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FASB Makes Good on Simplifying GAAP for Stock Options and Tax Effects in ASU 2016-09
June 22, 2016

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WITH YOU TODAY

Yosef Barbut, Program Moderator
National Assurance Partner, BDO USA, LLP

Jennifer Kimmel
National Assurance Senior Manager, BDO USA, LLP

Cullen Walsh
Assistant Director, Financial Accounting Standards Board

Peter Klinger
Principal, Compensation & Benefit Services
BDO USA, LLP

Jennifer Kimmel
National Assurance Senior Manager, BDO USA, LLP

Joe Russo
Tax Partner and ASC 740 Practice Leader
BDO USA, LLP

LEARNING OBJECTIVES

Upon completion of this program, participants will be able to:

- Describe key recognition, measurement and transition provisions of ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*
- Identify impact of the new standard on financial and tax accounting and contrast new guidance with current accounting
- Explain practical implications from implementation of the new standard
AGENDA

• Accounting for stock compensation: fundamentals, challenges & complexity
• FASB Simplification Initiative
• Key recognition, measurement and transition provisions of ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*
• Impact of the new standard on financial and tax accounting
• Practical implications from implementation of the new standard
• Transition considerations
• Effective date and early adoption
• Questions

ACCOUNTING FOR STOCK COMPENSATION: FUNDAMENTALS

Topic 718 governs accounting for all share-based payment awards to employees for service and generally requires:
• Compensation expense based on fair value of award
  – Grant-date fair value measurement of most awards
  – Recognition over requisite service period (period in which employee is required to provide service for an award)
  – “Vesting” condition(s) requirement for recognition
• Classification of awards as equity or liability
• Adjustments for certain modifications
• Complex valuation models (e.g., Black-Scholes)
• Extensive disclosures
FASB SIMPLIFICATION INITIATIVE

Background & Objectives:
• A series of short-term projects intended to make narrow-scope simplifications and improvements to accounting standards
• Maintain usefulness of information to stakeholders
• Reduce cost and complexity of financial reporting

Current projects
• Balance sheet classification of debt
• Accounting for income taxes - intra-entity asset transfers
• Nonemployee share-based payments

Completed projects
• Employee share-based payments
• Cloud computing fees
• Extraordinary items
• Debt issuance costs
• Inventory
• B/S classification of deferred taxes
• Discontinued operations

OVERVIEW
ASU 2016-09, IMPROVEMENTS TO EMPLOYEE SHARE-BASED PAYMENT ACCOUNTING

Amendments applicable to all entities:
• Accounting for income taxes upon vesting or exercise of share-based payments and related EPS effects
• Classification of excess tax benefits on the statement of cash flows
• Accounting for forfeitures policy election
• Liability classification exception for statutory tax withholding requirements
• Cash flow presentation of employee taxes paid when an employer withholds shares for tax-withholding purposes
• Elimination of the indefinite deferral in Topic 718

Amendments applicable to nonpublic entities:
• Expected term of awards policy election
• Intrinsic value election for liability-classified awards
ACCOUNTING FOR INCOME TAXES

CHANGES MADE BY ASU 2016-09

• All income tax effects from share-based payments recognized in income tax expense (no exception)
• Tax windfalls recognized when claimed on the tax return even if resulting in NOLs (no delayed accounting)
• Tax windfalls and shortfalls recognized in the interim period they arise (discrete period recognition)
• New accounting applies prospectively to tax windfalls/shortfalls arising on or after the adoption period
• Existing ‘off balance sheet’ NOLs recognized through opening retained earnings and assessed for valuation allowance (also recognized through opening retained earnings)

Transition

• Recognition of excess tax benefits and tax deficiencies in the income statement
  − Prospective
• Recognition of off-balance sheet windfall NOLs
  − Modified retrospective through cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption
• Interim period early adoption reflected retrospectively as of the beginning of the fiscal year (e.g., Q2-16 adoption must be reflected as of 1/1/16)
• Refer to effective dates slide
ACCOUNTING FOR INCOME TAXES
KEY IMPLICATIONS OF CHANGES

