Dividend-Protected Stock Compensation Awards

Accounting and Tax Considerations

By Josef Rashty

The recipients of stock compensation awards may be entitled to the dividends that companies pay on their underlying equity shares, while the stock awards are still outstanding but not vested (ASC 718-10-55-45). FASB considers these divided-protected stock awards as participating securities under certain conditions. Share-based payments that include dividend-protection features, such as dividend payments or adjustments to the exercise price for dividends declared, have certain accounting implications for both expense recognition and earnings per share (EPS) calculations.

Dividend-protected stock awards have gained popularity recently due to the emergence of SPACs (Special Purpose Acquisition Companies). SPACs offer an appealing alternative to the costly and time-consuming traditional IPOs (initial public offerings) for companies in burgeoning industries. SPACs often use contingency shareholders or compensation earnout provisions as part of the transaction due to uncertainty in the value of the target companies. In some instances, equity earnout provisions entitle the holder to nonforfeitable dividends during the vesting or contingency period.

This article explicates the accounting implications for awards that have such dividend-protection features. The dividend-protected features of awards impact their fair values and most likely determine their status as participating securities. Participating securities have certain accounting and tax implications; they may require that companies calculate their EPS pursuant to the two-class method. The illustration in this article juxtaposes two different scenarios for dividend-protected stock awards—with and without forfeitable option—and reflects that accounting for such awards is a major aberration in stock compensation accounting.

Fair Value of Dividend-Protected Stock Awards

Companies may structure their stock awards such that they can protect their holders by providing them certain dividend rights. In such circumstances, companies take into account the expected dividends that they intend to pay to the holders of their stock awards and incorporate such dividends into their pricing models (Black-Scholes or any other mathematical model, such as lattice or Monte Carlo simulation) for the valuation of their underlying stock awards. Such dividend protection rights may take a variety of forms (e.g., forfeitable or nonforfeitable), and companies should reflect these in estimating their fair values (ASC 718-10-55-44). In practice, companies treat the value of such protected dividend payments and the value of the corresponding awards as two different components:

- The present value of the estimated dividend payments that holders are entitled to receive prior to exercise of their awards
- The fair value of the stock award, ignoring the protected dividend payments, calculated by the Black-Scholes (BSM) or any other mathematical model.

The fair value of stock awards, as a whole, reflects both these components, and it is higher than the fair value of similar awards that do not have a dividend-protection feature.

Accounting Considerations for Dividend-Protected Stock Awards

Companies estimate the cost associated with dividends or dividend equivalents consistent with their policies for forfeiture of the stock awards, and record them in retained earnings or additional stock compensation cost based upon the following criteria:

- If dividends or dividend equivalents are nonforfeitable, they are reflected in retained earnings.
- If, however, dividends or dividend equivalent are forfeitable, they are reflected in additional stock compensation costs upon forfeiture of stock awards.

If a company has a policy regarding how to estimate the number of forfeited awards for its stock compensation, it should estimate the additional compensation costs for dividends or dividend equivalents in a similar fashion. The company should, however, reclassify dividends and dividend equivalents between retained earnings and additional stock compensation cost if actual forfeitures differ from previous estimates (ASC 718-10-65-6). To justify this reclassification, companies reflect the present value of any future dividend

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payments in the fair value of the awards at grant-date; thus, when companies reverse the stock compensation expense due to true-up of forfeited awards, they must also reverse the fair value of dividends that grantees have not refunded as additional stock compensation costs. If dividends are nonforfeitable, therefore, companies reinstate them as expense in additional stock compensation cost.

Recently Issued Standards

In March 2016, FASB issued Accounting Standards Update (ASU) 2016-09, *Improvements to Employee Share-Based Payment Accounting.* The new guidance has the following provision: Entities have the option to elect an accounting policy to either estimate the number of granted stock award forfeitures (similar to previous guidance) or account for them as they occur on an actual basis. If the policy of the company is to account for forfeitures as they occur (ASC 718-10-35-3), the company must reclassify the nonforfeitable dividends from retained earnings to additional stock compensation cost for the actual forfeitures that occurred.

In June 2018, FASB issued ASU 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.* The new guidance expands the scope of ASC Topic 718 to include share-based payments granted to nonemployees in exchange for goods or services used or consumed in an entity's own operations and supersedes the guidance in ASC Topic 505-50.

In November 2019, FASB issued ASU 2019-08, *Compensation—Stock Compensation (Topic 718)* and *Revenue from Contracts with Customers (Topic 606),* as codification improvements applicable to all companies, within the scope of ASC 606, *Revenue from Contracts with Customers,* which provide share-based payment awards to nonemployees. The objective of this guidance is to eliminate diversity in practice and expand the scope of ASC Topic 718 to include share-based payments granted to customers.

