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FASB Issues Proposed ASU to Simplify the Accounting for Share-Based Payments

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Introduction

On June 8, 2015, the FASB issued a proposed ASU[1] on share-based payments as part of its simplification initiative (i.e., the Board's effort to reduce the cost and complexity of current U.S. GAAP while maintaining or enhancing the usefulness of the related financial statement information). The proposed ASU simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, minimum statutory withholding requirements, classification in the statement of cash flows, and classification of awards with repurchase features. In addition, the proposed ASU contains two practical expedients for nonpublic entities under which such entities can use the simplified method[2] to estimate the expected term of an award and make a one-time election to switch from fair value measurement to intrinsic value measurement for liability-classified awards.

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

Editor's Note: The proposed changes related to the accounting for income taxes (i.e., recognition of excess tax benefits and tax deficiencies within income tax expense or benefit in the income statement) are more consistent with IFRSs than current U.S. GAAP. Regarding the other proposed changes, IFRSs do not have similar guidance and do not contain a practical expedient.

Key Provisions of the Proposed ASU

Accounting for Income Taxes

Under current guidance, when a share-based payment award is granted to an employee, the fair value of the award is generally recognized over the vesting period and a corresponding deferred tax asset is recognized to the extent that it is tax-deductible. The tax deduction is generally based on the intrinsic value at the time of the exercise or vesting of the award, which results in a deduction that is greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the

[1] FASB Proposed Accounting Standards Update, *Improvements to Employee Share-Based Payment Accounting*.

[2] Question 6 of SEC Staff Accounting Bulletin Topic 14.D.2, "Expected Term," outlines a simplified method of estimating the expected term as the midpoint between the vesting term and the contractual term (i.e., the expected term = ((vesting term + original contractual term) ÷ 2).

financial statements. All excess tax benefits are recognized in additional paid-in capital (APIC), and tax deficiencies are recognized either in the income tax provision or in APIC to the extent that there is a sufficient APIC pool.

Under the proposed ASU, an entity would recognize all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement. This change would eliminate the notion of the APIC pool and significantly reduce the complexity and cost of accounting for excess tax benefits and deficiencies. Further, the ASU would eliminate the requirement to defer recognition of an excess tax benefit until the benefit is realized.

Example — Excess Tax Benefits

Assume the following:

- Company A grants a fully vested, nonqualified option with a strike price of $40 and a grant-date fair value of $30 to its employee in 20X1.
- The option is exercised in 20X2 when the share price is $80.
- The entity has a 40 percent tax rate for both years.

The income tax journal entries for 20X1 and 20X2 are shown below. In 20X1, compensation expense of $30 is recognized. The associated deferred tax asset and benefit of $12 ($30 × 40%) are recorded in the income tax entry. This entry would be the same under the proposed guidance as it is under current guidance.

Income Tax Journal Entries	Current Guidance		Proposed Guidance	
Dr. Deferred tax asset	12		12	
Cr. Deferred tax benefit		12		12

In 20X2, the award has an intrinsic value of $40 upon exercise of the option when the share price is $80. The intrinsic value exceeds the book expense of $30, resulting in an excess tax benefit of $10. The entity records two journal entries in 20X2:

- The first entry is the reversal of the 20X1 entry, which is the same under the proposed guidance as it is under current guidance.
- The second entry would differ under the proposal. Under current guidance, the tax deduction reduces current taxes payable by $16 (intrinsic value of $40 × 40%) and the $4 excess tax benefit ($16 – $12) is recorded in APIC. Under the proposed guidance, the $4 excess tax benefit is recorded in current tax expense, resulting in an incremental $4 net benefit in the income statement.

Income Tax Journal Entries	Current Guidance		Proposed Guidance	
Dr. Deferred tax expense	12		12	
Cr. Deferred tax asset		12		12
Dr. Current taxes payable	16		16	
Cr. APIC		4		n/a
Cr. Current tax expense		12		16

Editor's Note: Under the proposed ASU, all tax impacts associated with differences between the book expense and tax deduction are recognized through the income statement, resulting in an impact on an entity's effective tax rate since these differences are treated as permanent differences. The Board acknowledged that the proposed guidance would create volatility in an entity's effective tax rate but determined that all tax consequences of a compensation arrangement should be recorded in the income statement and that existing income tax disclosures should give users the reasons for the volatility. The Board also considered requiring entities to recognize all excess tax benefits and deficiencies in APIC but rejected that view.

The proposed guidance on recording excess tax benefits and deficiencies in the income statement has a corresponding impact on the computation of diluted earnings per share (EPS) when an entity applies the treasury stock method.[3] An entity that applies the treasury stock method under current guidance estimates the excess tax benefits and deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. However, under the proposed guidance, excess tax benefits and deficiencies are excluded from the calculation of assumed proceeds since such amounts are recognized in the income statement.