• Intraperiod allocation made more straightforward and cleaner
• Closer alignment of Income tax expense and income tax payable
• Interim period accounting rel. to share-based payments easier to perform
• Off balance sheet “accounting” eliminated
• Tax windfalls NOLs recognized and assessed for valuation allowance with all other DTAs
• Closer alignment of NOLs in financial statements and in tax returns (only difference is FIN 48)
• Tax windfalls and shortfalls have a “permanent” impact on effective tax rates
• EPS impact*
  • Basic & diluted - income tax benefit included in net income
  • Diluted - estimated windfalls/shortfalls no longer included in assumed proceeds

*Refer to appendix for example

ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTRAPERIOD ALLOCATION

Facts:
• Entity A generates $1,000 pretax book taxable income and $400 tax windfalls in the current year
• Entity A has no other income, no significant temporary differences, and no NOLs or credit carryforwards
• Entity A’s tax rate is 40% (applicable statutory federal plus state rate)
ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTRAPERIOD ALLOCATION (CONTINUED)

Current Accounting:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense</td>
<td>$400 ($1,000 x 40%)</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td></td>
<td>$240 (($1,000 - $400) x 40%)</td>
</tr>
<tr>
<td>Additional paid in capital</td>
<td></td>
<td>$160 ($400 x 40%)</td>
</tr>
</tbody>
</table>

New Accounting:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense</td>
<td>$240 (($1,000 - $400) x 40%)</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td>$240 (($1,000 - $400) x 40%)</td>
<td></td>
</tr>
</tbody>
</table>

ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: RECOGNITION OF TAX WINDFALL NOL

Facts:

- Entity B generates $1,000 pretax book taxable loss and $400 tax windfalls in the current year
- Entity B has no other income or loss, no significant temporary differences, and no NOLs or credits carryforwards
- Entity B has $2,000 of gross taxable reversing temporary differences (or a DTL of $800) and does not require a valuation allowance
- Entity B’s tax rate is 40% (applicable statutory federal plus state rate)
ACCOUNTING FOR INCOME TAXES

ILLUSTRATION: RECOGNITION OF TAX WINDFALL NOL (CONTINUED)

Current Accounting:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA - NOL*</td>
<td>$400 ($1,000 pretax loss x 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td></td>
<td>$400</td>
</tr>
</tbody>
</table>

*Windfall NOL of $400 is included in actual tax NOL carryforward of $1,400, but is required to be tracked off balance sheet for accounting purposes

New Accounting:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA - NOL</td>
<td>$560 (($1,000 pretax loss + $400 tax windfalls) x 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td></td>
<td>$560</td>
</tr>
</tbody>
</table>

ACCOUNTING FOR INCOME TAXES

ILLUSTRATION: RECOGNITION OF PRE-EFFECTIVE-DATE TAX WINDFALL NOL

Facts:

- Entity C adopts ASU 2016-09 as of the beginning of the current year
- Entity C has $2,000 of regular NOL carryforwards and a DTA of $800 with no valuation allowance as it has sufficient positive evidence including reversing taxable differences, recent income and a reliable forecast of income
- Entity C has $500 of tax windfalls NOL from prior years with remaining carryforward period of more than 10 years
- Entity C concludes that the tax windfalls NOL can be recognized without a valuation allowance
- Entity C’s tax rate is 40% (applicable statutory federal plus state rate)
ACCOUNTING FOR INCOME TAXES

ILLUSTRATION: PRE-EFFECTIVE-DATE TAX WINDFALL NOL (CONTINUED)

Journal entry to recognize tax windfall NOL as of beginning of current year:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA - NOL</td>
<td>$200 (500 tax windfall NOL x 40%)</td>
<td></td>
</tr>
<tr>
<td>Opening retained earnings</td>
<td></td>
<td>$200</td>
</tr>
</tbody>
</table>

