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THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: FASB

IMPROVEMENTS TO EMPLOYEE SHARE-BASED PAYMENT ACCOUNTING

CONTENTS

INTRODUCTION

In March 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued ASU 2016-09[1] ("the ASU" or "the new guidance") to simplify the accounting for stock compensation related to the following items: income tax accounting, award classification, estimation of forfeitures, and cash flow presentation. The ASU also provides two accounting policy alternatives on expected term and intrinsic value measurement to nonpublic entities as defined in Topic 718, Compensation – Stock Compensation.

For public business entities[2], the amendments are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

Early adoption is permitted for any entity in any interim or annual period for which the financial statements have not been issued or made available to be issued. If an entity early

1 *Improvements to Employee Share-Based Payment Accounting*

2 As defined in the FASB ASC Master Glossary. This definition was codified by ASU 2013-12, *Definition of a Public Business Entity*.

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adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period.

The full standard is available **here**.

BACKGROUND

The FASB has undertaken a Simplification Initiative with the objective of making targeted amendments intended to simplify and improve operability of certain accounting standards. The FASB assessed the need to clarify certain aspects of share-based payment accounting through both Simplification Initiative outreach and Private Company Council (PCC) pre-agenda research. Furthermore, several aspects of share-based payment accounting were identified as difficult to understand or apply in the Financial Accounting Foundation (FAF)'s 2014 Post-Implementation Review[3] of Topic 718. That report noted that in general, nonpublic entities had more difficulty understanding and applying share-based payment guidance due to the complexity of financial instruments underlying their awards, as well as lack of internal expertise. The report further noted that certain aspects of share-based payment accounting were difficult to understand or apply for both public and nonpublic entities, including: accounting for additional paid-in capital (APIC) pools; liability versus equity classification; minimum tax withholdings; estimating expected forfeitures; and measuring share-based payment awards. The amendments in ASU 2016-09 address each of those topics.

SCOPE

The amendments in ASU 2016-09 affect all entities that issue share-based payment awards to their employees. Certain of the amendments, as further discussed below, are only applicable for non-public entities.

BDO OBSERVATION

The FASB has a separate project on its agenda to reduce the cost and complexity and improve the accounting for nonemployee share-based payment awards issued by public and private companies. The FASB has reached tentative decisions to expand the scope of Topic 718 to include all share-based payment transactions for acquiring goods and services from nonemployees, to more closely align the accounting for nonemployee options with the accounting for employee options, and to provide some practical alternatives for nonpublic entities. A proposed ASU is expected to be issued after the FASB has solicited feedback from stakeholders.

SUMMARY

ASU 2016-09 simplifies several aspects of the stock compensation guidance in Topic 718 and other related guidance. The following six amendments apply to all entities:

- Accounting for income taxes upon vesting or settlement of share-based payments – Entities will no longer need to maintain and track an APIC pool. Rather, entities should recognize all excess tax benefits and tax deficiencies, including tax benefits of dividends on share-based payment awards, as income tax expense or benefit in the income statement.
- Classification of excess tax benefits on the statement of cash flows – Entities should classify excess tax benefits along with other income tax cash flows as an operating activity in the statement of cash flows.
- Accounting for forfeitures – The ASU provides an accounting policy election, to be applied on an entity-wide basis, to either estimate the number of awards that are expected to vest (consistent with existing U.S. GAAP) or account for forfeitures when they occur.
- Liability classification exception for statutory tax withholding requirements – The ASU increases the allowable statutory tax withholding threshold to qualify for equity classification from the minimum statutory withholding requirements up to the maximum statutory tax rate in the applicable jurisdiction(s).

3 *Post-Implementation Review Report – FASB Statement No. 123(R), Share-Based Payment (Codified in Accounting Standards Codification Topic 718, Compensation—Stock Compensation)*

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- Cash flow presentation of employee taxes paid when an employer withholds shares for tax-withholding purposes – The ASU clarifies that cash paid to a taxing authority by an employer when directly withholding equivalent shares for tax withholding purposes should be considered similar to a share repurchase, and thus classified as a financing activity.
- Elimination of the indefinite deferral in Topic 718 – The FASB removed the indefinite deferral in paragraph 718-10-65-1 on the need to apply another Topic when the rights conveyed by a freestanding financial instrument are no longer dependent on the holder being an employee.

In addition, the following two amendments apply only to nonpublic entities:

- Expected term of awards – The ASU provides an accounting policy election to nonpublic entities under which they can utilize a practical expedient to establish the expected term of an award.
- Intrinsic value election for liability-classified awards – A nonpublic entity can make a one-time accounting policy election to measure all liability-classified awards at intrinsic value.

For a more in-depth discussion of each of the amendments included in ASU 2016-09, see the questions and answers below.

QUESTIONS & ANSWERS

ACCOUNTING FOR INCOME TAXES

Q1. ***How will an entity account for current income tax effects arising from share-based payment awards?***

A1. The amendments require an entity to recognize all excess tax benefits ("windfalls") and tax deficiencies ("shortfalls"), including tax benefits of dividends on share-based payment awards, as income tax expense or benefit in the income statement. These tax effects are generally determined upon exercise of stock options or vesting of restricted stock awards. Windfalls occur when the tax deduction exceeds cumulative compensation cost for financial reporting purposes, while shortfalls occur when cumulative compensation cost exceeds the tax deduction. Shortfalls may also occur when an entity reverses a deferred tax asset (DTA) for vested awards which expire unexercised (resulting in no tax deduction).

BDO OBSERVATION

As a result of recognizing all windfalls and shortfalls in earnings, entities will no longer need to maintain and track an APIC pool upon adoption of the ASU. While windfalls recognized in equity prior to the adoption date would remain in equity, the APIC pool memo account would no longer be relevant or necessary. However, entities will still need to determine future windfalls and shortfalls on an "award by award" basis since the ASU has not changed that requirement (i.e., the unit of account is an award).

An entity should recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. As such, off-balance sheet tracking of net operating losses (NOLs) resulting from excess tax benefits will no longer be required. The NOLs will be assessed for valuation allowance together with all other deferred tax assets. Existing NOLs that are currently tracked off-balance sheet must be recognized, net of any valuation allowance, through an adjustment to ***opening*** retained earnings in the period of adoption.

In addition, the amendments simplify the intraperiod tax allocation. All tax effects of share-based payments will generally be allocated to continuing operations except when a tax effect relates to discontinued operations.

The amendments also eliminate the intraperiod allocation to equity for:

- Employee stock ownership plans (ESOPs) – An entity will now recognize a tax benefit from deductible dividends paid on unallocated shares in income tax expense, as opposed to retained earnings as currently required. This change will create accounting symmetry with the treatment of tax deductible dividends paid to shareholders which is already required to be allocated to income tax expense.
- Business combinations – An entity will now recognize windfalls or shortfalls arising from replacement awards after the acquisition date in income tax expense, as opposed to APIC.

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BDO OBSERVATION

The income tax accounting changes are very significant and will considerably reduce the complexity from intraperiod allocation accounting in Subtopic 740-20. Moreover, FASB's decision on income tax effects could potentially accelerate undertaking a future project to simplify Subtopic 740-20's intraperiod allocation (in the past, the FASB has considered a project on intraperiod allocation). Importantly, income tax expense will be better aligned with income tax payable, providing more relevant and representational information about an entity's effective income tax cost (under current accounting, income tax expense is effectively grossed up as if tax windfalls do not reduce income tax).

