

AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

FASB



SUBJECT:

FASB SIMPLIFIES ASPECTS OF ACCOUNTING FOR STOCK COMPENSATION

SUMMARY:

The FASB recently issued ASU 2016-09¹ to simplify the accounting for stock compensation. It focuses on income tax accounting, award classification, estimating forfeitures, and cash flow presentation. The ASU also provides certain accounting policy alternatives to nonpublic entities. The ASU is available [here](#) and becomes effective in 2017 for public companies and in 2018 for all other entities. Early adoption is permitted. Certain disclosures and detailed transition provisions apply.

MAIN PROVISIONS:

ASU 2016-09 simplifies several aspects of the stock compensation guidance in Topic 718² and other related guidance. The following six amendments apply 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
- ▶ 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.

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¹ *Improvements to Employee Share-Based Payment Accounting*

² *Compensation—Stock Compensation*

The following two amendments apply only to nonpublic entities:

- ▶ Expected term of awards
- ▶ Intrinsic value election for liability-classified awards.

BDO Observation: Accounting teams may wish to communicate with their investor relations departments to ensure they are equipped to explain the impact of these accounting changes to external stakeholders, particularly those changes affecting earnings per share.

Accounting for income taxes upon vesting or settlement of share-based payments and related EPS effects

An entity will no longer need to maintain and track an “APIC pool.” Rather, the entity should 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, generally determined upon exercise of stock options or vesting of restricted stock awards, should be treated as discrete items in the interim reporting period in which they occur. That is, entities do 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. 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 resulting from excess tax benefits will no longer be required. The valuation allowance will be assessed together with all other deferred tax assets. Existing net operating losses 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.

BDO Observation: Current recognition of all excess tax benefits and losses may create significant volatility in earnings. Because of the requirement to recognize the entire amount of the excess tax benefit or loss in the period in which the tax deduction arises, periods with larger amounts of award vestings will be impacted the most. Companies that have historically granted awards that cliff vest at the end of a multi-year period may experience significant swings in income tax expense and thus net income in the period in which the awards vest.

Impact on earnings per share calculations

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.

Under the treasury stock method used to calculate diluted EPS, windfalls are included in the proceeds assumed to be used to purchase shares. Under the new guidance, windfalls 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. Therefore, this will generally increase the dilutive effect of share options and similar awards.

Classification of excess tax benefits on the statement of cash flows

The ASU clarifies that an entity should classify excess tax benefits along with other income tax cash flows as an operating activity in the statement of cash flows. This change eliminates the current practice of grossing up the cash flow statement for the effect of windfalls, i.e., reporting windfalls as outflows in operating activities and 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.

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. The accounting policy election applies only to awards with service conditions; 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. An

entity that elects an accounting policy 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. The entity should reverse compensation cost previously recognized when an award is forfeited before the completion of the requisite service period (the reversal is recognized in the period the award is forfeited). Therefore, regardless of the policy election, compensation cost will be recognized for all awards that ultimately vest.

The accounting for non-forfeitable dividends (and 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., compensation expense). If an entity elects to estimate forfeitures, compensation expense will be recognized at the time dividends are paid based on the entity's forfeiture estimate, consistent with current guidance. In subsequent periods, dividends will be reclassified between retained earnings and compensation cost when the forfeitures estimate changes or when actual forfeitures differ from previous estimates. If forfeitures are accounted for when they occur, dividends will be reclassified from retained earnings to compensation cost in the period in which the forfeiture occurs.

Regardless of the policy election, estimating forfeitures is still required when (a) accounting for an award modification and (b) accounting for a replacement award in a business combination. A modification of the terms or conditions of an equity award generally results in incurring additional compensation cost for any incremental value. When measuring the effect of a modification, an entity must assess, on the modification date, whether the performance or service conditions of the original award are expected to be satisfied regardless of its accounting policy. However, the entity would apply its accounting policy to subsequent accounting for the modified award. Similarly, when measuring the effect of replacement awards on goodwill in a business combination an acquirer must determine expected forfeitures for the portion of a nonvested replacement award included in the consideration transferred (i.e., the purchase price). Post-acquisition changes in estimated forfeitures of replacement awards included in the purchase price should be recognized in compensation cost (not an adjustment to goodwill). If an entity's policy is to account for forfeitures when they occur, the amount excluded from goodwill because of the forfeiture estimate should be attributed to post-acquisition services and recognized in compensation over the requisite service period and be adjusted only when forfeitures 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). In other words, a partial cash-settlement³ 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.

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. Further, the amount withheld cannot exceed the maximum statutory rates in applicable jurisdictions. This exception is intended to apply by using a single maximum rate in a jurisdiction as a "ceiling" on withholding tax, i.e., 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 a jurisdiction.

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. All other employer withholding taxes on compensation transactions and other events that enter into the determination of net income continue to be presented within operating activities.

³ Partial cash-settlement or "net settlement" is a feature used in share-based awards requiring the employer to withhold shares to meet an employer's tax-withholding requirements.

Expected term of awards

A nonpublic entity can make an accounting policy election to prospectively apply a practical expedient to estimate the expected term for all awards with performance or service conditions.⁴ If elected, it 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 practical expedient does not apply to awards with 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.

Intrinsic value election for liability classified awards

A nonpublic entity can 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 250.⁵

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. Because this guidance was never implemented, the elimination will not impact current practice.

EFFECTIVE DATE AND TRANSITION:

For public business entities, the amendments are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods.⁶ 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 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.

⁴ Public entities have an accounting policy choice to estimate the expected terms of certain “plain vanilla” share options under Staff Accounting Bulletin (SAB) Topic 107 & 110 - application of the “simplified method”.

⁵ Accounting Changes and Error Corrections

⁶ While the scope of ASC 718 has not been amended, paragraph BC38 of the Basis for Conclusions of the ASU clarifies that the ASC Master Glossary definition of a “public business entity” included in ASU 2013-12 is to be used for determining the effective date of the amendments. However, the Topic 718 definitions of “public entity” and “nonpublic entity” are used to determine eligibility for the practical expedients in ASU 2016-09 (i.e., the expected term and intrinsic value elections).

Amendments related to the timing of when off-balance sheet net operating losses from excess tax benefits are recognized, the exception to liability-classification for statutory withholding requirements, the forfeitures accounting policy election, and the one-time intrinsic value election 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.

Amendments related to the presentation of employee taxes paid on the statement of cash flows when an employer withholds shares to meet the minimum statutory withholding requirement should be applied retrospectively.

Amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement and the practical expedient for estimating expected term should be applied prospectively.

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.

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