Tax Considerations for Dividend-Protected Stock Awards

In some tax jurisdictions, employers receive a tax deduction for dividends paid to employees holding unvested stock awards, regardless of whether those dividends are charged to retained earnings or additional stock compensation cost for financial reporting purposes. Because the dividends that an employer pays on an equity instrument are directly related to the fair value of that instrument, the tax effects of the dividends should be accounted for similar to the tax effects of the awards [analogous to the guidance in ASC 740-20-45-11(e)]. The following illustration clarifies this concept.

Illustration

Entity A grants 300 RSUs (restricted stock units) to a few of its employees. The RSUs have two-year cliff vesting and a grant date fair value of $10 per share that includes the present value of future dividends. Each RSU is entitled to receive a $1 annual dividend prior to vesting. One of the employees leaves the company in the second year and Entity A forfeits 100 RSUs prior to vesting.

First Scenario

In this scenario, the employee does not have an obligation to return the dividends for the forfeited awards and Entity A accounts for forfeitures on an actual basis pursuant to ASC 718-10-35-3. The following journal entries would be recorded.

First Year

1. Stock compensation	$1,500	
Additional paid-in capital (APIC)		$1,500

300 RSUs with fair value of $10 and two years vesting (300 × $10 ÷ 2)

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Account	Debit	Credit
Deferred tax assets (DTA)	$300	
Deferred tax benefits		$300
Taxes at 20% for $1,500 stock compensation		
2. Retained earnings	$300	
Dividends paid		$300
$1 annual dividend for 300 dividend-protected RSUs		
Taxes payable	$60	
Current tax benefits		$60
Taxes at 20% for $300 dividends		

Second Year

Account	Debit	Credit
3. Stock compensation	$1,000	
APIC		$1,000
200 RSUs (100 RSU forfeited in second year) with fair value of $10 and two years vesting (200 × $10 ÷ 2)		
DTA	$200	
Deferred tax benefits		$200
Taxes at 20% for $1,000 stock compensation		
4. APIC	$500	
Stock compensation		$500
First-year expense reversal for 100 forfeited RSUs (100 RSUs times $10 fair value, divided by two)		
Deferred tax benefits	$100	
DTA		$100
Reversal of taxes at 20% for $500 stock compensation		
5. Retained earnings	$300	
Dividends paid		$300
$1 annual dividend for 300 dividend-protected RSUs outstanding		
Taxes payable	$60	
Current tax benefits		$60
Taxes at 20% for $300 dividends		
6. Additional stock compensation cost	$200	
Retained earnings		$200
Dividend reclassification for 100 forfeited awards in the second year for two years		

Second Scenario

This entails the same facts as the first scenario, but this time the employee has an obligation to return the dividends for the actual forfeited shares. All journal entries remain the same as the first scenario, with the exception of the last (journal entry no. 6), which will be revised as follows:

Account	Debit	Credit
Dividends paid	$200	
Retained earnings		$200
The amount that employees are expected to pay back to the employer because of forfeiture of shares (100 × $1) ×2		
Current tax benefits	$40	
Taxes payable		$40
Reclassification of taxes at 20% for $200 dividends payback		

EPS Calculation for Dividend Protected Stock Awards

Earnings per share (EPS) is one of the most common and complex performance measurements that publicly held companies present in their quarterly and annual reports. ASC Topic 260 requires companies that have multiple classes of common stock or have issued securities other than common stock that participate in dividends with common stock use the two-class method to compute and present their EPS.

Participating securities participate in dividends with common stocks according to a predetermined formula (ASC 260-10-45-49A). Participating securities may also participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not (ASC 260-10-20). The two-class method is an earnings allocation formula that treats participating securities as having rights to earnings that otherwise would have been available only to common shareholders (ASC 260-10-45-60).

The RSUs in the following illustration participate in dividends with common stocks outstanding based on a predetermined formula; thus, they are considered participating securities. By contrast, unvested stock compensation awards that contain rights to receive dividends only if the awards are fully vested.

The example presented in the *Sidebar* reflects the calculation of two-class method EPS calculation. The summary of the EPS calculation detailed in the *Sidebar* is as follows:

	Common Shares	Participating Securities
Basic EPS	$0.4550	$0.4450
Diluted EPS	$0.4239	$0.4214

In practice, SEC registrants usually calculate their EPS to two decimal points. In this example, however, four decimal points are used so that rounding does not conceal the impact of the two-class method calculation.

