms. The requirements are documented in the following categories:

- How are stock-based transactions measured?
- How are stock-based transactions recognized?
- Disclosure standards for stock-based transactions

How are stock-based transactions measured?

Measuring the cost of stock-based transactions can be complex. The Section requires the use of the fair value-based method of accounting for all non-employee and employee stock-based transactions.

The fair value-based method of accounting requires enterprises to estimate the fair value of the equity instruments on which the transactions are based.[2] For example, the fair value of a share of stock is the market price in an active market or the estimated market price if the stock is not actively traded. Other instruments like stock options require more complex valuation models (for example, the Black-Scholes model) to estimate fair value. Enterprises are required to recognize compensation expense based on the fair value of the equity instruments.

The recognition of stock-based transactions depends on the following:

- the type of stock-based transaction;
- the type of financial instrument used in the transaction; and

[1] See paragraphs 3870.08 (a) and (b) for a list of these conditions.

[2] "Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act." (See Section 3870.07(b) of the CICA Accounting Handbook).

- the settlement terms of the transaction.

The above issues are discussed in detail below for each type of stock-based transaction. A summary of the requirements is included in Appendix A.

Non-compensatory employee stock-based transactions

Enterprises with non-compensatory employee stock purchase plans should treat these transactions as capital transactions when employees purchase stock. These transactions are measured at the consideration received.

Compensatory employee stock-based transactions

Compensatory employee stock-based transactions are intended to compensate employees for current or future service and are recognized over the period in which the related employee services are rendered. If the service period is not defined as an earlier or shorter period, the service period is presumed to be the period from the grant date to the vesting date of the award, providing its exercisability does not depend on continued employee service. If the transaction is for past services, it should be recognized in the period in which it is granted.

The substance of compensatory employee stock-based transactions is important in determining the accounting implications of the transaction. For example, if a principal shareholder directly transfers equity instruments to an employee as compensation, the transaction is accounted for as if the principal shareholder had made a capital contribution to the enterprise, and the enterprise awarded equity instruments to the employee (stock-based compensation). [3]

Granting of stock

When stock is granted to employees in exchange for services, the company should record compensation expense and an increase in equity equal to the fair value of the stock, net of the amount, if any, that the employees pay for the stock on the date the stock is granted. Assume that your enterprise grants 1,000 shares of common stock to the CEO on March 1, 2006, as a bonus for increasing the enterprise's market share. Also, the CEO can immediately do whatever he wishes with the 1,000 shares, and the market price of the stock on March 1, 2006 is $50 per share. Based on the fair value method of accounting, your enterprise must recognize compensation expense of $50,000 (1,000 x [$50 - $0]) on March 1, 2006.

Granting of stock appreciation rights (SARs)

Stock appreciation rights settled by issuing stock or in cash are also accounted for using the fair value-based method of accounting.

When stock appreciation rights are settled in cash, compensation cost and the corresponding liability is measured as the amount by which the quoted market value of the stock (on which the transaction is based) exceeds the option price or value specified in the transaction. The transaction is initially measured at the grant date and the compensation expense is recognized in a rational and systematic manner over the service period. The compensation cost (and the corresponding liability) is adjusted each period, until the settlement date, to reflect the change in the obligation (due to the change in the market value of the stock).

When stock appreciation rights are settled by issuing equity, compensation cost and a corresponding increase in equity should be recognized and measured using either of the following methods:

- Based on their fair value at the date of grant (i.e. using an option pricing model). Therefore there is a one time measurement of compensation expense at the date of grant which is recognized over the service period.

[3] "A principal shareholder is one who either owns 10 per cent or more of an enterprise's common stock or has the ability, directly or indirectly, to control or significantly influence the enterprise." (See Section 3870.07(l) of the CICA Accounting Handbook)

- In the same manner as cash SARs as described above. Therefore in each period both the compensation expense and corresponding equity account are adjusted to reflect changes in the market value of the stock.

Granting of stock options and other stock-based payments

Stock options may be granted with an exercise price below, above or equal to the fair market value of the shares on the grant date. Stock options must be accounted for based on fair value. If the stock options can only be settled by issuing equity instruments, the fair value should be estimated using an option pricing model. If the stock-based transaction results in the enterprise incurring a liability (or making cash payments) the fair value is measured in the same way as SARs settled in cash. One example of this type of transaction is stock options that are settled by making cash payments. If an enterprise grants stock options to employees that are to be settled in equity but in the past have settled similar stock options in cash, such past practice of cash settlement is considered evidence of a substantive liability. These transactions are to be accounted for in the same way as SARs settled in cash.

