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BDO **FLASH** REPORT
FASB

SUBJECT

FASB ISSUED EXPOSURE DRAFT OF ACCOUNTING PROPOSALS INTENDED TO SIMPLIFY AND IMPROVE THE ACCOUNTING FOR SHARE-BASED PAYMENTS

PREFACE

On June 8, 2015, the Financial Accounting Standards Board ("FASB" or "Board") issued an Exposure Draft ("ED") containing a proposed Accounting Standards Update ("ASU") to amend ASC Topic 718, *Compensation – Stock Compensation*. The ED is the culmination of the FASB's share-based payments accounting simplification project initiated in 2014.

The tax accounting for share-based payments is one of the most complex areas in current U.S. Generally Accepted Accounting Principles ("GAAP"). Some requirements of the current model have led to unintended consequences and significant compliance costs. These proposals are designed to simplify the accounting, reduce compliance costs, and improve the decision-usefulness of information presented in financial statements.

The ED has six proposals which apply to all entities and two proposals which apply only to non-public entities. They cover several aspects of the accounting for share-based payments including income tax accounting, award classification, cash flow presentation, accounting for withholding taxes paid with shares, forfeitures, an award's expected term, and a measurement option. These proposals represent significant steps toward simplifying and improving certain pretax and tax accounting requirements of the current model and are expected to have a broad-reaching effect on both private and public companies of all industries.

DETAILS:

The following six proposals apply to *all* entities:

1. **Accounting for Income Taxes upon Vesting or Settlement of Share-Based Payments.**

   The proposal requires (a) the recognition of all tax effects (i.e., excess benefits or windfalls and shortfalls) related to share-based payments in income tax expense, and (b) the elimination of off-balance sheet accounting for net operating losses ("NOLs") stemming from windfall tax benefits – i.e., excess benefits would be recognized even when they do not reduce income tax payable in the current period (off balance sheet NOLs existing on the effective date would be recorded on the balance sheet and assessed for realization to determine whether a valuation allowance is required).

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

2. Cash Flow Presentation of Windfall Tax Benefits.

The proposal requires excess tax benefits to be shown within operating activities. This proposal is consistent with the decision to eliminate equity accounting for all tax effects related to share-based payments and instead require recognition of the tax effects in income tax expense.

Under the current model, excess tax benefits that reduce the amount of income taxes a company will pay on its tax return are required to be presented as a cash inflow from financing activities and a cash outflow from operating activities.

3. Accounting for Share Award Forfeitures.

The proposal requires electing an entity-wide accounting policy to either estimate forfeitures (i.e., current GAAP) or account for forfeitures as they occur. The accounting policy election would only apply to awards with service conditions; awards with performance conditions would still be assessed at each reporting date to determine whether it is probable that the performance condition will be achieved. Estimation of forfeitures would still be required when (a) accounting for an award modification, and (b) accounting for a replacement award in a business combination. An accounting policy election to account for forfeitures when they occur would result in reversing compensation costs 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). Dividends paid while an option is outstanding which do not have to be paid back upon forfeiture would be reclassified to compensation cost in the period in which the forfeiture occurs (i.e., they would result in a charge).

Under the current model, entities are required to estimate the number of share-based payment forfeitures (awards that will not vest) when determining the amount of compensation cost to be recognized over the vesting period (i.e., the accrual of compensation costs is based on the estimated number of awards that will vest). Companies are then required to revise their estimates based on actual results (e.g., previously recognized compensation cost is reversed upon award forfeiture). This procedure can be complex and time consuming (and thus costly).

4. Minimum Statutory Tax Withholding Requirements

The proposal requires that a partial cash-settlement for withholding tax up to the maximum individual statutory withholding tax rate (in the applicable jurisdictions) would not by itself require liability-classification. That is, states that a statutory obligation to withhold tax on an employee's behalf would not cause liability classification if the amount withheld does not or cannot exceed the employee's maximum individual statutory rate in a given jurisdiction. The FASB observed that a single "maximum" statutory rate for a given jurisdiction would need to be determined and not a "maximum" rate per individual in a given jurisdiction. The maximum individual statutory tax rates would be based on rates required by the relevant tax authority (or authorities, for example, federal, state, and local) and provided in tax law, regulations, or the authority's administrative practice.