If Entity C concludes that it needs a valuation allowance for the tax windfalls NOL which is being recognized on the balance sheet for the first time, record:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening retained earnings</td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>Valuation allowance</td>
<td></td>
<td>$200</td>
</tr>
</tbody>
</table>

ACCOUNTING FOR INCOME TAXES

ILLUSTRATION: INTERIM PERIOD ACCOUNTING

Facts:

- Entity D prepares the Q1 provision for the current year
- Entity D has a year-to-date loss and expects to break even by Q3 and potentially be profitable by Q4
- In Q1, Entity D realizes a $100 tax windfall deduction for stock option exercise/vesting of RSUs
- Entity D has sufficient taxable reversing temporary difference to avoid a valuation allowance on current year loss and deductible temporary differences as of Q1 and expect to have sufficient taxable differences at year end
- Entity D’s intraperiod allocation policy is “with or without”
- Entity D’s tax rate is 40% (applicable statutory federal plus state rate)
ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTERIM PERIOD ACCOUNTING (CONTINUED)

**Current Accounting:**
It depends on Entity D’s accounting policy/practice. If the forecast is considered reliable but still marginal, Entity D might not recognize anything in Q1 and wait until Q3 or even Q4 to be certain it has taxable income for the year that can be reduced by the tax windfall.

**New Accounting:**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA - tax windfalls</td>
<td>$40 ($100 times 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td></td>
<td>$40</td>
</tr>
</tbody>
</table>

ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTERIM PERIOD ACCOUNTING - ASU EARLY ADOPTED MID-YEAR

**Facts:**
- Entity E prepares the Q2 provision for the current year
- Entity E has year-to-date income and expects to have income at year end
- In Q1, Entity E realized a $100 tax windfall benefit which was not recognized (through equity) because it expected non-windfall deductions to reduce current year income and the tax windfall becomes a carryforward at year-end following “with-and-without” intraperiod allocation
- There is sufficient positive evidence of taxable income including reversing taxable differences to avoid a valuation allowance
- Entity E’s tax rate is 40% (applicable statutory federal plus state rate)
- During Q2, Entity E realizes an additional tax windfall of $120
- Entity E early adopts all of the provisions of ASU 2016-09 in Q2 of the current year
ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTERIM PERIOD - ASU EARLY ADOPTED MID-YEAR (CONTINUED)

Q2 journal entries to adopt ASU 2016-09 as of the beginning of Q1 of current year:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA/tax payable - tax windfalls</td>
<td>$88 (($100 + $120) x 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred/current tax benefit - Q1 windfall</td>
<td></td>
<td>$40 ($100 x 40%)</td>
</tr>
<tr>
<td>Deferred/current tax benefit - Q2 windfall</td>
<td></td>
<td>$48 ($120 x 40%)</td>
</tr>
</tbody>
</table>

Note: Income tax expense (benefit) for Q1 and Q2 (i.e., 6-month results) would include $88 of windfall tax benefit, which is allocated to Q1 and Q2 as shown above.

ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: INTERIM PERIOD - ASU EARLY ADOPTED MID-YEAR (CONTINUED)

Assume the same facts as the previous example, except that Entity E recognized in Q1 a windfall tax benefit of $40 through APIC.

Q2 journal entries to adopt ASU 2016-09 as of the beginning of Q1 of current year:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add'l paid in capital - tax windfalls</td>
<td>$40 ($100 x 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred/current tax benefit - Q1 windfall</td>
<td></td>
<td>$40</td>
</tr>
<tr>
<td>DTA/tax payable - tax windfalls</td>
<td>$48 ($120 x 40%)</td>
<td></td>
</tr>
<tr>
<td>Deferred/current tax benefit - Q2 windfall</td>
<td></td>
<td>$48</td>
</tr>
</tbody>
</table>
STATEMENT OF CASH FLOWS: EXCESS TAX BENEFITS
SUMMARY OF CURRENT GUIDANCE AND CHANGES UNDER ASU 2016-09

