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FASB Issues Accounting Standards Update on Employee Share-Based Payment Accounting Improvements

The Financial Accounting Standards Board (FASB) on March 30, 2016 issued Accounting Standards Update (ASU) 2016-09, which finalizes amendments intended to improve and simplify accounting for stock compensation under FASB Accounting Standards Codification (ASC) Topic 718 (topic 718). The issuance of ASU 2016-09 concludes this narrow-scope fast-track project. [1]

For public companies, ASU 2016-09 is effective for annual reporting periods beginning after December 15, 2016, and interim periods within those annual periods (that is, 2017 financial statements for calendar year companies). For nonpublic companies, ASU 2016-09 is effective for annual reporting periods beginning after December 15, 2017 (that is, 2018 financial statements for calendar year companies), and interim periods within annual periods beginning after December 15, 2018 (that is, 2019 quarterly statements for calendar year companies).

Importantly, early adoption of ASU 2016-09 is permitted in any interim or annual period for which financial statements have not been issued, but companies must adopt all of the guidance in the same period. For example, if a company wishes to early adopt to take advantage of the more favorable stock-for-tax withholding provisions, it must also early adopt all other provisions of the ASU including the potentially volatile income tax provisions discussed below.

The topics for improvement and simplification were identified during outreach efforts by the FASB staff as well as the Financial Accounting Foundation's (FAF) post-implementation review of the overall effectiveness of Topic 718. ASU 2016-09 amends Topic 718 in the following areas:

Provision	Current Topic 718	ASU Amendments
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 maximum individual statutory tax rate for each applicable tax jurisdiction. The requirement to limit withholding to the minimum required rate is eliminated The maximum statutory rate is based on federal, state, and local taxes and is determined on a jurisdiction-by-jurisdiction basis as opposed to individual basis

[1] Refer to our most recent alert letter on this topic dated December 21, 2015 on our website at http://www.fcowok.com/alert_letters/12-21-15_Improvements_to_Employee_Share-Based_Payment_Accounting-FASB_ASU.pdf. Additional alert letters on this topic are dated June 15, 2015, February 20, 2015, and November 7, 2014, and can be found on our website.

Provision	Current Topic 718	ASU Amendments
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 period (that is, the vesting period), with true-ups in the 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 For companies that elect to recognize forfeitures as they occur, the Form 10-K stock compensation footnote disclosure should provide information about nonvested awards rather than awards expected to vest
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 tax effects of exercised or vested awards are discrete items in the reporting period in which they occur, and they are not considered when determining the annual estimated effective tax rate The concept of 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 expense 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 income tax cash flows as an operating activity

Provision	Current Topic 718	ASU Amendments
Estimating Expected Term of Stock Option Awards 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 make an entity-wide accounting policy election to use the simplified method for stock options with a service-vesting condition, awards with a performance-vesting condition that is probable of attainment, and awards with a performance-vesting condition that is not probable of attainment but there is an explicit service period For awards with a performance-vesting condition that is not probable of attainment and no explicit service period, companies are to use the maximum contractual term Expected term under the simplified method is calculated as the midpoint between the vesting date and the maximum contractual term The election applies solely to stock options that are granted at-the-money, have limited post-termination exercise terms of no more than 90 days, are subject to anti-sale and hedging provisions, and do not have market vesting conditions
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 accounting policy election to switch from measuring liability awards at fair value to intrinsic value

Provision	Current Topic 718	ASU Amendments
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	The proposed ASU would have required companies 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 The FASB decided not to adopt the proposed ASU guidance in ASU 2016-09, but to perhaps address this issue as part of another project regarding distinguishing liabilities from equity

ASU 2016-09 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.

ASU 2016-09 is to be implemented using the following transition methods:

Prospective Transition Method – ASU amendments apply to transactions occurring after the date of the policy change, with recognition of the effect of changes in accounting estimates in the current and future periods. The ASU amendments do not apply to prior year financial statements
• The amendment to recognize all excess tax benefits and deficiencies on the income statement • The amendment to permit nonpublic companies to use the simplified method for determining the expected term of stock options or stock appreciation rights
Retrospective Transition Method – ASU amendments apply as if they had always been enacted and prior year financial statements are restated. With the retrospective transition method, the information in multi-period financial statements are more comparable
• The amendment to classify stock-for-tax withholding transactions as a financing activity on the statement of cash flows

Modified Retrospective Transition Method – ASU amendments apply as if they had always been enacted, but prior year financial statements are not restated. Rather, a cumulative-effect adjustment is recognized in equity in the period of adoption
• The amendment to permit stock-for-tax withholding up to the maximum individual statutory tax rate • The amendment to permit companies to elect to recognize award forfeitures as they occur • The amendment to recognize excess tax benefits regardless of whether the benefits are realized • The amendment to permit nonpublic companies to elect to measure liability awards at intrinsic value
May Elect to Use Either the Prospective or Retrospective Transition Method
• The amendment to present excess tax benefits as an operating activity on the statement of cash flows

Under all transition methods, companies are required to disclose the nature of and reason for the change in accounting principle as well as the cumulative effect of the change to equity or net assets. However, companies do not have to quantify the income statement effect of the change in the period of adoption.

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A complete summary of Topic 718 can be found on our website at http://www.fwcook.com/alert_letters/04-06-16_(ORIGINALLY_4-29-05)_-_Accounting_for_Stock_Compensation_Under_FASB_ASC_Topic_718.pdf

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.