Entities will need to recognize any pre-adoption date windfall NOL that is currently tracked off balance sheet through an adjustment to opening retained earnings (refer to example below). If a valuation allowance is required, it is recognized also as an adjustment to opening retained earnings. In some circumstances, the intraperiod allocation accounting policy of "with and without" might have resulted in financial statement recognition of non-windfall tax benefits such as the research tax credits (R&D credit) instead of windfalls from share-based awards. This accounting policy effectively resulted in substitution of tax attributes for financial reporting purposes (meaning, the R&D credit is deemed to reduce income tax liability, even though windfalls were actually used to reduce taxable income and the R&D credit is a carryforward). This resulted in the R&D credit carryforwards being considered windfall NOLs for accounting purposes (tracked off-balance sheet). Such tax benefits will also be recognized upon adoption of the ASU, net of valuation allowance, as an adjustment to opening retained earnings as if they are "off-balance sheet" windfalls.

After the adoption of the ASU, the only difference between windfall NOL carryforwards on the tax return and recognized (net of valuation allowance) in the financial statements will be an uncertain tax benefit (UTB) liability related to windfall NOLs.

Additionally, current recognition of all excess tax benefits and losses may create volatility in earnings. Because of the requirement to recognize these effects in the period in which the tax deduction arises or the related DTA is reversed due to forfeiture, annual and interim periods with larger amounts of awards vesting will be the most significantly impacted. Entities that have historically granted awards that cliff vest at the end of a multi-year period may experience swings in income tax expense and thus net income in the period in which the awards vest. While the relative magnitude will depend on the entity's stock price and other variables (e.g., the cost to exercise, if any, which reduces the tax deduction), entities can explain the impact on effective tax rates with clear disclosures. Current SEC disclosure rules require that the annual rate reconciliation separately identify tax effects that increase or decrease the effective tax rate by more than 5% of the US statutory rate (i.e., 5% x 35% or 1.75%).[4] Public entities also frequently address such changes in the effective tax rate within Management's Discussion and Analysis.

EXAMPLE 1 - RECOGNITION OF TAX WINDFALL NOL

Entity B generates $1,000 in pretax book taxable loss and $400 in 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).

Prior to adoption of the ASU, Entity B would record the following entry to recognize the tax windfall NOL:

DTA-NOL*	$400 ($1,000 pretax loss x 40%)	
Deferred tax benefit		$400

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

In contrast, under the new guidance, Entity B would record the following entry to recognize the tax windfall NOL:

DTA-NOL	$560 (($1,000 pretax loss + $400 tax windfalls) x 40%)	
Deferred tax benefit		$560

4 Rule 4-08(h) of Regulation S-X

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Q2. ***Do the amendments affect deferred tax accounting for share-based payment awards?***

A2. No. An entity will continue to recognize deferred tax assets for compensation recognized on awards expected to result in taxable wages to individuals (i.e., "nonqualified" awards). If employees terminate with out-of-the-money vested share options, the deferred tax asset related to those share options would be written off when those options expire.

Q3. ***How will an entity recognize income tax effects of share-based payment awards in interim periods?***

A3. Tax windfalls and shortfalls from share-based payments will be treated as discrete items in the interim reporting period in which they occur. That is, an entity does not need to include the effects of windfalls and shortfalls in the annual effective tax rate estimate from continuing operations used for interim reporting purposes. However, the effect should be separately disclosed in the interim period if it causes significant variation in the customary relationship between income tax expense and pretax accounting income and it is not otherwise apparent from the financial statements or from the nature of the entity's business).[5]

A tax benefit recognized in an interim period is assessed for realization together with all deferred tax assets existing as of the interim period and expected at the end of the year. No valuation allowance is necessary in an interim period if the benefit is expected to be realized throughout the remaining year or recognized as a DTA at year end.

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This change will simplify (and eliminate diversity in) interim period income tax accounting related to share-based payments as there will no longer be delayed recognition of known tax effects from stock options and other share-based payments (i.e., no need to determine whether or not sufficient taxable income is expected for the year to absorb windfalls). Also, by specifying these tax effects as "discrete" period effects, entities will not have to undertake the difficult task of estimating windfalls and shortfalls. However, when the deduction is expected to result in an NOL for the current year, the deferred tax benefit from the stock option (or other award) deduction would be assessed, along with other DTAs, for valuation allowance.

Entities should consider their current systems and processes to ensure they timely identify and report tax effects from windfalls and shortfalls in interim periods.

EXAMPLE 2 - INTERIM PERIOD ACCOUNTING

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 differences to avoid a valuation allowance on the current year loss and deductible temporary differences as of Q1 and expects to have sufficient taxable differences at year end. Entity D's intraperiod allocation policy is "with or without," and its tax rate is 40% (applicable statutory federal plus state rate).

Prior to adoption of the ASU, Entity D's accounting policy and practices dictate the accounting treatment. If the forecast is considered reliable but still marginal, Entity D might not recognize a DTA in Q1, but instead wait until Q3 or even Q4 to be certain it has taxable income for the year that can be reduced by the tax windfall.

Under the new guidance, Entity D must recognize in Q1 a tax benefit (through earnings) for the tax windfall. A DTA would be recognized and assessed for a valuation allowance together with all DTAs that exist as of Q1 and that are expected to exist at the end of the year. The accounting entry (shown below) is based on the assumption that Entity D expects to record income in subsequent interim periods and also expects to have sufficient taxable differences at year end to avoid a valuation allowance. Note that if Entity D were to have year-to-date taxable income (as opposed to a loss), the tax windfall would be expected to generate a current benefit and a reduction in tax payable for the period.

DTA - tax windfalls	$40 ($100 x 40%)	
Deferred tax benefit		$40

5 Par. 740-270-50-1

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EXAMPLE 3 - INTERIM PERIOD ACCOUNTING WHEN ASU IS EARLY ADOPTED MID-YEAR

Entity E prepares the Q3 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, thus the tax windfall would become a carryforward at year-end following "with-and-without" intraperiod allocation. Entity E did not realize any windfall or shortfall in Q2. There is sufficient positive evidence of taxable income including reversing taxable differences to avoid a valuation allowance, and Entity E's tax rate is 40% (applicable statutory federal plus state rate).

During Q3, Entity E realizes an additional tax windfall of $120. Entity E early adopts all of the provisions of ASU 2016-09 in Q3 of the current year.

Entity E would record the following entries in Q3 to adopt the ASU as of the beginning of Q1 of the current year:

DTA/tax payable - tax windfalls	$88 (($100 + $120) x 40%)	
Deferred/current tax benefit - Q1 windfall		$40 ($100 x 40%)
Deferred/current tax benefit - Q3 windfall		$48 ($120 x 40%)

Note: Income tax expense (benefit) for Q1 and Q3 (i.e., 9-month results) would include $88 of windfall tax benefit, which is allocated to Q1 and Q3 as shown above.

Assume the same facts as above, except that Entity E recognized in Q1 a windfall tax benefit of $40 through APIC. Entity E would record the following entries in Q3 to adopt ASU 2016-09 as of the beginning of Q1 of current year:

Add'l paid in captial - tax windfalls	$40 ($100 x 40%)	
Deferred/current tax benefit - Q1 windfall		$40
DTA/tax payable - tax windfalls	$48 ($120 x 40%)	
Deferred/current tax benefit - Q3 windfall		$48

Q4. ***What are the transition requirements related to the income tax provisions of the ASU?***

A4. The amendments requiring recognition of windfalls and shortfalls in the income statement should be applied prospectively to those windfalls and shortfalls occurring after the date of adoption. Windfalls that have been recognized in APIC in periods prior to the date of adoption will not be reclassified. However, if an entity elects to early adopt the ASU and does so in an interim period (e.g., Q3 2016), it is required to reflect adoption as of the beginning of the fiscal year of adoption. Thus, any windfalls recognized in APIC in an earlier interim period (e.g., Q1 2016) should be reversed and recognized in year-to-date income tax expense (refer to the above example).

