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Easy Does It
FASB Simplifies the Accounting for Share-Based Payments

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This *Heads Up* supersedes our March 31, 2016, *Heads Up* on the FASB's simplification of the accounting for share-based payments. It contains revisions that reflect subsequent discussions with the FASB and SEC staffs related to entities' changes to the net-settlement terms of their share-based payment arrangements from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. The revised *Heads Up* notes that such changes would *not* be accounted for as a modification.

Background

On March 30, 2016, the FASB issued ASU 2016-09,[1] which 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, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance, which is part of the Board's simplification initiative,[2] also contains two practical expedients under which nonpublic entities can use the simplified method[3] 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.

Editor's Note: The FASB decided to eliminate the proposed ASU's amendments to the guidance on classification of awards with repurchase features. It decided not to align the classification guidance on put and call rights that are contingent on an event within the employee's control because feedback from some stakeholders indicated that doing so "would not achieve the objective of reducing complexity in classifying awards as equity or liabilities." The Board noted that it is considering a more comprehensive approach as part of a potential project to distinguish equity from liabilities.

[1] FASB Accounting Standards Update No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*.

[2] The simplification initiative is 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.

[3] 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)).

Key Provisions of the 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 the award is tax-deductible. The tax deduction is generally based on the intrinsic value at the time of exercise (for an option) or on the fair value upon vesting of the award (for restricted stock), and it can be either greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the 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" related to previously recognized excess tax benefits.

Under the ASU, an entity recognizes all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement.[4] This change eliminates the notion of the APIC pool and significantly reduces the complexity and cost of accounting for excess tax benefits and tax deficiencies. In addition, excess tax benefits and tax deficiencies are considered discrete items in the reporting period they occur and are not included in the estimate of an entity's annual effective tax rate.

The ASU's guidance on recording excess tax benefits and tax deficiencies in the income statement also has a corresponding effect on the computation of diluted earnings per share (EPS) when an entity applies the treasury stock method.[5] An entity that applies such method under current guidance estimates the excess tax benefits and tax deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. However, under the ASU, excess tax benefits and tax deficiencies are excluded from the calculation of assumed proceeds since such amounts are recognized in the income statement. In addition, the new guidance affects the accounting for tax benefits of dividends on share-based payment awards, which will now be reflected as income tax expense or benefit in the income statement rather than as an increase to APIC.

Further, the ASU eliminates the requirement to defer recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable.

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

[4] This change in guidance would apply to both share-based payment transactions and employee stock ownership plan transactions.

[5] 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*."

Example — Excess Tax Benefits (continued)

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 eliminates the deferred tax asset recorded in 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

In addition to addressing the recognition of excess tax benefits and tax deficiencies, the ASU provides guidance on the related cash flow presentation. Under existing guidance, 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 ASU, excess tax benefits no longer represent financing activities since they are recognized in the income statement; therefore, excess tax benefits are not separate cash flows and should be classified as operating activities in the same manner as other cash flows related to income taxes. Accordingly, the ASU eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

Editor's Note: The ASU's requirement to present all tax effects under operating activities may be welcomed since many practitioners and users find the current presentation confusing. That is, they have struggled to understand why a noncash reclassification related to income taxes is made within the statement of cash flows. The new guidance eliminates the need for this reclassification because all excess tax benefits are recorded in the income statement and treated consistently with other income tax benefits.

An entity should recognize all excess tax benefits previously unrecognized (because the related tax deduction had not been realized through a reduction in taxes payable), along with any valuation allowance, on a modified retrospective basis as a cumulative-effect adjustment to retained earnings as of the date of adoption. This eliminates the need to track unrealized excess tax benefits for both new and existing awards. In addition, the entity should prospectively apply the recognition of all excess tax benefits and tax deficiencies in the income statement, as well as related changes to the computation of diluted EPS.

Further, an entity may elect to apply the change in presentation in the statement of cash flows either prospectively or retrospectively to all periods presented.