Current guidance - excess tax benefits (windfalls) presented as:
• Cash inflows from financing activities (cash retained as a result of tax deduction)
• Cash outflows from operating activities (reconciling item between net income and operating cash flow under the indirect method)

ASU 2016-09*:
• Cash tax benefit from excess tax deductions (windfalls) presented as operating activities
• Transition: retrospective or prospective (accounting policy election)

*Refer to appendix for example

ACCOUNTING FOR FORFEITURES
SUMMARY OF CURRENT GUIDANCE AND CHALLENGES

• Recognize compensation cost over requisite service period, adjusted for:
  − Probability of meeting any performance conditions; and
  − Estimated rate of forfeitures*

*Forfeiture - awards that do not vest due to failure to satisfy a vesting condition (e.g., employee termination or failure to achieve a performance target)

• Two-part process:
  − Estimate expense net of forfeiture rate assumption for awards not yet vested,
  − True up expense based on awards vested and/or forfeited during the period.
ACCOUNTING FOR FORFEITURES
SUMMARY OF CURRENT GUIDANCE AND CHALLENGES

- Estimated forfeiture rate affects compensation cost recognition, but not fair value of awards, so timing issue only.
- Estimation may be challenging for some entities:
  - Startup companies with no historical experience
  - Acquisitions with newly acquired employees
  - Lack of sophisticated software systems to process calculations
  - Newly IPO companies

ACCOUNTING FOR FORFEITURES
CHANGES UNDER ASU 2016-09 AND IMPLICATIONS

- Entity-level accounting policy election:
  1. Estimate forfeitures (consistent with current guidance); or
  2. Recognize forfeitures when they occur (new)
- If recognizing forfeitures as they occur:
  - Compensation expense is only adjusted for actual forfeitures, and therefore can only be reduced.
  - Compensation cost is “front-loaded” compared to estimating
  - Expense is reversed in period forfeiture occurs
  - Awards with performance conditions - still required to assess probability at each reporting period
  - Estimating forfeitures still required for:
    - Award modifications
    - Replacement awards in a business combination
ACCOUNTING FOR FORFEITURES
CHANGES UNDER ASU 2016-09 AND IMPLICATIONS

• Transition: modified retrospective*
  – Cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption
  – Difference between:
    ▪ Cumulative compensation recognized to date, and
    ▪ Cumulative compensation that would have been recognized if no estimation (instead actual forfeitures were recognized)
  – Recognize related effect on DTAs (net of valuation allowance) also through an adjustment to opening retained earnings

*Refer to appendix for example
STATUTORY WITHHOLDING TAX REQUIREMENTS

SUMMARY OF CURRENT GUIDANCE AND CHALLENGES

Net settlements
- Employer retains shares to satisfy required withholding taxes
- Equity accounting if:
  - A statutory requirement to withhold exists, and
  - Fair value of shares withheld does not exceed minimum statutory withholding rates
- Liability accounting if:
  - More than the minimum statutory withholding is settled in cash by company
- Most plans/awards specify if net-settlement is required/allowed

STATUTORY WITHHOLDING TAX REQUIREMENTS

CHANGES UNDER ASU 2016-09 AND IMPLICATIONS

- Net settlements - equity classification maintained if:
  - A statutory requirement to withhold exists, and
  - Fair value of shares withheld does not exceed maximum statutory rate
- ‘Maximum statutory rate’ = maximum statutory rates in the employees’ applicable jurisdiction (e.g., federal, state, and local)
  - Entities only need to determine one maximum rate in each jurisdiction
  - An employee’s highest individual rate is not relevant
STATUTORY WITHHOLDING TAX REQUIREMENTS