The amendments requiring the recognition of NOLs that are currently tracked off-balance sheet should be applied on a modified retrospective basis through an adjustment to opening retained earnings in the period of adoption. Prior comparative periods should not be restated. Any valuation allowance required for a DTA recognized as a result of adoption should also be recognized through opening retained earnings, but subsequent release of the valuation allowance initially recognized through retained earnings should follow the normal intraperiod allocation rules (i.e., released to continuing operations if based on forecasted income in future years or to the source of the income in the year of release).[6]

6 Post-adoption date change in valuation allowance follows the intraperiod allocation rules for valuation allowance changes in par(s) 740-10-45-20 and 740-20-45-4 through 45-8. That is, subsequent release is generally allocated to continuing operations (if future and/or current income is expected), unless the release is supported by another source of income in the current year (e.g., gains in discontinued operations and/or other comprehensive income). That is, there is no "backward tracing" or reattribution to retained earnings.

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The following table depicts the impact of the effective date and early adoption for entities with a calendar year-end:

	JANUARY 1, 2016	JANUARY 1, 2017	JANUARY 1, 2018
Public business entities[7]			
Early adoption	Recognize windfall NOLs (net of any valuation allowance) as of December 31, 2015 through opening retained earnings and all windfalls and shortfalls arising on or after 1/1/16 in income tax expense	—	N/A
Mandatory adoption	—	Recognize windfall NOLs (net of any valuation allowance) as of December 31, 2016 through opening retained earnings and all windfalls and shortfalls arising on or after 1/1/17 in income tax expense	N/A
All other entities			
Early adoption (including any interim period within the fiscal year of adoption)	***If early adopting in 2016:*** Recognize windfall NOLs (net of any valuation allowance) as of December 31, 2015 through opening retained earnings and all windfalls and shortfalls arising on or after 1/1/16 in income tax expense	***If early adopting in 2017:*** Recognize windfall NOLs (net of any valuation allowance) as of December 31, 2016 through opening retained earnings and all windfalls and shortfalls arising on or after 1/1/17 in income tax expense	—
Mandatory adoption	—	—	Recognize windfall NOLs (net of any valuation allowance) as of December 31, 2017 through opening retained earnings and all windfalls and shortfalls arising on or after 1/1/18 in income tax expense

EXAMPLE 4 - RECOGNITION OF PRE-EFFECTIVE-DATE TAX WINDFALL NOL

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 windfall NOLs from prior years with a remaining carryforward period of more than 10 years. Entity C concludes that the tax windfall NOLs can be recognized without a valuation allowance. Entity C's tax rate is 40% (applicable statutory federal plus state rate).

Entity C would record the following entry to recognize the tax windfall NOLs as of beginning of current year:

DTA - NOL	$200 ($500 tax windfall NOL x 40%)	
Opening retained earnings		$200

If Entity C concludes that it needs a valuation allowance for the tax windfall NOLs being recognized on the balance sheet for the first time, it would also record the following entry:

Opened retained earnings	$200	
Valuation allowance		$200

7 As defined by ASU 2013-12 and codified in the ASC Master Glossary.

Q5. ***What disclosures are required upon adoption of the income tax provisions of the ASU?***

A5. In the first interim and annual period of adoption, an entity must disclose both the nature of and reason for the change in accounting principle, and the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the period of adoption.

EXAMPLE 5 – INITIAL DISCLOSURE (INCOME TAX FOOTNOTE)

"We have adopted the provisions of ASU 2016-09 as of the beginning of the current fiscal year which requires recognition through opening retained earnings of any pre-adoption date NOL carryforwards from nonqualified stock options and other employee share-based payments (e.g., restricted shares and share appreciation rights), as well as recognition of all income tax effects from share-based payments arising on or after January 1, 2016 (our adoption date) in income tax expense. As a result, we recognized through opening retained earnings $XX,XXX,XXX of pre-adoption date NOL carryforwards with remaining carryforward periods of more than 10 years (the corresponding deferred tax asset is $X,XXX,XXX). No valuation allowance is needed as the newly recognized NOL is considered more likely than not realizable given that we have sufficient positive sources of taxable income including continued profitability and utilization of NOLs, taxable reversing temporary differences and a reliable forecast of income. In addition, we realized windfall tax benefits in the interim period of adoption of $XXX,XXX, which we recognized as a discrete period income tax benefit as required by the ASU. This benefit resulted in lowering our effective tax rate for the interim period by X%."

Q6. ***How will the new income tax accounting requirements impact earnings per share (EPS) calculations?***

A6. As a result of including income tax effects from windfalls and shortfalls in income tax expense, the calculation of both basic and diluted EPS will be affected.

Basic EPS calculations will change due to the inclusion of actual windfalls and shortfalls in net income, which is the numerator in the basic EPS formula.

Likewise, the change in net income will also impact the diluted EPS numerator. In addition, the application of the treasury stock method will change, which will also result in a change in the diluted EPS denominator. Under current accounting guidance, expected windfalls & shortfalls from outstanding awards are included in the proceeds assumed to be used to purchase shares when calculating incremental shares to be included in the denominator under the treasury stock method. Under the new guidance, windfalls and shortfalls are recognized in net income and thus no longer included in assumed proceeds under the treasury stock method. In effect, fewer shares are assumed to be repurchased when windfalls are expected, as if all outstanding awards will vest or be exercised by the end of the year. Therefore, this will generally increase the dilutive effect of share options and similar awards.

For purposes of computing diluted earnings per share, an entity will also apply the changes made to income tax accounting to the assumed proceeds of the treasury stock method on a prospective basis.

BASIC EPS FORMULA	CURRENT ACCOUNTING	NEW ACCOUNTING	DIFFERENCE
Net income	Tax windfalls excluded; tax shortfalls included *only* when no APIC pool to absorb shortfalls	Tax windfalls and tax shortfalls included	Increase (decrease) net income by tax windfalls (shortfalls)
No. outstanding shares	X	X	No difference

DILUTED EPS FORMULA

$$\frac{\text{Net income}}{\text{No. outstanding shares (X)} + \text{Incremental shares from options (Y)}}$$

CURRENT ACCOUNTING

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

X + Y

NEW ACCOUNTING

Tax windfalls and tax shortfalls included

X + Revised Y

DIFFERENCE

Increase (decrease) net income by tax windfalls (shortfalls)

"Y" is higher (lower) by windfalls (shortfalls) excluded from assumed proceeds

Average number of share options outstanding during the period *less* assumed shares repurchased (*Y)

$$\frac{\text{Assumed proceeds}}{\text{Average market price of share}}$$

CURRENT ACCOUNTING

Estimated windfalls (shortfalls) *included* to increase (*decrease*) assumed proceeds or shares repurchased

NEW ACCOUNTING

Estimated windfalls (shortfalls) excluded from assumed proceeds

CLASSIFICATION OF EXCESS TAX BENEFITS ON THE STATEMENT OF CASH FLOWS

Q1. ***How will excess tax benefits ("windfalls") be presented in the statement of cash flows?***

A1. The amendments clarify that an entity should classify windfalls along with other income tax cash flows as an operating activity in the statement of cash flows. This change eliminates the current practice of reclassifying the effect of windfalls as inflows in financing activities. Under the new guidance, the effect of windfalls will generally be reflected in net income from continuing operations under the indirect method or income taxes paid/received under the direct method. Disclosure of the tax benefit from stock options exercised during an annual period continues to be required, albeit now under paragraph 718-10-50-2A. The following table illustrates the change in cash flow presentation under the amendments.