In addition to addressing the recognition of excess tax benefits and deficiencies, the proposed ASU provides guidance on the related cash flow presentation. Currently, excess tax benefits are viewed as a financing transaction and are presented as financing activities in the statement of cash flows. However, there is no cash receipt but only a reduction in taxes payable. Therefore, a reclassification is made in the statement of cash flows to reflect a hypothetical inflow in the financing section and a hypothetical outflow from the operating section.

Under the proposed ASU, excess tax benefits no longer represent financing activities since they would be recognized in the income statement; therefore, excess tax benefits are not separate cash flows and should be classified in the same manner as other cash flows related to income taxes. Accordingly, the proposal eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

Editor's Note: The proposal's requirement to present all tax effects under operating activities is likely to be welcomed since most practitioners and users find the current presentation confusing. That is, practitioners and users have a hard time understanding why a noncash reclassification related to income taxes is made within the statement of cash flows. The proposed guidance eliminates the need for this reclassification because all excess tax benefits would be recorded in the income statement and treated consistently with other income tax benefits.

The ASU proposes a modified retrospective approach under which entities would recognize previously unrecognized excess tax benefits upon adoption as a cumulative-effect adjustment in retained earnings, which eliminates the need to track unrecognized excess tax benefits for both new and existing awards. Further, the recognition of all excess tax benefits/deficiencies in the income statement and changes to the computation of diluted EPS would be applied prospectively.

An entity would also be required to apply the change in presentation in the statement of cash flows retrospectively to all periods presented.

[3] ASC 260-10-45-29 provides guidance on the application of the treasury stock method and what is included in assumed proceeds for share-based payment arrangements. For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Accounting for Forfeitures

The proposed ASU would allow entities to elect as an accounting policy either to continue to estimate the total number of awards for which the requisite service period will not be rendered (current requirement) or to account for forfeitures as they occur. This accounting policy election only applies to service conditions; for performance conditions, an entity would continue to assess the probability that such conditions will be achieved.

> **Editor's Note:** Paragraph BC13 of the proposed ASU's Basis for Conclusions indicates that the Board decided not to require all entities to account for forfeitures when they occur because "estimating forfeitures generally provides a more accurate reflection of periodic compensation cost." In addition, the calculation of diluted EPS should continue to be based on the actual number of nonforfeited awards regardless of the entity's accounting policy election related to the accounting for forfeitures.
>
> This practical expedient does not apply to (1) subsequent measurement of an award as a result of a modification or (2) the accounting for replacement awards exchanged in a business combination. In those circumstances, forfeitures must be estimated irrespective of an entity's accounting policy election since the estimate can affect the cumulative amount of compensation cost recognized.

The ASU proposes a modified retrospective approach under which entities that elect to recognize forfeitures as they occur would record a cumulative-effect adjustment to retained earnings as of the adoption date.

Statutory Withholding Requirements

The proposed ASU would modify the current exception to liability classification when an employer uses a net-settlement feature to withhold shares to meet the employer's minimum statutory tax withholding requirement. Currently, the exception only applies when no more than the number of shares necessary for the minimum statutory tax withholding requirement to be met is repurchased or withheld. The proposed ASU stipulates that the partial cash settlement of an award for statutory tax withholding purposes would not result, by itself, in liability classification of the award provided that the amount withheld for taxes does not exceed the employee's maximum individual statutory tax rate in the relevant tax jurisdiction.

> **Editor's Note:** The classification exception would not apply to entities that do not have a statutory tax withholding obligation; for such entities, any net settlement for tax withholding would result in a liability-classified award.

Further, to eliminate diversity in practice, the ASU proposes that cash payments to tax authorities in connection with shares withheld to meet statutory tax withholding requirements be presented as a financing activity in the statement of cash flows because such payments represent an entity's cash outflow to reacquire the entity's shares.

The ASU proposes a modified retrospective approach under which an entity would reassess outstanding liability awards as of the adoption date and determine whether the awards should be reclassified as equity awards with a cumulative-effect adjustment to retained earnings. An entity would be required to apply the change in presentation in the statement of cash flows retrospectively to all periods presented.

Classification of Awards With Repurchase Features

The accounting for repurchase features is complex and has resulted in diversity in practice. Although EITF Issue 00-23[4] was superseded by Statement 123(R)[5] (codified in ASC 718), many continue to apply Issue 00-23's provisions related to repurchase features by analogy. For instance, some believe it is appropriate to consider the probability of the occurrence of a contingent event that is within the control of an employee when the repurchase feature is in the form of a call right; however, others believe that probability should never be considered for a contingent repurchase feature (for both puts and calls) if the contingent event is within an employee's control. Accordingly, the Board decided to eliminate diversity in practice and concluded that irrespective of who controls the contingent event, if it is not probable that the contingent event will occur before the employee bears the risks and rewards normally associated with equity share ownership for a reasonable period, the award should be classified as equity unless it meets other criteria that require liability classification. This proposed guidance would apply to both put and call rights.