EPS Calculation for Nonprotected Awards

The EPS calculations in the above example if the RSUs were not dividend-protected stock awards would be as follows:

Basic EPS	$0.5000 [1]
Diluted EPS	$0.4630 [2]

1) $500,000 net income ÷ 1,000,000 average number of common stock outstanding.

2) $500,000 net income ÷ 1,080,000 average number of diluted shares outstanding.

Know the Implications

FASB defines a participating security as a security that contains a nonforfeitable right to dividends or dividend equivalents. The capital structure of certain companies may

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include stock compensation awards that participate in dividends with common stocks according to a predetermined formula (i.e., participating securities). The dividend right of participating securities could be forfeitable or nonforfeitable upon forfeiture of stock awards.

Participating securities have certain accounting and tax implications. These awards may impact earnings directly due to their higher fair values. Furthermore, employers may receive tax deduction benefits for dividends paid to grantees holding unvested stock awards in certain tax jurisdictions, regardless of whether those dividends are charged to retained earnings or additional stock compensation cost for financial reporting purposes.

Moreover, companies may need to apply the two-class method in calculation of their basic and diluted EPS. The two-class EPS calculation often presents a different and a lower EPS (due to a smaller numerator and a larger denominator), and its calculation often adds an additional layer of complexity to companies' financial reporting. Because of such complications, companies need to be aware of the financial and tax implications of dividend-protected stock compensation awards when they initiate and approve their stock compensation plans. ■

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Two-Class Method EPS Calculation

Average number of common stock outstanding	1,000,000
Average number of diluted shares outstanding—calculated based on treasury stock method	1,080,000
Participating securities—unvested RSUs that receive nonforfeitable dividend	100,000
Net income	$500,000
Dividends paid to common stock holders	$100,000
Dividends paid to participating security	$9,000
Undistributed earnings applicable to both common stock and participating securities holders	$391,000

Company uses actual forfeiture and has not had any forfeitures. The holders of unvested RSUs participate in cash dividends on a $1.00:$0.90 basis with the holders of common shares. RSUs are participating securities because of their nonforfeitable entitlement to participate in dividends with the common shares (ASC 260-10-45-61A–68B).

Calculation of Basic EPS Two-Class Method

	Common Shares	Participating Securities
Distributed earnings	$0.1000 [1]	$0.0900 [3]
Undistributed earnings	$0.3550 [2]	$0.3550 [2]
Basic EPS	$0.4550	$0.4450

Calculation of Diluted EPS Two-Class Method

ASC Topic 260 does not explicate calculation of the diluted two-class method EPS. However, an earlier exposure draft, which was never finalized, recommended use of "allocation method." Under this method, companies reverse the undistributed earnings allocated away from common shareholders in calculation of basic two-class method EPS and reallocate the result to each of common shares and participating securities that are outstanding and dilutive for calculation of diluted two-class method EPS.

The allocation method is the most prevailing method used in practice, and the following example uses this method. However, there are other methods, such as using the numerator of the two-class method basic EPS for diluted EPS calculation. As long as companies use a logical method for calculation of two-class method diluted EPS consistently, the SEC will not object.

	Common Shares	Participating Securities
Distributed earnings	$100,000 [4]	$9,000 [4]
Undistributed earnings	355,500 [5]	35,500 [5]
Add-back allocation:		
Nonvested shares	35,500 [6]	(35,500) [6]
Less reallocation:		
Nonvested shares	(33,136) [7]	33,136 [7]
Total	$457,864	$42,136
Average shares outstanding	1,080,000	100,000
Diluted EPS	$0.4239	$0.4214

1) $100,000 ÷ 1,000,000

2) 1,000,000 (common shares) + 100,000 (participating securities) = 1,100,000
$391,000 (undistributed earnings) ÷ 1,100,000 = $0.3555
$391,000 undistributed earnings consist of undistributed earnings for common shares for $355,500 plus undistributed earnings for participating securities for $35,500

3) $9,000 ÷ 100,000

4) $100,000 (common shares) and $9,000 (participating securities) distributed earnings

5) 1,000,000 (common shares) + 100,000 (participating securities) = 1,100,000
$391,000 ÷ 1,100,000 = $0.3555
1,000,000 (common shares) × $0.3555 = $355,500
100,000 (unvested shares) × $.03555 = $35,500

6) 100,000 (unvested shares) ÷ [(1,000,000 common shares + 100,000 unvested shares = 1,100,000] × $391,000 = $35,500

7) 100,000 (unvested shares) ÷ (1,000,000 common shares + 100,000 unvested shares + 80,000 diluted shares) 1,180,000 × $391,000 = $33,136

EPS=earnings per share
RSU=restricted stock unit ■

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