RELEVANT SECTIONS OF CASH FLOW STATEMENT	PREVIOUS GAAP	ASU 2016-09
Operating		
Net income (NI)	Excludes tax windfalls; excludes tax shortfalls unless no APIC pool to absorb	Includes tax windfalls and tax shortfalls[8]
Financing		
Inflows (outflows)	Tax windfalls	—

8 Under the ASU, tax windfalls that increase and/or create NOLs would be recognized as a deferred tax benefit, which would result in a tax-related adjustment in cash flows from operating activities.

Q2. ***What are the transition requirements related to the windfall cash flow presentation provisions of the ASU?***

A2. An entity may elect to apply the amendments related to the presentation of excess tax benefits on the statement of cash flows using either a prospective transition method or a retrospective transition method. If an entity elects the full retrospective method, the underlying accounting for windfalls in prior periods presented remains unchanged. That is, windfalls previously recognized through APIC remain in APIC even though the cash tax benefit would be reclassified to operating activities in the cash flow statement.

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ACCOUNTING FOR FORFEITURES

Q1. ***What is the forfeiture rate assumption and how is it applicable under current accounting guidance?***

A1. A key principle of Topic 718 is that the total amount of share-based compensation cost recognized at the end of the requisite service period should be based on the number of instruments for which the requisite service is rendered and that vest. In contrast, compensation cost should not be recognized for instruments for which the requisite service period is not rendered and the awards are forfeited. Current guidance requires an entity to estimate at grant date the number of instruments expected to vest. This estimate does not affect the grant date fair value of an award, but does affect the amount of grant-date fair value that will be recognized as compensation expense over the requisite service period.[9]

In estimating forfeitures, an entity should consider historical turnover rates for employees within each experience group, as well as expectations about the future. An entity should revise its forfeiture estimate if subsequent information indicates that the actual number of instruments expected to vest is likely to differ from previous estimates, with the cumulative effect of the change recognized in compensation cost in the period of the change (i.e., accounting for a change in estimate with recognition in the current period of a cumulative effect from applying the revised estimate retrospectively).[10] An entity should not reverse previously recognized compensation cost if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised.

Some awards contain both service and performance conditions. For this type of award, an entity would recognize compensation cost, adjusted for estimated forfeitures, throughout the requisite service period if it is considered probable that the performance condition will be achieved. If an entity does not consider it probable that the performance condition will be achieved, no compensation cost should be accrued until the period in which the performance condition becomes probable of achievement. Conversely, sometimes vesting is accelerated when either a service or a performance condition is met (e.g., vesting occurs after three years of continuous service or sooner if an employee completes a specified project). In such circumstances, the performance condition is assessed to determine whether it is probable of being achieved, and compensation cost is recognized over the shorter of the explicit service period or the implicit performance condition period.

Further, an award may contain a performance target which may be achieved after the requisite service period has been completed, regardless of whether the employee is rendering service at the time the performance target is achieved. Topic 718 requires this type of performance target to be treated as a performance condition, with compensation cost recognized accordingly.[11] In such circumstances, the stated vesting period includes the period the performance target can be achieved and is longer than the requisite service period. Total compensation cost recognized during and after the requisite service period should reflect the number of awards expected to vest and be adjusted to reflect total awards that ultimately vest.

EXAMPLE 6 - PRE-ASU ACCOUNTING[12]

Entity T, a public entity as defined in Topic 718, grants at the beginning of 20X1 at-the-money employee share options with a contractual term of 10 years which vest at the end of a 3-year service period. The share options are considered nonqualified compensation for U.S. federal tax purposes which means they expect to result in taxable wages to the recipients and a corresponding deductible expense to Entity T which has a federal tax rate of 35% (state tax is ignored for this illustration and no valuation allowance is assumed to be required). Entity T issued a total of 900,000 options to 3,000 employees. A lattice-based valuation model is used to develop a fair value measurement of $14.69 per option (the assumptions used to develop the fair value are not relevant for the purpose of this illustration and thus not provided). It is also assumed that none of the compensation cost is capitalized as part of the cost of an asset.

Entity T's expected annual forfeiture assumption rate is 3% and is developed based on its experienced historical turnover rate and expectations about the future for the recipients' group level. Therefore, at the grant date (20X1), a total of 821,406 options are expected to vest,[13] and total compensation is expected to be $12,066,454 (i.e., 821,406 options expected to vest times $14.69 option grant-date fair value), which must be recognized over the 3-year requisite service period.

9 Under Topic 718, service and performance conditions that affect vesting do not affect grant-date fair value measurement.

10 Par. 718-10-35-3

11 This means the performance target should not be reflected in estimating the grant-date fair value of the award.

12 Example adapted from par(s) 718-20-55-6 through 55-16

13 The annual forfeiture rate assumption of 3% is compounded annually in the following manner: [(100% less 3%) x (100% less 3%) x (100% less 3%)] x 900,000, to arrive at 821,406 options.

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20X1 Annual Journal Entries:

Compensation cost	$4,022,151	
Additional paid in capital		$4,022,151
(to recognize one third of total compensation cost)		
Deferred tax asset	$1,407,753	
Deferred tax benefit		$1,407,753
(to recognize deferred income tax effect)		

During 20X1, actual forfeitures were 5% but Entity T concludes that its annual forfeiture rate estimate of 3% continues to be reasonable, thus it does not need to record a change in estimate. Therefore, during 20X2, Entity T continues to recognize compensation cost based on a 3% forfeiture assumption rate.

20X2 Annual Journal Entries:

Compensation cost	$4,022,151	
Additional paid in capital		$4,022,151
(to recognize one third of total compensation cost)		
Deferred tax asset	$1,407,753	
Deferred tax benefit		$1,407,753
(to recognize deferred income tax effect)		

During 20X2, the actual forfeiture rate is again 5% and by the end of 20X2, Entity T revises its annual forfeiture estimate to 6%. Under its revised forfeiture rate, only 747,526 options are expected to vest.[14] The revised expected total compensation cost is $10,981,157 (747,526 options expected to vest times $14.69 fair value per option). As a result, the amount recognized annually as compensation expense should be $3,660,386, for a total of $7,320,771 as of the end of 20X2, representing cost for two years of service.

Entity T is required to make the following cumulative pretax and tax adjustments as of the end of 20X2 to account for the change in forfeiture estimate:

Accumulated compensation cost recognized based on a 3% forfeiture assumption rate:	$8,044,302
Accumulated compensation costs based on a 6% forfeiture assumption rate:	$7,320,771
Cumulative compensation cost adjustment (as of the end of 20X2)	$ (723,531)

Additional paid in capital	$723,531	
Compensation cost		$723,531
Deferred tax expense	$253,236	
Deferred tax asset		$253,236

Entity T would need to recognize the remaining compensation cost of $3,660,386 and the related deferred tax effect during 20X3. However, at the end of 20X3, which represents the end of the requisite service period, Entity T would need to evaluate actual forfeitures and make any necessary adjustments to cumulative compensation cost for the number of shares that actually vested.

14 At the end of 20x2, the revised annual forfeiture rate assumption of 6% is compounded annually in the following manner: [(100% less 6%) x (100% less 6%) x (100% less 6%)] x 900,000, to arrive at 747,526 options.

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EXAMPLE 7 - PRE-ASU ACCOUNTING

Entity C grants an award to an employee on 1/1/20X1, which contains a four-year service condition and two distinct performance conditions, all of which must be satisfied for the award to vest. At grant date, the four-year service condition is probable of achievement, but neither of the performance conditions is probable of achievement. Entity C estimates forfeitures as required under Topic 718 prior to adoption of ASU 2016-09.

20X1

Because neither of the performance conditions is considered probable of achievement, no compensation cost would be recognized for the first year.

