June 15, 2015

FASB Proposes Accounting Standards Update to Improve and Simplify Accounting for Stock Compensation under FASB ASC Topic 718

The Financial Accounting Standards Board (FASB) on June 8, 2015 released a proposed Accounting Standards Update (ASU) on its narrow-scope fast-track project to improve and simplify accounting for stock compensation under FASB Accounting Standards Codification (ASC) Topic 718. The proposed ASU is titled "Improvements to Employee Share-Based Payment Accounting" and is now subject to a public comment period that ends on August 14, 2015. The FASB decided to hold off on determining an effective date for the proposed ASU until feedback is received from the comment period.[1]

The topics for improvement and simplification were identified based on recently completed outreach efforts by the FASB staff as well as the Financial Accounting Foundation's (FAF) post-implementation review of the overall effectiveness of ASC Topic 718. The proposed ASU amends Topic 718 in the following eight areas:

Provision	Current Topic 718	Proposed ASU Revisions
Stock-for-Tax Withholding	Companies must limit stock-for-tax withholding transactions for equity awards to minimum statutory withholding rates or face liability accounting for the entire award.	Companies are permitted to use stock-for-tax withholding up to the highest applicable marginal tax rate for each tax jurisdiction. The requirement to limit withholding to the minimum required rate is eliminated.
Presentation of Stock-for-Tax Withholding on Statement of Cash Flows	There is no current guidance. As a result, diversity in practice exists in regard to the classification of cash paid to meet withholding requirements on the statement of cash flows.	Companies should report stock-for-tax withholding transactions as a financing activity on the statement of cash flows because the substance of the transaction is a repurchase of shares from employees.
Accounting for Award Forfeitures	Companies are required to estimate forfeitures for awards with service and/or performance vesting conditions when recognizing compensation cost over the requisite service (that is, vesting) period, with true-ups in event actual forfeitures differ from prior period estimates.	Companies are permitted to make an entity-wide accounting policy election for awards with service vesting conditions to either estimate forfeitures and true-up, or recognize forfeitures as they occur. This election is not permitted for awards with performance vesting conditions.

[1] Refer to our alert letter dated November 7, 2014 on our website at http://www.fwcook.com/alert_letters/11-7-14_FASB_Commences_Project_to_Improve_and_Simplify_Accounting_for_Stock_Compensation_under_FASB_ASC_Topic_718.pdf and our alert letter dated February 20, 2015 on our website at http://www.fwcook.com/alert_letters/02-20-15_FASB_Continues_Project_to_Improve_and_Simplify_Accounting_for_Stock_Compensation_under_FASB_ASC_Topic_718.pdf.

Provision	Current Topic 718	Proposed ASU Revisions
Accounting for Excess Tax Benefits and Deficiencies	If the tax deduction reported on a company's tax return for equity awards is more than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise exceeds fair value at grant), the effect of the "excess tax benefit" is reported as an increase to additional paid-in capital (referred to as the APIC pool) on the balance sheet. Conversely, if the tax deduction reported on the company's tax return is less than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise is less than fair value at grant), the effect of the "tax deficiency" is first offset against the APIC pool, and the remainder (if any) is recognized as an increase to income tax expense on the income statement.	Companies must recognize all excess tax benefits and deficiencies on the income statement, regardless of whether the tax benefit reduces taxes payable in the current period (because of, for example, a net operating loss). The APIC pool is eliminated. Thus, an excess tax benefit would reduce income tax expense and increase net income, and a tax deficiency would increase income tax and decrease net income.
Presentation of Excess Tax Benefits and Deficiencies on Statement of Cash Flows	Companies are required to present excess tax benefits both as financing cash receipt and operating cash payment on the statement of cash flows.	Companies are no longer required to separately present excess tax benefits on the statement of cash flows. Rather, excess tax benefits are commingled with other operating cash flows.
Classification of Awards with Contingent Repurchase Features	Awards with a puttable or callable repurchase provision that can occur less than 6 months after option exercise or share vesting are accounted for as liability awards. Awards with a repurchase provision that is contingent on an event within the employee's control (such as voluntary resignation) are accounted for as liability awards, regardless of whether the contingent event is probable of occurring or not. Awards with a repurchase feature that is contingent on an event outside the employee's control (such as change in control or initial public offering) are accounted for as liability awards if the contingent event is probable of occurring, and as equity awards if not probable.	Companies are to conduct a probability assessment on the contingent event to determine whether the award should be classified as equity or liability. If the contingent event is probable of occurring within 6 months of option exercise or share issuance, the award is classified as a liability. Conversely, if the contingent event is not probable of occurring within 6 months of option exercise or share issuance, the award is classified as equity. It is no longer relevant whether the contingent event is within or outside the employee's control.

Provision	**Current Topic 718**	**Proposed ASU Revisions**
Estimating Expected Term of Stock Option Award for Nonpublic Companies	Nonpublic companies must estimate the expected term of stock options in the same manner as public companies. That is, companies are to take into consideration the maximum contractual term, vesting period (expected term must at least include the vesting period), expected early exercise and post-vesting employment termination behavior, expected volatility, black-out periods, and employee age, length of service, and location demographics. The SEC staff provides for a simplified method to estimate expected term for plain vanilla stock options for companies that conclude their own historical option exercise experience does not provide a reasonable basis for estimating expected term, calculated as the midpoint between the vesting date and the maximum contractual term.	Nonpublic companies are permitted to elect to use the simplified method for awards with only a service-vesting condition and awards with a performance-vesting condition that is probable of attainment. Expected term under the simplified method is calculated as the midpoint between the vesting date and the maximum contractual term. For awards with a performance-vesting condition that is not probable of attainment, companies are to use the maximum contractual term.
Using Intrinsic Value Rather than Fair Value for Liability Awards for Nonpublic Companies	Nonpublic companies must make a policy decision as to whether to measure all liability awards using the preferable fair value method or the less complex intrinsic value method. Because the fair value method is regarded as preferable over the intrinsic value method, companies that elect fair value cannot revert to intrinsic value. Many nonpublic companies apparently did not take advantage of the intrinsic value election.	Nonpublic companies get a second chance and are permitted to make a one-time election to switch from measuring liability awards at fair value to intrinsic value.

The proposed ASU also codifies previous guidance that requires an award granted for past or future employee services to remain subject to the measurement and recognition provisions of Topic 718 for the entire existence of the award, unless the award is subsequently modified when the holder is no longer an employee.

The proposed amendments would transition to the new guidance on a modified retrospective basis through a cumulative-effect adjustment to equity as of the beginning of the fiscal year in which the guidance is effective, with some exceptions. The proposed amendments for the accounting for excess tax benefits and deficiencies and estimating expected term for nonpublic companies would transition to the new guidance on a prospective basis. The two proposed amendments dealing with presentation of stock-for-tax withholding and excess tax benefits and

deficiencies on the statement of cash flows would transition to the new guidance on a retrospective basis.

Implications

The proposed amendments dealing with stock-for-tax withholding, award forfeitures, repurchase features, and nonpublic company simplifications are likely to be favorably received by companies. The proposed amendment to run all income tax effects through the income statement could be controversial and draw adverse reaction during the comment period, however, due to the potential increase in the variability of reported income tax expense from period to period.

In light of the proposed amendment to increase allowable tax withholding from minimum required to maximum marginal tax rates, companies should review their stock plan documents to determine if a plan amendment is necessary and, if so, whether shareholder approval of the amendment is required.

******

General questions about this summary can be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by email at tmhaines@fwcook.com. Specific questions should be referred to the company's professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com.