Accounting for Forfeitures

The ASU allows an entity 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 (as currently required) or to account for forfeitures when they occur. This entity-wide accounting policy election only applies to service conditions; for performance conditions, the entity continues to assess the probability that such conditions will be achieved. An entity must also disclose its policy election for forfeitures.

This change affects other aspects of the accounting for share-based payments under ASC 718 as well. For example, under current guidance, nonforfeitable dividends paid on share-based payment awards that are not expected to vest are recognized as additional compensation cost (in a manner consistent with an entity's forfeiture estimate). If an entity elects to account for forfeitures when they occur, all nonforfeitable dividends are initially charged to retained earnings and reclassified to compensation cost only when forfeitures of the underlying awards occur. In addition, ASC 718-10-50-2(e) requires entities to disclose options expected to vest. Under the ASU, if an entity elects to account for forfeitures when they occur, the entity would disclose unvested 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" rather than options expected to vest. However, the change does not affect the calculation of diluted EPS, which continues to be based on the actual number of nonforfeited awards regardless of an entity's accounting policy election related to the accounting for forfeitures.

Editor's Note: 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." However, the accounting policy election described above does not apply to (1) the original award associated with the accounting for a modification in the measurement of the effects of the modification or (2) replacement awards exchanged in a business combination attributed to precombination service. In a modification, forfeitures related to the original award must be estimated since the estimate can affect the cumulative amount of compensation cost recognized, but the accounting policy for forfeitures will apply to the subsequent accounting for the modified award. In a business combination, forfeitures for the portion of the replacement award attributable to precombination service must be estimated since the estimate may affect the amount included as part of the consideration exchanged in a business combination, but the accounting policy for forfeitures will apply to the portion of the replacement award attributable to postcombination service. Compensation cost for postcombination service will include the amount excluded from the consideration exchanged (if excluded because the requisite service is not expected to be rendered) if an entity elects to account for forfeitures when they occur.

An entity that elects to account for forfeitures when they occur should apply the accounting change on a modified retrospective basis as a cumulative-effect adjustment to retained earnings as of the date of adoption.

Statutory Tax Withholding Requirements

The ASU modifies the current exception to liability classification of an award 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 new guidance stipulates that the net 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 maximum statutory tax rate in the employees' relevant tax jurisdictions.

Editor's Note: The new guidance significantly reduces the complexity of the exception to liability classification. Under current guidance, an entity is required to track the minimum statutory tax withholding requirement applicable to each specific award grantee in each applicable jurisdiction if shares are repurchased or withheld. Under the new guidance, the maximum rate is determined on a jurisdiction-by-jurisdiction basis even if that rate exceeds the highest rate applicable to a specific award grantee. However, 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.

For statutory tax withholding purposes, some entities may change the net-settlement terms of their share-based payment arrangements from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. While this change may be made to existing awards, entities would *not* account for it as a modification of those awards pursuant to ASC 718-20-35-3.[6] This accounting treatment applies only in these narrow circumstances (i.e., solely to change the net-settlement provisions from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate for statutory tax withholding purposes) and should not be analogized to other situations.

Further, to eliminate diversity in practice, the ASU requires 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.

An entity would reassess outstanding liability awards as of the adoption date and determine whether the awards should be reclassified as equity awards. Any change should be applied on a modified retrospective basis as a cumulative-effect adjustment to retained earnings as of the date of adoption. Any change in presentation in the statement of cash flows would be applied retrospectively to all periods presented.