20X2

Assume both performance conditions become probable of achievement on 1/1/20X2 (one year after the grant date), and Entity C estimates that both performance conditions will be achieved by the end of the second year. However, because both the service and two performance conditions must be satisfied in order for the awards to vest, the requisite service period would be four years as that is the longer of the explicit service period and the implicit service periods. Because the performance conditions are now probable of achievement, compensation cost will be recognized in the period of the change in estimate as the cumulative effect on current and prior periods of the change in the estimated number of awards for which the requisite service is expected to be rendered. Therefore, compensation cost for the first year will be recognized immediately at the time of the change in estimate for the awards for which the requisite service is expected to be rendered. The remaining unrecognized compensation cost for those awards would be recognized prospectively over the remaining requisite service period (20X2 through 20X4).[15]

Q2. ***What is the new forfeiture accounting policy election provided by the ASU?***

A2. The ASU requires an entity to make an entity-wide accounting policy election to apply one of the following approaches:

- Estimate the number of awards that are expected to vest and base initial accruals of compensation cost on the estimate (consistent with existing guidance, as described above); or
- Recognize the effect of forfeitures in compensation cost when they occur.

If electing to recognize forfeitures as they occur, an entity will recognize compensation cost for all awards granted, as if all will vest. If an award is forfeited before the completion of the requisite service period, the entity will reverse compensation cost previously recognized related to that award during the period the award is forfeited.

Awards with performance conditions will still be assessed at each reporting date to determine whether it is probable that the performance conditions will be achieved. In the case of an award containing both a service and one or more performance conditions, an entity that elects to account for forfeitures when they occur would assume that the service condition will be achieved when determining the initial amount of compensation cost to recognize once it becomes probable that the performance conditions will be achieved. That is, assuming the performance condition is probable of achievement, the entity would recognize compensation cost as service is provided with no adjustment for a forfeiture estimate and would adjust (i.e., reverse) compensation cost for actual forfeitures as they occur.

BDO OBSERVATION

Electing to recognize the effect of forfeitures as they occur will likely result in "front-loading" of compensation cost recognized in the income statement (or in the balance sheet to the extent that an entity capitalizes compensation cost). In other words, the effect of a forfeiture rate will no longer be spread over the requisite service period. Entities with a high rate of forfeitures which elect the option not to estimate will likely see more volatility in the income statement due to full recognition of compensation expense in the earlier part of an award's life, and reversal of such expense later in an award's life, as actual forfeitures occur.

15 Example adapted from par. 718-10-55-76.

EXAMPLE 8 – NO FORFEITURE ESTIMATION[16]

Assume the same fact pattern as in Example 6 above, except that Entity T has adopted the ASU and has elected to account for forfeitures as they occur instead of estimating forfeitures.

The compensation cost to be recognized over the requisite service period at 1/1/20X1 is $13,221,000 (900,000 × $14.69), and the compensation cost to be recognized (excluding the effect of forfeitures) during each year of the 3-year vesting period is $4,407,000 ($13,221,000 ÷ 3). Therefore, in 20X1, Entity T would recognize $4,407,000 of compensation cost and a related deferred tax asset of $1,542,450 ($4,407,000 x 35%).Entity T records the following journal entries for 20X1 to recognize compensation cost and related deferred tax asset:

Compensation cost	$4,407,000	
APIC		$4,407,000
Deferred tax asset	$1,542,450	
Deferred tax benefit		$1,542,450

During 20X1, 45,000 share options are forfeited; accordingly, Entity T remeasures compensation cost to reflect the effect of forfeitures when they occur and recognizes compensation cost for 855,000 (900,000 – 45,000) share options (net of forfeitures) at an amount of $12,559,950 (855,000 × $14.69) over the 3-year vesting period, or $4,186,650 each year ($12,559,950 ÷ 3). Therefore, Entity T reverses recognized compensation cost of $220,350 (45,000 share options × $14.69 ÷ 3) to account for forfeitures that occurred during 20X1. Entity T records the following journal entries to recognize the effect of forfeitures during 20X1 and the related reduction in the deferred tax asset:

APIC	$220,350	
Compensation cost		$220,350
Deferred tax benefit	$77,123	
Deferred tax asset		$77,123

As of January 1, 20X2, Entity T determines the compensation cost and related tax effects to recognize during 20X2. The journal entries for 20X2 to recognize compensation cost and related deferred tax benefit are as follows (excluding the effect of forfeitures in 20X2).

Compensation cost	$4,186,650	
APIC		$4,186,650
Deferred tax asset	$1,465,328	
Deferred tax benefit		$1,465,328

In 20X2, 47,344 share options are forfeited (that is, 92,344 share options in total have been forfeited by 12/31/20X2); accordingly, Entity T would recognize compensation cost for 807,656 share options over the 3-year vesting period. On the basis of actual forfeitures in 20X1 and 20X2, Entity T should recognize a cumulative compensation cost of $11,864,467 (807,656 × $14.69) for the 3-year vesting period, or $3,954,822 per year ($11,864,467 ÷ 3 years). Therefore, Entity T reverses recognized compensation cost of $231,828 ($4,186,650 – $3,954,822) for 20X1 and 20X2, or $463,656 in total, to account for forfeitures that occurred during 20X1 and 20X2. Entity T records the following journal entries to recognize the effect of forfeitures during 20X2 and the related reduction in the deferred tax asset:

APIC	$463,656	
Compensation cost		$463,656
Deferred tax benefit	$162,280	
Deferred tax asset		$162,280

Entity T follows the same approach in 20X3 as it applied in 20X2 to recognize compensation cost and related tax effects.

Q3. ***How will the forfeiture accounting policy election be applied to dividend protected awards?***

A3. Certain awards allow employees to receive the dividends paid on the underlying equity shares while the option is outstanding. Topic 718 requires dividends (and dividend equivalents) paid to employees on the portion of an award that vests to be charged to retained earnings. If employees are not required to return the dividends (and dividend equivalents) received if they forfeit their awards, dividends (and equivalents) paid on instruments that do not vest must be recognized as additional compensation cost. The accounting for non-forfeitable

16 Example adapted from par(s) 718-20-55-6 through 55-16

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dividends (and dividend equivalents) paid to holders of unvested awards depends on whether the awards will ultimately vest (i.e., charge to retained earnings) or be forfeited (i.e., recognize compensation expense).

If an entity's accounting policy is to estimate the number of awards expected to be forfeited, the entity's estimate of compensation cost for dividends (and dividend equivalents) paid on instruments that are not expected to vest must be consistent with its estimates of forfeitures. If the entity revises its forfeiture estimates (or actual forfeitures differ from previous estimates), it would reclassify dividends (and equivalents) from retained earnings into compensation cost in the period in which the change in estimate occurs.

Q4. *How will the forfeiture accounting policy choice affect accounting for modifications of awards?*

A4. Topic 718 defines a modification as "a change in any of the terms or conditions of a share-based payment award," and requires modifications to be treated as if the original award is exchanged for a new award with equal or greater value.[17] Any incremental value from the modified award must be recognized as compensation cost. Generally, modifications can affect vesting conditions and/or the fair value of the award. To determine the incremental compensation cost, an entity must compare the fair value of the award immediately prior to modification to the fair value immediately after modification and also consider the vesting conditions before and after modification.

The ASU clarifies that when measuring the effect of a modification an entity must assess at the modification date whether the performance or service conditions of the original award are expected to be satisfied, regardless of whether its policy is to estimate forfeitures or account for them as they occur.[18] The expectation of whether or not the award will vest determines whether or not compensation cost is recognized under the original and modified terms, thereby determining the type of modification.