CHANGES UNDER ASU 2016-09 AND IMPLICATIONS

- Transition: modified retrospective*
  - Cumulative-effect adjustment to retained earnings and affected net assets as of the **beginning** of the period of adoption
  - Difference between:
    - Compensation recognized to date under liability classification, and
    - Compensation that would have been recognized as if equity classified on grant date (using grant-date fair value and all required assumptions)
  - Only apply to outstanding awards that have not been settled as of adoption date (including an earlier interim period of the fiscal year if adopted mid-year - i.e., early adoption)
  - Recognize related effect on DTA in opening retained earnings
  - Additional consideration - plan/award amendments and modification accounting

*Refer to appendix for example

CASH FLOW PRESENTATION OF EMPLOYEE TAXES PAID

CHANGES UNDER ASU 2016-09

Current guidance:
- Does not specify cash flow treatment of net settlement, thus, diversity in practice
- Requires presentation of all other income/withholding/payroll tax in operating activities

ASU 2016-09:
- Cash paid by employer for taxes when directly withholding equivalent shares to satisfy statutory obligation is a **financing activity**
- Requires presentation of all other income/withholding/payroll tax in operating activities (no change from current guidance)
- Transition: retrospective
PRIVATE COMPANY ALTERNATIVE - EXPECTED TERM
BACKGROUND AND CHANGES UNDER ASU 2016-09

➢ What is expected term?
  • Estimated period of time from grant to settlement that an option will be outstanding
    • Usually more than vesting period, but less than contractual term
    • Input for pricing model (i.e., Black-Scholes) to determine fair value

➢ What is the practical expedient under ASU 2016-09?
  • Generally, the midpoint between the requisite service period and the contractual term (also applies to awards with performance conditions if probable of occurrence)
  • Only for Nonpublic entities
  • Certain criteria must be met
  • If elected, must apply to all qualifying equity- and liability-classified awards
  • Transition: prospective

PRIVATE COMPANY ALTERNATIVE - EXPECTED TERM
CRITERIA FOR APPLICATION

Available for a share option or similar award that meets all of the following:
1. Granted at the money;
2. Employee has only a limited time to exercise if employee terminates service after vesting (typically 30-90 days);
3. Employee can only exercise the award (cannot sell or hedge the award); and
4. No market conditions

SEC already allows “simplified method” under SAB 107/110 (ASC Section 718-10-S99)
• (Weighted Average Vest Term + Contractual Term)/2
• Certain criteria must be met
• Simple” or “plain vanilla” stock option using the Black-Scholes-Merton model
PRIVATE COMPANY ALTERNATIVE - INTRINSIC VALUE
BACKGROUND AND CHANGES UNDER ASU 2016-09

➢ What is intrinsic value?
  ▪ Fair market value of stock, or spread value of a stock option
  ▪ Doesn’t require a pricing model, but FMV of stock must be determined

➢ Why is it important?
  ▪ Upon initial adoption of ASC 718 (formerly SFAS 123R), nonpublic entities were allowed a one-time election to use intrinsic value to measure liability-classified awards

➢ What is the election under ASU 2016-09?
  ▪ One-time election to switch from measuring all liability-classified awards at fair value to intrinsic value, with no required preferability assessment
  ▪ Transition: modified retrospective transition (cumulative-effect adjustment to equity as of the beginning of the period of adoption)
  ▪ Eligibility based on Topic 718 definition of nonpublic entity

ELIMINATION OF INDEFINITE DEFERRAL IN TOPIC 718

➢ 718-10-35-10 to 35-13 require application of other GAAP when the rights conveyed by a freestanding financial instrument (as defined) are no longer dependent on the holder being an employee
➢ 718-10-65-1 (formerly FAS 123R-1) indefinitely deferred the guidance above
➢ ASU 2016-09 removes that indefinite deferral in 718-10-65-1
➢ ASU 2016-09 also removes par. 718-10-35-13
➢ No change in current practice expected
TRANSITION CONSIDERATIONS

Additional considerations when implementing the new guidance:

- Tracking ‘award by award’ to determine windfalls/shortfalls increased in importance given new income statement recognition of these effects
- Identifying windfalls/shortfalls in interim period and discretely recognizing them in the appropriate interim period
- Applying private company alternatives consistently (intrinsic value and expected term)
- Considering the one-time option and opportunity afforded private companies to elect intrinsic value measurement
- Applying forfeiture policy consistently (consider business combinations and modification events)

EFFECTIVE DATE AND EARLY ADOPTION

<table>
<thead>
<tr>
<th>Public Business Entities</th>
<th>All Other Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal years beginning after 12/15/16 (and interim periods within)</td>
<td>Fiscal years beginning after 12/15/17 (interim periods within FYs beginning after 12/15/18)</td>
</tr>
</tbody>
</table>

- Note: In determining relevant effective dates, the guidance in ASU 2013-12 applies (i.e., definition of a public business entity).
- Early adoption permitted:
  - Any interim or annual period for which the financial statements have not been issued or made available to be issued
  - If early adopting in an interim period, reflect as of the beginning of fiscal year
- If early adopting, must apply all amendments in same period
ACCOUNTING FOR INCOME TAXES
SUMMARY OF CURRENT GUIDANCE

Two broad categories of share-based payment awards:

1. **Nonqualified awards** - expected to result in ordinary taxable salary to employees and corresponding deduction to employer
2. **Qualified awards** - expected to result in capital gain income to employees and no tax deduction to employer

**Nonqualified award income tax accounting:**
- DTAs recognized (awards expected to result in tax deduction)
- Differences between book expense and tax deduction yields tax windfall or shortfall (employee’s cost, if any, to own the stock reduces tax deduction)
- Tax windfalls recognized in equity when reducing taxable income
- Tax shortfalls recognized in equity up to available “windfall pool” or income tax expense
- Tax windfalls included in a net operating loss (NOL) carryforward cannot be recognized
- Accounting done on an award-by-award basis

ACCOUNTING FOR INCOME TAXES
CHALLENGES OF CURRENT GUIDANCE

- Very complex intraperiod allocation - quantifying and allocating tax windfalls to APIC
- Income tax expense grossed up by the effect of tax windfalls
- Indirect effect on measuring permanent benefits (e.g., R&D credit, sec. 199 deduction)
- Difficult measurement of tax windfalls when AMT is incurred in valuation allowance periods
- Tracking off balance sheet and accounting for tax windfall NOLs
- Reconciling tax NOLs in the financial statements and the income tax returns
- Valuation allowance and FIN 48 complexities affecting accounting for tax windfalls
- Interim period tax accounting - when and how tax windfall is recognized in interim periods
ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: CURRENT ACCOUNTING FOR WINDFALLS AND SHORTFALLS

<table>
<thead>
<tr>
<th>Award No.</th>
<th>Grant-date FV compensation recognized</th>
<th>Vesting/exercise date value</th>
<th>Tax windfall (“APIC pool”)</th>
<th>Tax shortfall</th>
<th>Equity/APIC (debit)</th>
<th>Income Tax Expense (debit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Award #1</td>
<td>Fair value $100</td>
<td>$120</td>
<td>$20</td>
<td>$20</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DTA/Tax Deduction $40</td>
<td>$48</td>
<td>$8</td>
<td>$8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award #2</td>
<td>Fair value $150</td>
<td>$120</td>
<td>$30</td>
<td>($20)</td>
<td>($20)</td>
<td>($10)</td>
</tr>
<tr>
<td></td>
<td>DTA/Tax Deduction $60</td>
<td>$48</td>
<td>($8)</td>
<td>$12</td>
<td>($58)</td>
<td>($54)</td>
</tr>
<tr>
<td>Award #3</td>
<td>Fair Value $100</td>
<td>$150</td>
<td>None*</td>
<td>None*</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DTA/Tax Deduction $40</td>
<td>$60</td>
<td>None*</td>
<td>None*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Award #4</td>
<td>Fair Value $100</td>
<td>$70</td>
<td>$30</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DTA/Tax Deduction $40</td>
<td>$28</td>
<td>$12</td>
<td>It depends</td>
<td>It depends</td>
<td></td>
</tr>
<tr>
<td>Award #5</td>
<td>Fair value $100</td>
<td>$120</td>
<td>None*</td>
<td>None*</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DTA/Tax Deduction None **</td>
<td>None **</td>
<td>None **</td>
<td>None **</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Award #3 - $50 tax windfall included in NOL due to “with-and-without” accounting policy (i.e., tracked off balance sheet)
** Award #5 – No tax accounting required because award is qualified (ISO)
Note: assumptions include tax rate of 40% and exercise price of zero for all awards

ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: EPS IMPLICATION OF INCOME TAX CHANGE

Basic EPS Formula
Net Income / No. outstanding shares

Current Accounting
Tax windfalls excluded; tax shortfalls included only when no APIC pool to absorb shortfalls

New Accounting
Tax windfalls & tax shortfalls included

Difference
Increase (decrease) net income by tax windfalls (shortfalls)
No difference

Remember, this is an example of current guidance.
ACCOUNTING FOR INCOME TAXES
ILLUSTRATION: EPS IMPLICATION OF INCOME TAX CHANGE

**Diluted EPS Formula**
- Net Income
- No. outstanding shares
- Incremental shares from options

**Current Accounting**
- Tax windfalls excluded; tax shortfalls included only when no APIC pool to absorb shortfalls

**New Accounting**
- Tax windfalls & tax shortfalls included
- \( x + \text{Revised } y \)

**Difference**
- Increase (decrease) net income by tax
- windfalls (shortfalls)
- \( y \) is higher (lower) by windfalls (shortfalls)
- excluded from assumed proceeds

**ACCOUNTING FOR INCOME TAXES**
**ILLUSTRATION: EPS IMPLICATION OF INCOME TAX CHANGE**

**Diluted EPS Formula**
- Net Income
- No. outstanding Shares
- Incremental Shares from options

**Current Accounting**
- Estimated windfalls (shortfalls) included to increase (decrease) assumed proceeds or shares repurchase

**New Accounting**
- Estimated windfalls (shortfalls) excluded from assumed proceeds

**Illustration:**
- Average number of share options outstanding during the period less assumed shares repurchased
- Assumed proceeds divided by average market price of share
STATEMENT OF CASH FLOWS: EXCESS TAX BENEFITS

ILLUSTRATION: CHANGES UNDER ASU 2016-09

NOTE: The example below demonstrates the statement of cash flows prepared using the indirect method.

<table>
<thead>
<tr>
<th>Relevant Sections of Cash Flow Statement</th>
<th>Current Accounting</th>
<th>New Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (NI)</td>
<td>Excludes tax windfalls; excludes tax shortfalls unless no APIC pool to absorb</td>
<td>Includes tax windfalls and tax shortfalls</td>
</tr>
<tr>
<td>Inflows (outflows) (Adjustments to NI)</td>
<td>(Tax windfalls)</td>
<td>--</td>
</tr>
<tr>
<td>Financing:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflows (outflows)</td>
<td>Tax windfalls</td>
<td>--</td>
</tr>
</tbody>
</table>

*Disclosure of tax benefit from stock options exercised during annual period continues to be required now under new paragraph 718-10-50-2A

ACCOUNTING FOR FORFEITURES

ILLUSTRATION: TRANSITION

- Entity F issued 100,000 non-qualified stock options to employees on 1/1/20X1, with the following terms and assumptions:
  - Requisite service period is 4 years (cliff vesting)
  - Grant date fair value of each option is $10
  - Exercise price is $10
  - Assumed 10% annual forfeiture rate
- Actual forfeitures for years X1 and X2 were 5% each (assume estimate is considered reasonable so no change in estimate as of X2)
- Entity F’s tax rate is 40% (applicable statutory federal plus state rate)
- Entity F has not recorded a valuation allowance on its deferred tax assets
- F adopts ASU 2016-09 in the first quarter of 20X3, and elects to account for forfeitures as they occur (i.e., it will no longer estimate forfeitures)
ACCOUNTING FOR FORFEITURES