The proposed ASU prescribes a modified retrospective approach under which entities would reassess the classification of outstanding liability awards as of the adoption date. In circumstances in which the proposed guidance would require equity classification, an entity would record a cumulative-effect adjustment to APIC in accordance with the guidance on the modification of an award from liability classification to equity classification in ASC 718-20-55-135 through 55-138.

Practical Expedients for Nonpublic Entities

Expected-Term Practical Expedient[6]

The proposed ASU would allow nonpublic entities to use the simplified method[7] to estimate the expected term for (1) awards with only service conditions and (2) awards with performance conditions when it is probable that the performance conditions (or both performance and service conditions) will be met. If it is not probable that an award's performance conditions will be met, nonpublic entities applying the practical expedient would use the award's contractual term as the estimate for the expected term.

The proposed ASU would require nonpublic entities to apply the simplified method prospectively to all awards that are measured at fair value after the adoption date.

Intrinsic Value Practical Expedient

The proposed ASU would allow nonpublic entities to make a one-time election to switch from fair value measurement to intrinsic value measurement, without demonstrating preferability, for share-based payment awards classified as liabilities.

Further, the proposed ASU contains a modified retrospective approach under which nonpublic entities making the one-time election would measure outstanding liability awards as of the adoption date at intrinsic value, with a cumulative-effect adjustment to retained earnings. However, the proposed ASU would not allow nonpublic entities to make this one-time election after the proposal's effective date.

[4] EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44."

[5] FASB Statement No. 123(R), *Share-Based Payment*.

[6] ASC 718-10-30-20B (added by the proposed ASU) states that a "nonpublic entity . . . would apply the practical expedient to 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.
c. The employee cannot sell or hedge the award (the employee can only exercise the award).
d. The award does not include a market condition."

[7] See footnote 2.

Editor's Note: The proposed ASU's accounting policy election was also available to entities upon the initial adoption of Statement 123(R); however, at the time, some nonpublic entities were unaware of this policy election and therefore measured liability-classified awards at fair value. The proposed ASU offers nonpublic entities another opportunity to make this policy election.

Entities that meet the current definition in ASC 718 of a "public entity" rather than the definition of a "public business entity" in the *FASB Accounting Standards Codification* master glossary may not apply either the existing ASC 718 practical expedients for nonpublic entities or the proposed practical expedients for nonpublic entities. Although confusion may result from the number of definitions of a public entity in U.S. GAAP, the proposed ASU does not eliminate the definition of a public entity in ASC 718.

Transition Disclosures

The Board decided that upon adoption, an entity must provide all disclosures under ASC 250-10-50 for a change in accounting principle except those related to the income statement effect.

Effective Date

Although the proposed ASU does not contain an effective date, it requests that stakeholders provide comment-letter feedback on this topic.

Appendix — Questions for Respondents

The proposed ASU's questions for respondents are reprinted below for reference purposes.

Question 1: Do you agree that the proposed amendments result in a reduction (or potential reduction) of cost and complexity while maintaining or improving the usefulness of information provided to users of financial statements? If not, why?

Question 2: Should excess tax benefits and tax deficiencies be recognized in the income statement? If not, why, and are there other alternatives that are more appropriate? Should an entity delay recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable? If yes, why?

Question 3: Should the effect on tax cash flows related to excess tax benefits be classified as an operating activity on the statement of cash flows? If not, what classification is more appropriate and why?

Question 4: Should entities be permitted to make an accounting policy election either to account for forfeitures when they occur or to estimate forfeitures? If not, why?

Question 5: Is the proposed expansion of the exception to liability classification related to the amount withheld for employee's taxes appropriate? If not, is there another exception that is more appropriate and why?

Question 6: Should the cash paid by an employer to the taxing authorities when directly withholding shares for tax-withholding purposes be classified as a financing activity on the statement of cash flows? If not, what classification is more appropriate and why?

Question 7: When assessing the classification of an award with a repurchase feature that can only be exercised on the occurrence of a contingent event, should a contingent event within the employee's control be assessed in the same manner as a contingent event outside the employee's control? If not, why should there be a difference in the assessment?

Question 8: Is the practical expedient for nonpublic entities to estimate the expected term of all awards with performance conditions that affect vesting or service conditions appropriate? If not, are there other practical expedients that are more appropriate and why? Should the expedient be limited to nonpublic entities?

Question 9: Should nonpublic entities be allowed to make a one-time election to switch from measuring liability-classified awards at fair value to intrinsic value? If not, why? While not proposed, should the Board consider making the ability to elect intrinsic value an ongoing election alternative for nonpublic entities?

Question 10: Are the transition requirements for each area appropriate? If not, what transition approach is more appropriate?

Question 11: How much time will be necessary to adopt the amendments in this proposed Update? Should the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

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