To quantify the effect of modifications, it is necessary to determine whether the award's original vesting condition (service and/or performance) is probable of being met immediately before the modification. If the original vesting condition is considered probable, the grant-date fair value continues to be recognized (subject to the forfeiture policy) and additional fair value (i.e., the incremental cost from modification) is measured by comparing the fair value of the modified award to the fair value of the original award immediately prior to the modification. Any incremental fair value or cost is recognized either immediately or over the remaining service periods, depending on the award's particular modification. If the original vesting condition is not probable of being met immediately before the modification, a new fair value measurement date is determined for the award and compensation cost to be recognized is based entirely on the fair value of the modified award (i.e., no portion of the grant-date fair value is recognized).

Subsequent to the measurement and recognition of incremental compensation cost, if any, an entity that has an accounting policy to account for forfeitures as they occur would apply that policy to the modified award.

Q5. *How will the forfeiture accounting policy choice affect accounting for replacement awards issued in a business combination?*

A5. In business combination accounting, the acquirer must determine fair value of consideration transferred on the acquisition date, including fair value of any replacement awards. Therefore, the fair value of replacement awards pertaining to pre-acquisition service must be recognized, subject to forfeiture estimate, through goodwill as a component of the consideration exchanged for an acquired business (i.e., a component of the purchase price).[19] The ASU does not change this requirement, regardless of the acquirer's forfeiture accounting policy. That is, an acquirer must estimate forfeitures related to the portion of ***nonvested*** replacement awards included in the purchase price, even when its forfeiture accounting policy is to account for forfeitures when they occur.[20] Any subsequent change in estimate of the forfeiture rate of the replacement awards should be reflected in the period in which the change occurs. That is, subsequent changes in estimate are not recorded as an adjustment to the consideration transferred at acquisition date.

Under the ASU, an entity that adopts an accounting policy to account for forfeitures as they occur should recognize the value of compensation cost related to estimated forfeitures and thus excluded from consideration transferred over the postcombination requisite service period. It would then reverse the compensation cost for any actual forfeitures in the period they occur. An entity that estimates forfeitures would not have to recognize such excluded costs because the initial exclusion of those costs upon acquisition date is consistent with its policy of reducing compensation cost for estimated forfeitures each accounting period.

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17 However, when vesting is not considered probable of achievement based on the award's original terms, the grant-date fair value is no longer relevant and a new fair value is recognized and attributed to compensation cost if vesting is considered probable under the revised terms.

18 Par. 718-20-35-3A

19 Vesting conditions affect recognition (through income statement or goodwill, as the case might be) rather than fair value measurement of an award.

20 Par. 805-30-55-11

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EXAMPLE 9 - BUSINESS COMBINATION

On 12/31/20X1, Entity Z acquires Entity E, at which date Entity E has outstanding restricted stock awards with two years of the requisite service period remaining. Upon acquisition, Entity Z (the surviving entity) replaces the unvested award with a similar award of Entity Z having total fair value of $1,200 as of the acquisition date. Entity Z has a policy to account for forfeitures as they occur. The portion of the replacement award attributed to precombination service is estimated at $400 before consideration of expected forfeiture.

For purposes of the business combination accounting, Entity Z estimates total forfeitures of 10% over the two year period, therefore the portion of the unvested replacement award's fair value included in consideration exchanged is $360 ($400 x 90%). Inclusion of this amount in consideration exchanged directly impacts the acquisition accounting, specifically the amount of goodwill recorded.

The difference between the grant date fair value of the award and the amount included in consideration exchanged, or $840 ($1,200-$360) is recognized as compensation cost in the post-acquisition period, over the remaining requisite service period. Entity Z will recognize forfeitures in the postcombination periods as they occur.

Q6. ***How will the new forfeiture accounting policy choice impact earnings per share (EPS) calculations under Topic 260 Earnings Per Share?***

A6. An entity that accounts for forfeitures as they occur would not estimate forfeitures for purposes of calculating EPS because it does not estimate forfeitures for purposes of determining compensation cost under Topic 718. Similarly, an entity that has a policy to estimate forfeitures must use consistent estimates for purposes of calculating EPS and for determining compensation cost.[21] Therefore, net income (the numerator) will be impacted by the forfeiture accounting policy choice as a policy to account for forfeitures as they occur would generally result in front-loading compensation cost, thereby reducing after-tax net income in early periods and reversing compensation cost in later periods as forfeitures occur. This will impact basic and diluted EPS calculations.

However, the calculation of incremental shares (the denominator in diluted EPS) from outstanding share options and similar share-based awards would not be affected by the forfeiture accounting policy. That is, Topic 260 requires that employee equity share options, nonvested shares, and similar equity instruments granted to employees be treated as potential common shares in computing diluted EPS. Diluted EPS is based on the actual number of options or shares granted and not yet forfeited regardless of the entity's accounting policy for forfeitures, unless doing so would be antidilutive.[22]

Topic 260 requires allocation of undistributed earnings (net income less dividends paid to holders of common stock and other participating securities) to *all* share-based payment awards outstanding during the period for purposes of calculating EPS under the two-class method.[23] An entity that accounts for forfeitures as they occur would include in the allocation of undistributed earnings those awards which were outstanding but which were forfeited during the period. An entity that has a policy to estimate forfeitures would include awards outstanding during the period for which the requisite service period is not expected to be rendered.

Further, under the two-class method, nonrefundable dividends on outstanding awards for which the requisite service period is not expected to be completed (under a policy to estimate) or which are actually forfeited (under a policy not to estimate) should not be included in the earnings allocation when computing EPS. This is to avoid "double-counting" nonrefundable dividends as both compensation in earnings and in earnings allocation (as dividends paid), which would understate undistributed earnings available to common shares and thus EPS on common stock.

Paragraphs 260-10-55-76A through 55-76D provide an example which illustrates this concept.

Q7. ***What are the transition requirements related to the new forfeiture accounting policy election?***

A7. An entity that elects a policy to account for forfeitures as they occur as permitted by the ASU should apply the policy change on a modified retrospective basis through an adjustment to opening retained earnings in the period of adoption. Prior comparative periods should not be restated. If an entity early adopts the ASU in any interim period, the adjustment must be recognized and measured as of the beginning of the annual period that includes that interim period. Similarly, an entity should record any related deferred tax effects, net of a valuation allowance, through an adjustment to opening retained earnings in the adoption period.

The cumulative effect adjustment will reflect the difference between cumulative compensation recognized to date, and cumulative compensation that would have been recognized if the entity had not estimated forfeitures, but instead had recognized actual forfeitures

21 Par. 260-10-45-68B

22 Par. 718-10-45-1

23 Par. 260-10-45-68B

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for all awards outstanding as of the beginning of the period of adoption. That is, an entity would look back to grant-date fair value of each award and compute the cumulative proportional compensation that would have been recognized without using a forfeiture estimate but considering actual forfeitures each period through the beginning of the period in which the change is adopted.

If an entity has a policy of capitalizing a portion of compensation cost (e.g., to inventory or construction-in-process), the cumulative effect adjustment should be allocated between opening retained earnings and affected net assets as appropriate.

EXAMPLE 10 - FORFEITURE POLICY TRANSITION

Entity F issues 20 non-qualified stock options to employees on 1/1/20X1, which will cliff vest in four years. The grant date fair value of each option is $5,000. Entity F expects annual forfeitures of 10%.

Actual forfeitures for years 20X1 and 20X2 were 5% each, however, assume the original estimate is considered reasonable so there is no need to account for a change in estimate as of 20X2. Entity F's tax rate is 40% (applicable statutory federal plus state rate), and 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 and will thus no longer estimate forfeitures. Compensation cost that has been recognized to date as of 12/31/20X2, based on estimated annual forfeitures of 10%, adjusted to reflect actual forfeitures of 5% in 20X1 and 20X2, is $29,525. Compensation cost that would have been recognized had Entity F accounted for actual forfeitures of 5% each for years 20X1 and 20X2 is $45,000.