Practical Expedients for Nonpublic Entities

Expected-Term Practical Expedient[7]

The ASU allows nonpublic entities to use the simplified method[8] to estimate the expected term for awards with service or performance conditions that meet certain requirements. Such entities would apply this practical expedient as follows:

- For awards with only a service condition, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term of the award.
- For awards with a performance condition, the estimate of the expected term would depend on whether it is probable that the performance condition will be achieved:

[6] Because a "modification" is defined broadly in ASC 718-20-20 as a "change in any of the terms or conditions of a share-based payment award," we considered an alternative view that a change in the net-settlement provisions for withholding purposes would be accounted for as a modification. Under this view, if the original awards are expected to vest (on the basis of any service or performance conditions) on the modification date, a change in the manner of net settlement would generally not result in incremental compensation cost. However, if the original awards are not expected to vest on the modification date, any compensation cost recognized for the modified awards would be based on the revised fair value measurement on the modification date (as opposed to the original grant-date fair value measurement). During discussions with the FASB staff, we confirmed that in the narrow circumstances described in this Editor's Note, an entity would not be required to account for the change as a modification.

[7] ASC 718-10-30-20B (added by the ASU) states that a "nonpublic entity that elects to apply the practical expedient . . . shall 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 (typically 30–90 days) if the employee terminates service after vesting.
c. The employee can only exercise the award. The employee cannot sell or hedge the award.
d. The award does not include a market condition."

[8] See footnote 3.

- If it is probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term.
- If it is not probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as (1) the contractual term if the award does not contain an explicit service period or (2) the midpoint between the requisite service period and the contractual term if the award does contain an explicit service period.

Editor's Note: This practical expedient also applies to liability-classified awards measured at fair value, even if the award ceases to be at the money upon remeasurement. For these awards, an entity should update its estimate of the expected term at each reporting period until settlement, and such updated estimate should reflect any change in the assessment of whether it is probable that a performance condition will be achieved.

Nonpublic entities that elect to use the practical expedient should apply the practical expedient prospectively to all awards that are measured at fair value after the adoption date.

Intrinsic Value Practical Expedient

The ASU allows 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.

Nonpublic entities that make the one-time election would measure outstanding liability awards as of the date of adoption at intrinsic value and apply the change on a modified retrospective basis as a cumulative-effect adjustment to retained earnings as of the date of adoption. Nonpublic entities are not allowed to make this election on an ongoing basis after the effective date of the new guidance.

Editor's Note: The one-time election was also available to entities upon the initial adoption of FASB Statement 123(R);[9] however, at the time, some nonpublic entities were unaware of the option and therefore measured liability-classified awards at fair value. The ASU gives 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 ASC Master Glossary may not apply either the existing ASC 718 practical expedients for nonpublic entities or the ASU's practical expedients for nonpublic entities. Although confusion may result from the number of definitions of a public entity in U.S. GAAP, the ASU does not eliminate the definition of a public entity in ASC 718.

Elimination of ASC 718 Indefinite Deferral

The ASU eliminated certain guidance in ASC 718 on when awards cease to be within the scope of ASC 718 and instead become subject to other U.S. GAAP. Since that guidance was indefinitely deferred shortly after the issuance of FASB Statement 123(R), the ASU does not provide transition or effective date guidance since "the amendments do not change the application of current GAAP."

[9] FASB Statement No. 123(R), *Share-Based Payment* (codified in ASC 718).

Transition Disclosures

In the period of adoption, entities are required to disclose:

- The nature of and reason for the changes in accounting principle.
- Any cumulative effects of the changes on retained earnings or other components of equity as of the date of adoption.

In addition, because the change in presentation in the statement of cash flows related to excess tax benefits can be applied either prospectively or retrospectively, entities are required to disclose either (1) "that prior periods have not been adjusted" if the change is applied prospectively or (2) the "effect of the change on prior periods retrospectively adjusted" if the change is applied retrospectively. For the change in presentation in the statement of cash flows related to statutory tax withholding requirements, entities are required to disclose the "effect of the change on prior periods retrospectively adjusted."

Effective Date

For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods.

For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018.

Editor's Note: While the FASB retained the current definitions in ASC 718 of a "public entity" and a "nonpublic entity," an entity will determine the ASU's effective date on the basis of whether it meets the ASC Master Glossary's definition of a "public business entity."

Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance. If early adoption is elected, all amendments in the ASU that apply must be adopted in the same period. In addition, if early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period.

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