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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT
FASB

SUBJECT:

FASB VOTES TO PURSUE SEVERAL PROJECTS INTENDED TO IMPROVE THE ACCOUNTING FOR SHARE-BASED PAYMENTS

PREFACE:

At its October 8, 2014 meeting, the Financial Accounting Standards Board ("FASB" or "Board") met with its staff to deliberate and vote on various proposals related to the FASB's share-based payments accounting simplification project. During the meeting, the FASB formally authorized five proposals which represent significant steps toward simplifying and improving certain pretax and tax accounting requirements of the current model. These proposals are expected to have a broad-reaching effect on both private and public companies. The five proposals, which are summarized below, relate to the following:

1. Accounting for Income Taxes upon Vesting or Settlement of Share-Based Payments
2. Cash Flow Presentation of Windfall Tax Benefits
3. Accounting for Share-Based Payment Forfeitures
4. Equity vs. Liability Classification of a Share-Based Payment
5. Cash Flow Presentation of Employee Payroll Taxes When Shares are Withheld by Entity to Pay Minimum Statutory Withholding Tax

The Board and the staff also discussed additional improvements that would reduce the cost to private entities of applying the current standard but deferred any final decisions until after the staff performs additional analysis relating to (a) the impact on the classification, as a liability or as equity, of certain features of share-based payment awards, including repurchase features and (b) practical expediency related to intrinsic value, expected term, and formula-based plans.

CONTACT:

YOSEF BARBUT
Tax Partner
212-885-8292 / ybarbut@bdo.com

STEPHEN C. ARBER
Senior Manager
212-885-7355 / sarber@bdo.com

ADAM BROWN
National Director of Accounting
214-665-0673 / abrown@bdo.com

DEBRA MACLAUGHLIN
National Assurance Partner
312-616-4656 / DMacLaughlin@bdo.com

An exposure draft ("ED") covering all decisions is expected after the Board and the staff meet once again to decide on the additional simplifications for private entities. The ED is expected to be issued in 2015.

BACKGROUND:

The tax accounting for share-based payments is one of the most complex areas in current U. S. Generally Accepted Accounting Principles ("GAAP"). Some requirements of the current model have led to unintended consequences and significant compliance costs. The FASB staff presented the Board with several proposals designed to simplify the accounting, reduce compliance costs, and improve the decision-usefulness of information presented in financial statements. The items identified for improvement resulted from the FASB staff's outreach program to constituents, prior deliberations with the Board and the Private Company Council ("PCC"), and the Financial Accounting Foundation's ("FAF") post-implementation review of the current accounting model (*a/k/a* FASB Statement No. 123R).

After much deliberation, the FASB voted to add the following five improvement proposals:

1. **Accounting for Income Taxes upon Vesting or Settlement of Share-Based Payments.** Under the current model, the tax benefit on the tax return that exceeds the tax benefit recognized in the financial statements (referred to as a "windfall tax benefit" or "excess tax benefit") is recognized within additional paid-in capital ("APIC") rather than in earnings.[1] Further, an entity cannot recognize an excess tax benefit until the tax deduction from vesting or settlement payments actually reduces taxes payable on the entity's income tax return. This "delayed-recognition" requirement leads to an off balance sheet accounting and tracking of net operating losses ("NOLs") stemming from excess tax benefits. Moreover, under the current model, entities must track an "APIC pool" specific to tax deductions from share-based payments accumulated since the adoption of the accounting requirements of Topic 718 to ensure that their "APIC pool" has a positive balance and thus can absorb any "shortfalls," or the excess of tax benefit recognized in earnings over the tax benefit actually realized on the tax return. Excess benefits increase the "APIC pool" (i.e., credits to APIC) and shortfalls reduce the APIC pool (i.e., debits to APIC), unless the APIC pool is zero, leading to recognition of shortfalls as income tax expense.

   The Board proposed (a) to eliminate the equity accounting for windfall tax deductions and shortfalls and require the recognition of all tax effects related to share-based payments in income tax expense, and (b) to eliminate the off-balance sheet accounting for net operating losses ("NOLs") stemming from windfall tax benefits.

   ***BDO Comments**. The Board ultimately acknowledged these solutions as possibly the best fix to accounting requirements that have added unnecessary complexity and cost, and obscured the economic impact of income tax effects. These decisions will (1) help eliminate a large amount of work currently required to quantify windfall benefits under various circumstances (e.g., an entity pays the United States Alternative Minimum Tax or/and is claiming other tax return benefits such as special deductions and research & development credits which interact with share-based compensation deductions), (2) conform the financial statements to the tax return presentation of these tax effects, (3) end "delayed-recognition" and the off-balance sheet accounting and tracking of NOLs stemming from windfall benefits and require all NOLs be treated the same under GAAP, and (4) end the need to track an APIC pool.*

   The proposal may also improve the decision-usefulness of income tax information presented in the financial statements because it would eliminate the disconnect that results from the current model between as-reported tax expense and tax payable. For example, assume a company has pretax book income of $1,000, and also generated a $1,000 windfall deduction in the same year (the company has no NOL carryforward and its applicable tax rate is 40%). For tax purposes, the company will have zero current tax payable, but for book purposes the windfall benefit cannot offset the tax provision and must be recorded in equity. As a result, the company would record a $400 current tax expense but zero tax payable. This outcome would be alleviated by the proposal.

[1] Recognition of an excess tax benefit in equity is required when the benefit results from fair value appreciation of the entity's underlying stock occurring from the measurement date for accounting to the measurement date for tax. Excess tax benefits stemming from other reasons are recognized in income tax expense. ASC 718-740-45-2.