Entity F would record the following entries on 1/1/20X3 to reflect adoption of the ASU and its new accounting policy election not to estimate forfeitures:

Opening retained earnings	$15,475 (45,000-29,525)	
APIC		$15,475
DTA	$6,190 (15,475 x 40%)	
Opening retained earnings		$6,190

Q8. *What disclosures are required upon adoption of a new forfeiture accounting policy?*

A8. As noted above, in the first interim and annual period of adoption, an entity must disclose both the nature of and reason for the change in accounting principle, and the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the period of adoption.

The ASU adds a new ongoing requirement whereby an entity must disclose its forfeiture accounting policy (i.e., estimation or recognition upon actual forfeiture). The ASU also expands the existing requirement to disclose certain metrics of options (or share units) outstanding and currently exercisable (or convertible) such that the disclosure requirement applies also to unvested share options for which the requisite service period has not been rendered but that are expected to vest based on the achievement of a performance condition, if an entity accounts for forfeitures when they occur.[24]

ACCOUNTING FOR STATUTORY TAX WITHHOLDING REQUIREMENTS

Q1. *What is a net-settlement feature and how is it accounted for under current guidance?*

A1. Many jurisdictions have laws that require an employer to withhold tax on share-based payment awards upon vesting and/or exercise of the awards. A common feature to satisfy this requirement is to allow/require net-settlement whereby an employer repurchases shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's statutory withholding requirements resulting from the exercise.[25] Net-settlement applies to supplemental taxable income, i.e., taxable wages triggered by share-based payment awards. Previous guidance requires awards to be classified as liabilities if the amount withheld, or which may be withheld at the employee's discretion, exceeds the minimum statutory requirement. Awards classified as liabilities must be remeasured at fair value at the end of each reporting period.

Because jurisdictions vary widely in terms of the required withholding rates and amounts, it can often be difficult to determine what constitutes the minimum level of statutory withholding. Furthermore, in some jurisdictions such as China, employers are required to withhold and pay employees' taxes while employees are not required to file income tax returns. Situations such as these led to economically

24 Par. 718-10-50-2e

25 Paragraph 718-10-25-18

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similar awards granted in different jurisdictions being classified differently on the balance sheet, and in the case of liability classification, resulted in recurring valuation work and income statement volatility.

Q2. ***What are the new requirements for net-settlement features to avoid liability classification?***

A2. The ASU increases the allowable statutory tax withholding threshold to qualify for equity classification from the minimum statutory withholding requirements up to the maximum statutory tax rate in the applicable jurisdiction(s). In other words, a partial cash-settlement for withholding tax would not by itself require liability-classification provided the amount withheld does not exceed the maximum statutory tax rate for an employee in the applicable jurisdiction(s). An entity should determine the maximum individual statutory tax rates based on the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll or similar taxes, as provided in tax law, regulations, or the authority's administrative practice. The amount withheld cannot exceed the maximum statutory rates in applicable jurisdictions.

This exception to liability classification due to withholding tax is only available when the employer has a statutory obligation to withhold taxes on the employee's behalf. In the U.S. jurisdiction, the income the employee earns as a result of the award must be considered "supplemental taxable income or wages" under the Internal Revenue Code in order for a statutory obligation to withhold to be present. Disqualified dispositions of incentive stock options (ISOs) are not considered supplemental income for withholding tax purposes, and therefore impose no withholding requirement, although the employee is subject to income tax on disqualified dispositions.

BDO OBSERVATION

This exception is intended to apply by using a single maximum rate in a jurisdiction as a "ceiling" on withholding tax. The amount withheld is not limited to the highest tax rate paid by the specific award grantee but instead is limited to the maximum tax rate in the applicable jurisdiction (e.g., federal, state, local), even if that rate exceeds the highest rate that may apply to the specific award grantee. Therefore, an entity would only need to determine one maximum rate in each jurisdiction.

Q3. ***Can existing plans or awards be modified to conform an existing net-settlement feature to the new accounting principle without triggering modification accounting?***

A3. Yes. The FASB staff has informally indicated that if a share-based compensation plan or award is amended to allow for a greater withholding pursuant to the recent amendment, the staff does not view this as a modification under Topic 718. The staff cautioned that this opinion should not be applied more broadly by analogy to other circumstances. That is, other non-substantive changes to a plan or award could in fact result in a modification. For example, if an entity added a net-settlement provision where one did not previously exist, it would need to determine whether modification accounting is required.

BDO OBSERVATION

The FASB has a separate project on its agenda to examine the scope of modification accounting in Topic 718. The FASB tentatively decided in October 2016 that an entity should not apply modification accounting under Topic 718 on stock compensation if the change to an award does not affect the total current fair value (or total calculated value or total intrinsic value, if such an alternative measurement method is used), vesting requirements, or classification of the award. A proposed ASU is expected in the near future.

Q4. ***What are the transition requirements related to accounting for statutory tax withholding requirements?***

A4. The amendments to accounting for statutory tax withholding requirements should be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Prior comparative periods should not be restated. If an entity early adopts the ASU in any interim period, the adjustment must be recognized and measured as of the beginning of the annual period that includes that interim period. Similarly, an entity should record any related deferred tax effects from a cumulative-effect pretax adjustment, net of a valuation allowance, through an adjustment to opening retained earnings in the adoption period.

The cumulative effect adjustment will reflect the difference between cumulative compensation cost recognized to date under liability classification, and cumulative compensation cost that would have been recognized as if the award had been equity-classified on its grant date using the same forfeiture rate assumption used to recognize compensation to date (i.e., grant-date fair value should be weighted proportionally to reflect requisite service provided to date and the forfeiture rate assumption). The amendments may only be applied to outstanding awards that have not been settled at the date of adoption.

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In the first interim and annual period of adoption, an entity must disclose both the nature of and reason for the change in accounting principle, and the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the period of adoption.

EXAMPLE 11 - STATUTORY WITHHOLDING TRANSITION

On 1/1/X4, Entity W issued restricted (non-vested) shares to CEO, which will cliff vest in four years. Grant date fair value was $800. 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/X4 and 12/31/X5, reporting them at fair value at each reporting date. The liability was valued at $1,000 as of 12/31/X5.

Entity W early adopts ASU 2016-09 for the year ended 12/31/X6. 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.

Total compensation recorded to date under liability classification is $500 ($400 grant date FV + $100 incremental FV ($200/4 x 2 years)). Total compensation that would have been recorded to date under equity classification is $400 ($800/4 x 2 years).

Entity W records the following journal entries to reflect the cumulative effect adjustment as of 1/1/20X6:

RSU liability	$500	
Opening retained earnings		$100
APIC		$400
Opening retained earnings	$40 ($100 x 40%)	
Deferred tax asset		$40

BDO OBSERVATION

When both classification of outstanding awards and the forfeiture accounting policy change concurrently upon adoption of the ASU, the cumulative effect adjustment of the classification change should be determined based on the forfeiture assumption rate as originally used (i.e., an adjustment to remove the impact of fair value remeasurement). The cumulative effect adjustment due to changing the forfeiture policy is then determined by comparing the re-determined cumulative compensation cost under equity classification to the cumulative compensation cost that would be recognized under an accounting policy to recognize forfeitures when they occur.