ILLUSTRATION: TRANSITION (COMPUTATIONS)

- Estimated annual forfeiture rate at grant date was 10%
  - $100,000 x $10 x (0.9^4) = $656,100 *expected to be recognized evenly over 4 years*
  - As of 12/31/X2, $328,050 ($656,100 / 2) compensation cost *has actually been recognized*

- Actual forfeitures for years X1 and X2 were 5% each
  - $100,000 x $10 x (0.95^2) = $902,500 *expected to be recognized evenly over 4 years*
  - As of 12/31/X2, $451,250 ($902,500 / 2) compensation cost *should have been recognized*

ACCOUNTING FOR FORFEITURES

ILLUSTRATION: TRANSITION

Journal entries on 1/1/X3 to reflect adoption of the ASU and accounting policy election not to estimate forfeitures:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening retained earnings</td>
<td>$123,200 (451,250-328,050)</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td></td>
<td>$123,200</td>
</tr>
<tr>
<td>DTA</td>
<td>$49,280 (123,200 x 40%)</td>
<td></td>
</tr>
<tr>
<td>Opening retained earnings</td>
<td></td>
<td>$49,280</td>
</tr>
</tbody>
</table>
STATUTORY WITHHOLDING TAX REQUIREMENTS

ILLUSTRATION: TRANSITION

• Entity W issued restricted (non-vested) shares to CEO on 1/1/14, with the following terms:
  − Four year requisite service period; cliff vesting
  − Entity W withholds shares to satisfy CEO’s income tax withholding requirement, but
    withholds shares with fair value exceeding the minimum statutory rate, but below the
    maximum statutory rate
  − Based on the above, Entity W classified CEO’s award as a liability for the years ended
    12/31/14 and 12/31/15, reporting them at fair value at each reporting date

• Additional assumptions:
  − The liability was valued at $1,000 as of 12/31/15
  − Grant date (1/1/14) fair value was $800
  − Entity W early adopts ASU 2016-09 for the year ended 12/31/16
  − No portion of compensation cost is capitalized; no forfeitures are expected or occur
  − Entity W’s tax rate is 40% (applicable statutory federal plus state rate)
  − Entity W has not recorded a valuation allowance on its deferred tax assets

STATUTORY WITHHOLDING TAX REQUIREMENTS

ILLUSTRATION: TRANSITION (CONTINUED)

Journal entries to adopt ASU 2016-09 as of 1/1/16:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>RSU liability</td>
<td>$500*</td>
<td></td>
</tr>
<tr>
<td>Opening retained earnings</td>
<td>$100 ($500 - ($800/4 x 2))</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$400* ($800/4 x 2)</td>
<td></td>
</tr>
<tr>
<td>Opening retained earnings</td>
<td>$40 ($100 x 40%)</td>
<td></td>
</tr>
<tr>
<td>DTA</td>
<td></td>
<td>$40</td>
</tr>
</tbody>
</table>

*Calculations:
• Total compensation under equity classification = $800/4 x 2 years = $400
• Total compensation under liability classification = $400 grant date FV + $100
  incremental FV ($200/4 x 2 years) = $500
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CONTACT INFORMATION

Yosef Barbut
National Assurance Partner, BDO USA, LLP
Tel: 212 885-8292
Email: ybarbut@bdo.com

Jennifer Kimmel
National Assurance Senior Manager, BDO USA, LLP
Tel: 617-239-7019
Email: jkimmel@bdo.com

Peter Klinger
Principal, Compensation & Benefit Services, BDO USA, LLP
Tel: 415 490-3214
Email: pklinger@bdo.com

Joe Russo
Tax Partner and ASC 740 Practice Leader, BDO USA, LLP
Tel: 214 665-0646
Email: jrusso@bdo.com
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