2. **Cash Flow Presentation of Windfall Tax Benefits.** Excess tax benefits, or windfalls, that reduce the amount of income taxes a company will pay on its tax return are currently required to be presented as a cash inflow from financing activities and a cash outflow from operating activities. The Board proposed to require the "tax savings" benefit from share-based payment windfalls to be shown within operating activities. This is consistent with the decision to eliminate equity accounting for all tax effects related to share-based payments and instead require recognition of the tax effects in income tax expense. The Board also observed that the proposed cash flow presentation is consistent with presentation of an entity's tax as an operating cash flow under the "direct method".

   BDO Comments. *The current recognition and cash flow presentation model is premised on the principle that share-based payments have "two transactions": one transaction with employees and another transaction with shareholders. Windfall benefits are considered to arise from "shareholder" transactions and thus are recognized in equity and are presented as financing cash flows. The proposed change is premised on the principle that both windfalls and shortfalls ultimately impact the entity's income tax which is an operating cash flow. The benefit of this proposal would be that companies will no longer be required to reclassify tax savings from stock award windfalls from the operating cash flows section to the financing section. The current model's treatment is an exception to presenting income tax-related activities as operating activities, resulting in additional complexities for the company and potential confusion for users. The proposal will eliminate this exception and result in presenting all income taxes as an operating cash flow.*

3. **Accounting for Share Award Forfeitures.** Currently, entities are required to estimate the number of share-based payment forfeitures (awards that will not vest) when determining the amount of compensation cost to be recognized over the vesting period. Companies are then required to revise their estimates based on actual results (e.g., previously recognized compensation costs are reversed upon award forfeiture). This procedure can be complex and time consuming (and thus costly). The Board proposed to allow an entity-wide accounting policy election to either (a) estimate forfeitures or (b) account for forfeitures as they occur.

   BDO Comments. *The forfeiture rate is an important factor in determining compensation costs from share-based awards. This proposal would allow companies the flexibility of determining the timing of accounting for award forfeitures, while potentially reducing the cost and complexity involved in the reporting. Some entities have accumulated experience and the necessary resources and systems to adequately estimate forfeiture rates (e.g., established entities in the technology industry), and are therefore likely to elect a policy to estimate forfeitures. For entities with fewer resources (and perhaps less experience), the option to elect a policy to account for forfeitures as they occur could bring relief.*

4. **Equity vs. Liability Classification of an Award.** The classification of a share-based payment is significant because it determines whether the award's grant-date fair value is fixed (equity classification) or is subject to periodic fair value adjustments recognized through earnings (liability classification). Today's accounting requires liability classification of an award with a repurchase provision such as net-settlement payment (i.e., the employer remits an amount equivalent to the award's value less withholding tax) if tax in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion. The relevant tax authorities in jurisdictions where employees provide services determine the applicable minimum statutory withholding requirements.

   However, complying with this requirement in practice has been challenging for entities that operate in many states and foreign jurisdictions, making timely and accurate determination of "minimum" statutory withholding rates complex and time consuming. For example, in a particular jurisdiction, "minimum" tax rates might be a function of the individual's personal income which means there can be different withholding rates for employees in the same jurisdiction. Also, determining the appropriate minimum withholding rates could be challenging in some foreign countries.

   The Board proposed that a partial cash-settlement for withholding tax up to the maximum statutory withholding tax rate would not by itself require liability-classification.

***BDO Comments**. The Board concluded that a provision requiring a partial cash net-settlement to cover statutory withholding taxes by itself should not cause liability classification. By allowing the use of "maximum" statutory withholding rates (i.e., a "ceiling" rate as opposed to a "floor" rate), it is presumed that entities would have less work to timely determine appropriate withholding rates because the highest statutory withholding rates provided by relevant tax law(s) are presumably readily available or more easily determinable.*

It is possible that the risk of noncompliance could shift from determining that withholding tax does not exceed a "floor" based on "minimum" statutory tax rates to the timely determination of a "ceiling" based on "maximum" statutory tax rates.

5. **Cash Flow Presentation of Employee Payroll Taxes When Shares are Withheld by Entity to Pay Minimum Statutory Withholding Tax.** Under current accounting, a liability for employee payroll taxes on employee stock compensation is generally considered an operating expense included in cash flows from operations.[2] However, diversity in practice emerged when shares are withheld to pay the employee's portion of payroll taxes (including minimum income tax) and some entities reclassify the credit from APIC to payroll tax liability and there is no expense recognition.

   The Board proposed that tax "paid" with shares withheld by the entity be classified as a financing activity rather than an operating activity. In reaching its decision, the Board drew a distinction between entity's tax and employee's tax, concluding that an employee's tax belongs in financing cash flows when the entity partially withholds shares to cover the cash equivalent of the employee's tax. That is, the "withholding" represents an in-substance treasury stock transaction.

   ***BDO Comments**. The Board's decision to require presentation of an employee's tax paid by the entity with shares withheld from the employee only covers the portion of taxes effectively paid for with shares. This presentation does not extend to any other portion of payroll taxes which the entity must withhold and remit to the relevant taxing authority.*

Finally, the Board also agreed to a separate research project on potential improvements to the accounting for share-based payment awards issued to nonemployees, including within the project the scope of nonemployee guidance as well as the accounting for awards having unresolved performance conditions.

BDO will continue to monitor each of these important projects as they proceed and issue additional communications, as necessary.

[2] ASC 718-10-25-22 through 25-23.