CLASSIFICATION OF EMPLOYEE TAXES PAID ON THE STATEMENT OF CASH FLOWS WHEN AN EMPLOYER WITHHOLDS SHARES FOR TAX-WITHHOLDING PURPOSES

Q1. ***How will cash paid to a tax authority by an employer when shares are withheld from an employee's award for tax-withholding purposes be presented in the statement of cash flows?***

A1. The amendments clarify that an employer should classify cash paid to a taxing authority when directly withholding equivalent shares for tax withholding purposes as a financing activity because it is considered similar to a share repurchase. Previous guidance did not specify cash flow classification of this type of transaction, resulting in diversity in practice. All other employer withholding taxes on compensation transactions and other events that enter into the determination of net income (e.g., employment, withholding, exercise, etc.) continue to be presented within operating activities.

Q2. ***What are the transition requirements related to the tax withholding payment cash flow presentation provisions of the ASU?***

A2. An entity should apply the amendments related to the presentation of these taxes paid on the statement of cash flows retrospectively. That is, all prior comparative periods should be restated.

In the first interim and annual period of adoption, an entity must disclose the nature of and reason for the change in accounting principle and the effect of the change on prior periods retrospectively adjusted. This disclosure would be included either in the supplementary notes to the statement of cash flows or in the disclosure describing the impact of new accounting principles.

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PRIVATE COMPANY PRACTICAL EXPEDIENT – EXPECTED TERM

Q1. *What is expected term and how is it used in Topic 718?*

A1. In the absence of observable market prices, the fair value of a share-based payment award is determined using a valuation technique that takes into account the expected *term* of the award. Expected term (also referred to as *estimated life*) is the estimated period of time that a share-based payment award will be outstanding, assuming it vests. In other words, it is the period of time from the service inception date to the date of expected exercise or other expected settlement. The expected term of the award must take into account both the contractual term of the option and the effects of employees' expected exercise and post-vesting employment termination behavior. In a closed-form valuation model such as Black-Scholes, the expected term is an assumption used in (or input to) the model, while in a lattice valuation model, the expected term is an output of the model, which provides further explanation of the expected term in the context of a lattice model.

Q2. *What is the new practical expedient regarding expected term and what entities are eligible to apply it?*

A2. The ASU permits a *nonpublic entity*, as defined by Topic 718,[26] to make an accounting policy election to use a practical expedient to estimate the expected term for all awards with performance or service conditions. If elected, the practical expedient must be applied to all qualifying equity- and liability-classified awards.

For an award with a service condition, the new guidance allows an entity to establish the expected term as the midpoint between the requisite service period and the contractual term. For an award with a performance condition, an assessment should be made at grant date to determine whether it is probable that the performance condition will be achieved. If it is probable, the expected term is the midpoint between the requisite service period and the contractual term. If it is not probable, the expected term depends on whether a service period is explicitly stated or implied. If explicitly stated, the expected term is the midpoint between the requisite service period and the contractual term; otherwise the expected term is the contractual term.

The practical expedient is only available for a share option or similar award that has all of the following characteristics:

a) The share option or similar award is granted at the money

b) The employee has only a limited time to exercise the award if the employee terminates service after vesting (typically 30-90 days)

c) The employee can only exercise the award (cannot sell or hedge the award), and

d) The award does not contain a market condition.

For liability-classified awards, the estimate of the expected term must be updated at each reporting date to reflect the loss of time value and any changes in the assessment of whether a performance condition is probable of being achieved.

BDO OBSERVATION

Although the expected term practical expedient provided to private companies is similar in some ways to the SEC's simplified method provided in SAB 110, it is not completely identical. During the proposal stage, the FASB received feedback from stakeholders indicating that the eligibility requirements for an entity to apply the SEC's simplified method may not be met by many private companies. Thus, the FASB designed its practical expedient such that it would be more widely applicable to private companies.

Additionally, the SEC's simplified method is permitted for entities that do not have sufficient historical data to objectively support an estimate of the expected term. Entities should use this method only until such time that they can make an objective estimate. In contrast, the new private company expedient under the ASU is available on an ongoing basis for all private companies.

Q4. ***What are the transition requirements related to the expected term practical expedient?***

A4. If an entity elects to apply the practical expedient for estimating expected term, it should apply the amendments prospectively. That is, it should apply the practical expedient to all fair value measurements related to share-based payment awards, both equity- and liability-classified, granted after the date of adoption. If an entity early adopts the ASU in any interim period, the adjustment must be reflected as of the beginning of the annual period that includes that interim period. In the first interim and annual period of adoption, an entity must disclose the nature of and reason for the change in accounting principle.

26 Topic 718 defines a "nonpublic entity" as any entity other than one that meets any of the following criteria: a) has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally; b) makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or c) is controlled by an entity covered by the preceding criteria. It should be noted that this definition differs slightly from the ASC Master Glossary definition of "public business entity," which is the definition used to determine the effective date of the ASU.

An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity.

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PRIVATE COMPANY ACCOUNTING ELECTION – INTRINSIC VALUE

Q1. *What is intrinsic value and how does it differ from fair value?*

A1. Topic 718 defines intrinsic value and fair value as follows:

- *Intrinsic value* - The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. (A nonvested share may be described as an option on that share with an exercise price of zero and the fair value and the intrinsic value of such an option are the same)
- *Fair value* - The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Because intrinsic value is based upon inputs that are generally known (the fair value of underlying stock and the exercise price of the award), it is generally easier to determine, particularly for private companies' whose stock is not regularly traded. Fair value of an award, on the other hand, is more judgmental and complex, and often requires involvement of specialists and the use of a stock option valuation method.

Q2. *What is the accounting election regarding intrinsic value and what entities are eligible to apply it?*

A2. The ASU permits a *nonpublic entity*, as defined by Topic 718, to make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value. The related transition provisions do not require the entity to evaluate whether the change in accounting policy is preferable under Topic 250.[27] If an entity elects the alternative, it would apply it to all existing and future measurements of liability-classified awards.

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It is important to note that this accounting alternative is a one-time election. That is, upon adoption of the ASU, an entity must determine whether or not it will apply the alternative.

Q3. *What are the transition requirements related to the intrinsic value accounting alternative?*

A3. If an entity elects to apply the accounting alternative to measure liability-classified awards at intrinsic value, it should be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Prior comparative periods should not be restated. If an entity early adopts the ASU in any interim period, the adjustment must be recognized and measured as of the beginning of the annual period that includes that interim period.

The cumulative effect adjustment will effectively adjust the carrying value of all liability-classified awards to intrinsic value as of the adoption date, with the difference between the fair value and intrinsic value recognized in opening retained earnings of the adoption period. Similarly, an entity should record any related deferred tax effects, net of a valuation allowance, through an adjustment to opening retained earnings in the adoption period.

In the first interim and annual period of adoption, an entity must disclose both the nature of and reason for the change in accounting principle, and the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the period of adoption.

ELIMINATION OF THE INDEFINITE DEFERRAL IN TOPIC 718

Q1. *What guidance was deferred, and why has the FASB removed that deferral?*

A1. Paragraphs 718-10-35-10 through 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. This guidance was indefinitely deferred by FAS 123R-1 (codified in paragraph 718-10-65-1). The ASU has removed that deferral, as well as paragraph 718-10-35-13, thus making the guidance in paragraphs 718-10-35-10 through 35-12 effective upon adoption of the ASU.

Q2. *What are the implications of eliminating the indefinite deferral?*

A2. Removing the indefinite deferral is generally not expected to cause changes since reporting entities already applied that guidance by analogy despite the indefinite deferral provision. As explained in paragraph BC32 of the Basis for Conclusions, the amendments do not change GAAP that is currently effective. Because there is no expected change in practice as a result of this amendment, transition and effective date guidance is not applicable for the amendment.

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27 *Accounting Changes and Error Corrections*

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