Granting of Restricted Stock Units (RSUs)

The granting of restricted share units is considered a direct award of stock and therefore would be accounted for at fair value. Compensation expense and the corresponding increase in equity would be determined at the grant date at the fair value of the stock. Compensation expense should be recognized over the vesting period of the RSUs.

Non-employee stock-based transactions

All non-employee stock-based transactions through which an enterprise acquires goods or services in exchange for issuing equity instruments or incurring liabilities to a non-employee in amounts based on the price of the enterprise's stock (i.e., reciprocal transactions) must be accounted for using the fair value-based method of accounting. The enterprise must record the transaction using the fair value of the consideration received or the fair value of the liability incurred or equity instrument issued, whichever is more reliably measurable. If the equity instruments are tradable, then the fair value of the equity instruments should be used. If they are non-tradable, then the fair value of the goods or services received should be used. These transactions should be recognized as assets or expenses in the same manner as if the enterprise had paid cash for the goods or services. The transaction would be recorded on the earliest of the following dates:

- the date at which the counterparty's performance is complete, (for example, the goods or services have been delivered);
- the date at which a commitment for performance by the counterparty is reached; or
- the date at which the equity instruments are granted if they are fully vested and non-forfeitable.

In addition, if your enterprise grants equity instruments by way of a non-reciprocal transfer (for example, to a registered charity) the fair value-based method of accounting must be used. Non-reciprocal transfers are measured based on the fair value of the liability incurred or equity instrument issued. They are recognized on the later of the date on which the detailed terms of the transfer are set, or the date at which the enterprise is committed to the transfer.

Determining fair value

Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. In a public company, fair value of its stock is determined by the quoted market value. An option pricing model, such as the Black-Scholes, is used to determine the fair value of options granted or SARs. The option pricing model should consider the following factors:

- current stock price;

- expected lives of the stock options;
- expected volatility of the stock price;
- expected dividends.

In the case of a private company, a quoted market value does not exist. Therefore, to determine the fair value of the shares of the company, an external valuation may be required. To determine the fair value of options granted, an option pricing model must be used. However, they have the option of using an expected volatility of zero.

Disclosure standards for stock-based transactions

How are stock-based transactions presented in the balance sheet?

Cash-settled stock-based transactions should be classified as liabilities. Equity-settled stock-based transactions should be classified as equity. The substantive terms of stock-based transactions may also affect the presentation of financial instruments used in stock-based transactions on the balance sheet. For instance, if an enterprise has the choice of settling awards by issuing stock or cash, it can avoid transferring assets (cash) by choosing to settle in stock. However, if the enterprise has a stated policy to settle in cash, or the employees have a reasonable basis to expect the award to be settled in cash based on past history, the enterprise has a substantive liability, and the award should be classified a liability on the balance sheet.

Required disclosures

The *CICA Handbook* provides a summary of annual disclosures required for stock-based transactions in paragraphs 3870.66 - .74, as well as samples notes in Appendix B of that section. All of the disclosures previously required by EIC-98 *Stock-Based Compensation Plans – Disclosures* remain in force, including the accounting policy for stock-based transactions, terms of stock-based compensation plans, information about stock options, and compensation cost. In addition, there are a couple additional disclosure requirements. Enterprises must also provide similar disclosures for non-employee stock-based transactions if they are important in understanding the effects of those transactions on their financial statements.

Transitional requirements

The recommendations in Section 3870 are to be applied to all awards granted on or after the date of adoption of the section.

All entities would have already adopted Section 3870 for the following stock based transactions:

- non-employee awards;
- awards to be settled in cash or other assets (i.e., stock options, stock appreciation rights);
- stock appreciation rights to be settled in stock or other equity instruments; and
- any award modified which, as a result of the modification, would be included in one of the above two categories.

For all other awards public enterprises, co-operative enterprises, deposit taking institutions and life insurance enterprises have already adopted Section 3870. Therefore, the transitional provisions only apply for all other awards issued by private enterprises.

In applying this portion of Section 3870, a choice of the following transitional alternatives exists:

- retroactive application with restatement of prior periods;
- retroactive application without restatement of prior periods and an adjustment to the opening balance of retained earnings of the current year to reflect the cumulative effect of the change on prior periods; or
- prospective application.

If awards of stock-based compensation were outstanding and not accounted for under the fair value-based method for any period for which an income statement is presented, the following information is disclosed for those periods:

- the total stock-based employee compensation that would have been included in the determination of net income if the fair value-based method had been applied to those awards;
- *proforma* net income as if the fair value based method had been applied to those awards; and
- *proforma* basic and dilute earnings per share as if the fair value-based method had been applied towards those awards.