The classification of a share-based payment is significant because it determines whether the award's grant-date fair value is fixed (equity classification) or is subject to periodic fair value adjustments recognized through earnings (liability classification). Today's accounting requires liability classification of an award with a repurchase provision such as net-settlement payment if tax in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion.

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

5. **Cash Flow Presentation of Employee Payroll Taxes When Shares are Withheld by Entity to Pay Minimum Statutory Withholding Tax.**

   The proposal requires that tax "paid" with shares withheld by the entity to cover the cash equivalent of the employee's tax be classified as cash flow from a financing activity rather than from an operating activity. That is, the "withholding" represents an in-substance treasury stock transaction.

   Under current accounting, a liability for employee payroll taxes on employee stock compensation is generally considered an operating expense included in cash flows from operations. However, diversity in practice emerged when shares are withheld to pay the employee's portion of payroll taxes (including minimum income tax) and some entities reclassify the credit from APIC to payroll tax liability and there is no expense recognition.

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

6. **Classification of Awards with Repurchase Features.**

   The proposal requires an assessment of whether a contingent repurchase event is probable of occurring before the employee bears the risks and rewards of equity share ownership for a reasonable period of time (a period of six months or more). This probability assessment would be required regardless of whether such event is within or outside of the employee's control. Equity classification would be required when it is not probable that the contingent event will occur before the employee bears the risks and rewards from equity share ownership for a reasonable period of time. That is, settlement of an award for cash or other assets is not probable.

   Currently, guidance differs regarding the assessment of repurchase features in stock awards (for example, puts and calls) depending on whether a contingency is within or outside of the employee's control.

The following two proposals only apply to *non-public* entities:

1. **Expected Term of Awards – Practical Expedient.**

   The proposal permits nonpublic companies to elect a practical expedient to estimate the expected term for all awards having service or performance conditions. If elected, it would apply to all qualifying awards. The expected term would be the midpoint between the vesting date and the contractual term for qualifying awards with a service condition; if vesting is conditioned upon satisfying a performance condition, an assessment would be made at grant date to determine whether it is probable that the performance condition would be achieved. If it is probable, the expected term would be the midpoint between the requisite service period and the contractual term; otherwise, the contractual term would be an appropriate estimate as it is more likely that the award would remain outstanding for the entire contractual term. The practical expedient would not apply to awards with a market condition.

   Under current rules, all entities are required to estimate the period of time that a share based award will remain outstanding, which for a private entity may be complex.

2. **Intrinsic Value Election for Liability Classified Awards.**

   The proposal would provide a one-time election for nonpublic companies to switch from a fair value measurement of liability-classified awards to an intrinsic value measurement. The election would be made as of the effective date of this proposal without the need for the entity to evaluate whether the change in accounting policy is preferable.

   Under current rules, private entities which did not elect upon initial adoption of Topic 718 to use intrinsic value to measure liability classified awards must use fair value measurement.

Effective Date, Transition Requirements, and Disclosures:

The Board did not set an effective date for the proposals and it intends to consider feedback to be obtained through the comment period in making this decision.

Generally, the proposed amendments which affect recognition and measurement would be transitioned in through a cumulative-effect adjustment to equity as of the beginning of the annual period in which the guidance is effective. The proposal to account for the excess tax benefits and tax deficiencies through income tax expense, as well as the practical expedient for estimating the expected term would be transitioned in on a prospective basis. The proposals related to the statement of cash flows classification would be applied retrospectively for all prior periods presented in the financial statements.

Certain disclosures would be required at transition, including the nature and reason for the change in accounting principle and quantitative information of the cumulative effect on retained earnings or additional paid in capital.

Comment Period

Comments on the proposed ASU are requested by August 14, 2015.