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EXEQUITY

Independent Board and Management Advisors

Client Alert

FASB Issues Update for Stock-Based Compensation Accounting

On March 30, 2016, the Financial Accounting Standards Board (FASB) released an update to Accounting Standards Codification 718, Stock-Based Compensation.[1] The FASB News Release announcing the ASU's release indicates that the changes being made are part of FASB's simplification initiative.[2]

The changes will be beneficial for companies and should streamline their administration of stock-based compensation plans. In that regard, two changes will be most beneficial to plan administration:

- Tax withholding in shares will now be permitted up to the maximum applicable statutory tax rate (previously, withholding shares above the minimum statutory tax rate threatened liability accounting for equity awards); and
- With respect to forfeitures, companies will be permitted to elect to either (1) account for forfeitures as they occur, or (2) estimate forfeitures and account for the equity awards that are expected to vest (which previously was the only option).

The ASU also makes a few other changes to accounting for stock-based compensation. Below is the summary chart provided by FASB concerning the accounting updates.

Current GAAP	Summary of Simplifications (i.e., the Updates)
Minimum Statutory Tax Withholding Requirements: One of the requirements for an award to qualify for equity classification is that an entity cannot partially settle the award in cash in excess of the employer's minimum statutory withholding requirements.	The threshold to qualify for equity classification permits withholding **up to the maximum statutory tax rates** [*emphasis added*] in the applicable jurisdictions.

[1] FASB Accounting Standards Update (ASU) No. 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, available at: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168028584.

[2] FASB News Release, FASB Issues New Guidance on Employee Share-Based Payment Accounting, March 30, 2016, available at: http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176168028957.

Current GAAP	Summary of Simplifications (i.e., the Updates)
Forfeitures: Accruals of compensation cost are based on the number of awards that are expected to vest.	An entity can make an entity-wide accounting policy election to **either estimate the number of awards that are expected to vest** (current GAAP) or **account for forfeitures when they occur** [*emphasis added*].
Accounting for Income Taxes: An entity must determine for each award whether the difference between the deduction for tax purposes and the compensation cost recognized for financial reporting purposes results in either an excess tax benefit or a tax deficiency. Excess tax benefits are recognized in additional paid-in capital; tax deficiencies are recognized either as an offset to accumulated excess tax benefits, if any, or in the income statement. Excess tax benefits are not recognized until the deduction reduces taxes payable.	All excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period.
Classification of Excess Tax Benefits on the Statement of Cash Flows: Excess tax benefits must be separated from other income tax cash flows and classified as a financing activity.	Excess tax benefits should be classified along with other income tax cash flows as an operating activity.
Classification of Employee Taxes Paid on the Statement of Cash Flows When an Employer Withholds Shares for Tax Withholding Purposes: There is no guidance on classification of cash paid by an employer to the taxing authorities when directly withholding shares for tax withholding purposes.	Cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity.
Practical Expedient—Expected Term: Entities are required to estimate the period of time that an option will be outstanding.	A **nonpublic entity** can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions.
Intrinsic Value: At initial adoption of Topic 718, Compensation—Stock Compensation, nonpublic entities were provided an option to measure all liability-classified awards at intrinsic value. Some nonpublic entities were not aware of that option.	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.

When Will These Changes in the Accounting Rules Apply?

- For **public** companies, the changes are effective for **annual periods beginning after December 15, 2016**, and interim periods within those annual periods.
- For **all other companies**, the changes 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.

What Should We Do Now?

Given these accounting changes, companies should:

- Review their current equity plans and determine whether they will need to be amended to permit withholding in shares up to (and including) the maximum statutory withholding rate, since many equity plans specifically prohibit withholding above the minimum statutory rate in order to avoid the potential for liability accounting for awards.
- Review the past several years of equity grants to determine how the estimated forfeitures compared to the actual forfeitures, and figure out which method would be preferable once the new accounting rules apply and provide the ability to elect from the two possible forfeiture methods.
- Determine the impact of accounting for excess tax benefits and tax deficiencies as an income tax expense or benefit in the income statement.
- Determine what impact classifying cash paid by the company for taxes when directly withholding shares for tax withholding as a financing activity will have.
- For nonpublic companies, determine whether to elect to apply a practical expedient to estimate the expected term of all awards meeting certain requirements.
- For nonpublic companies, determine whether to switch from measuring all liability-classified awards at fair value to intrinsic value.
- Determine whether to adopt these accounting changes early.

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