How can BDO Dunwoody LLP help?

BDO Dunwoody LLP is well qualified to help you determine if the new rules apply to your enterprise, when the rules are effective, and their impact on your enterprise.

If you have any questions on accounting for stock-based transactions, or on anything covered in this publication, please contact your local BDO Dunwoody partner.

Appendix A

Accounting for Stock-based Transactions

Type of Stock-Based Transaction	*Classification of Instruments*	*Accounting Method*	*Measurement Date*	*Measurement of Cost/Asset*	*Disclosures*
Employee transactions: *Granting stocks (including stock options issued with a nominal exercise price and restricted stock units)*	*Equity*	*Fair Value*	*Grant Date[4].*	*Fair value of the stock on the grant date less the amount paid by employee (if any) for the instrument when it is granted.*	*Yes*
Granting stock appreciations rights (settled in equity)	*Equity*	*Fair Value*	*Two acceptable methods:* *1. Grant Date* *2. Settlement or exercise date - the transaction is measured initially at the grant date and is remeasured each period until the settlement date*	*1. Fair value of the option on the grant date using an option pricing model.* *2. Fair value of the stock on the grant date less the amount paid by the employee for the instrument. This is adjusted for changes in the quoted market value of the stock between the grant date and the settlement date*	*Yes*
Granting stock options settled in equity	*Equity*	*Fair Value*	*Grant Date*	*Fair value of the option on the grant date using an option pricing model.*	*Yes*
Incurring liabilities or making cash payments (awards settled in cash or other assets including cash-settled SARS and cash-settled stock options)	*Liability*	*Fair Value*	*Settlement or exercise date - the transaction is measured initially at the grant date and is remeasured each period until the settlement date.*	*Fair value of the stock on the grant date less the option price or value specified in the transaction at the grant date. This is adjusted for changes in the quoted market value of the stock between the grant date and the settlement date.*	*Yes*

[4] This is the date at which an enterprise and an employee have a mutual understanding of the terms of a stock-based compensation award

Appendix A cont'd

Accounting for Stock-based Transactions

Type of Stock-Based Transaction	*Classification of Instruments*	*Accounting Method*	*Measurement Date*	*Measurement of Cost/Asset*	*Disclosures*
Non-employee transactions: *Reciprocal transactions*	*Equity/Liability*	*Fair Value*	*This is the earliest of the following:* • *the date at which the counterparty's performance is complete;* • *the date at which a commitment for performance by the counterparty is reached (note that a commitment for performance is when the performance by the counterparty to earn the equity instrument is probable because of a sufficiently large disincentives for non-performance; or* • *the date at which the equity instruments are granted if they are fully vested and non-forfeitable at that date.*	*Fair Value of equity instruments issued, liabilities incurred, or goods and services received, whichever is more reliably measurable. If the equity instruments are tradable, then the fair value of the equity instruments should be used. If they are non-tradable, then the fair value of the goods or services received should be used.*	*Yes, to the extent required for understanding the effects of the transaction*
Non-reciprocal transactions	*Equity/Liability*	*Fair Value*	*This is the later of:* • *the date on which the detailed terms of the transfer are set; or* • *the date at which the enterprise is committed to the transfer.*	*Fair value of the equity instruments issued or liabilities incurred.*	*Yes, to the extent required for understanding the effects of the transaction.*

Appendix B

Sample Disclosures

Interim and Annual Disclosures

Accounting policy note - Stock-based compensation

For fiscal 2003, the Company adopted the recommendations of The Canadian Institute of Chartered Accountants (“CICA”) handbook Section 3870, Stock-Based Compensation and Other Stock-Based Payments. These standards require that direct awards of stock or liabilities incurred, or other compensation arrangements that are based on the price of common stock, be measured at fair value at each reporting date, with the change in fair value reported in the Statement of Operations. The Company did not use the fair value method to account for employees stock-based compensation plans, but disclosed proforma information for options granted in fiscal 2003.

Effective October 1, 2003, the Company adopted the revisions to Section 3870 that required the use of the fair value method for all stock-based compensation transactions. The Company, as permitted by Section 3870, has adopted the change prospectively for options granted on or after October 1, 2003.

Note xx –Stock Options

EIC-98, Stock-Based Compensation Plans – Disclosures had required annual disclosure related to stock-based compensation plans. Section 3870 requires the same annual disclosure as well as annual disclosure related to the weighted average grant-date fair value of options. Please refer to Section 3870 for examples of full disclosures required.