Defining Issues®

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FASB Proposes to Simplify Accounting for Share-based Payments

The FASB recently issued a proposed Accounting Standards Update (ASU) intended to simplify the accounting for share-based payment transactions, which is part of the FASB's simplification initiative.[1] The proposal did not suggest an effective date. The FASB will determine the effective date and whether to permit early adoption after considering stakeholder feedback. The comment period ends August 14, 2015.

Key Facts

- Incremental current and deferred tax benefits or deficiencies of share-based payments at settlement or expiration would be recorded through the income statement instead of equity. Excess tax benefits would be classified as operating activities in the statement of cash flows.
- Entities would be permitted to make an accounting policy election to either estimate the number of forfeitures (current GAAP) or account for forfeitures when they occur.
- An award that is contingently redeemable for cash could be equity classified, with reclassification to a liability only required if the contingent event becomes probable – even if the employee controls its occurrence.
- Entities would be allowed to withhold up to the maximum individual statutory tax rate without classifying the awards as a liability. The cash paid to satisfy the statutory income tax withholding obligation would be classified as a financing activity in the statement of cash flows.
- Nonpublic entities would be allowed to use a practical expedient to determine the expected term of certain share-based awards. They also would be allowed to make an election to change the measurement basis for all liability-classified awards to intrinsic value.

Key Impact

- The proposed guidance is intended to reduce the cost and complexity of accounting for share-based payments. However, certain proposed changes could result in increased volatility in reported earnings.

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[1] Proposed Accounting Standards Update, Improvements to Employee Share-Based Payment Accounting, June 8, 2015, and the FASB's Simplification Initiative, available at www.fasb.org.

The proposed guidance would eliminate the need to track APIC pools but increase the volatility in reported earnings.

Entities would present excess tax benefits as an operating activity in the statement of cash flows.

Excess Tax Benefits and Deficiencies

Accounting and Cash Flow Classification of Excess Tax Benefits and Deficiencies

The difference between the deduction for tax purposes and the compensation cost recognized in the financial statements results in an excess tax benefit or tax deficiency.

Current GAAP	Proposed GAAP
• Excess tax benefits are recognized in additional paid-in capital (APIC). The accumulation of excess tax benefits is referred to as the APIC pool. Tax deficiencies are recognized either as an offset to accumulated excess tax benefits in the APIC pool, if any, or in the income statement.	• All excess tax benefits and tax deficiencies would be recognized as an income tax benefit or expense in the income statement. The APIC pool would be eliminated.
• Recognition of excess tax benefits is deferred until the benefit is realized through a reduction to current income taxes payable.	• The requirement to delay recognition of excess tax benefits until they are realized would be removed. Excess tax benefits would be recognized in the period they are deducted on the tax return.
• Excess tax benefits are separated from other income tax cash flows and are presented as a cash inflow from financing activities and cash outflow from operating activities.	• Excess tax benefits would be recorded along with other income tax cash flows as an operating activity.

Transition Requirements

The recognition of excess tax benefits and deficiencies and changes to the calculation of diluted earnings per share would be applied prospectively.

For tax benefits that were not previously recognized because the related tax deduction had not reduced taxes payable, entities would record a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption.

The change in the presentation in the statement of cash flows would be applied retrospectively to all periods presented.

KPMG Observations

Greater volatility in reported earnings likely would occur because all tax impacts associated with differences between the book expense and tax deduction would be recognized through earnings. The volatility would be the result of a combination of changes in the share price as well as the timing of exercise of share options and vesting of share awards.

There also would be changes to the denominator in the diluted earnings per share calculation when entities use the treasury stock method. One of the components for the assumed available cash to repurchase shares is the estimated excess tax benefits and deficiencies to be recorded in APIC. Under the proposal, those amounts would represent an element of future earnings and, therefore, would be excluded from the calculation.

The proposed changes to record excess tax benefits and deficiencies also would apply to awards under employee stock ownership plans.

The proposed change to record deferred taxes for excess tax benefits in the period of the deduction would require some entities to face difficult judgments about whether to record full or partial valuation allowances.

Entities would make an accounting policy choice to estimate forfeitures or record them as they occur.

Forfeitures of Awards That Do Not Vest

Forfeitures	
Current GAAP • Entities are required to estimate the number of awards that will vest when determining compensation cost.	**Proposed GAAP** • Would permit an accounting policy election to continue to apply current GAAP or to reverse compensation cost of forfeited awards when they occur.
Transition Requirements Entities that elect to recognize forfeitures as they occur would record a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption.	

KPMG Observations

Electing to account for forfeitures as they occur would create greater volatility in earnings if forfeitures occur unevenly throughout the vesting period.

The proposed change is for an election that would apply to all types of awards, including shares, share options, and employee stock purchase plans.

The Board's intent is to simplify the accounting for forfeitures related to an employee's failure to meet the award's service conditions, but still recognize the same cumulative compensation costs for the awards. Entities that grant awards with performance conditions would be required to continue assessing whether it is probable that the performance condition will be achieved. Compensation cost would continue to be based on the best estimate of the outcome of the performance condition. This practical expedient would not apply to modified awards or replacement awards in a business combination, because the difference in estimated forfeitures could affect the cumulative compensation cost for the awards.

Entities could be required to continue to recognize compensation cost for an award expected to be forfeited. This could occur if a large layoff in a future period is planned, but the award does not accelerate vesting upon involuntary termination.

Repurchase feature classification rules would be relaxed.

Classification of Awards with Repurchase Features

Balance Sheet Classification of Awards with Repurchase Features	
Current GAAP	**Proposed GAAP**
• There has been mixed practice when assessing repurchase features (put and call rights) that are contingent on an event within the employee's control. Some entities have concluded those contingent provisions lead to liability classification.	• Would eliminate the guidance on contingent puts that are within the employee's control. Entities would only have to consider whether a contingent event is probable of occurring, regardless of which party controls the occurrence of the contingent event.
Transition Requirements If a change from liability to equity classification is required, the final measurement of the liability prior to adoption would be reclassified to APIC.	

KPMG Observations

More awards with employee-controlled put rights may qualify for equity classification. A common example of a contingent provision in the scope of this proposal is one that allows an employee to force the redemption of an award for cash in the event of a voluntary termination.

The proposal would allow nonpublic entities and debt registrants that have a history of repurchases from put options exercised by former employees to classify the awards as equity until the contingent event becomes probable, assuming all other criteria for equity classification are met. If the contingent event becomes probable, only awards to affected employees would be reclassified.

Entities would be allowed to repurchase more of an employee's shares for tax withholding purposes than under current GAAP without resulting in liability classification.

For awards with contingent features linked to continued employment, the resolution of the contingency would likely be the period in which employees provide notice of their intent to leave. In some cases, entities may have advance notice, in which case the reclassification of the award would be sooner than when the employee terminates.

The amendment does not eliminate the requirement for temporary equity presentation for SEC registrants who issue awards with redemption features triggered by events outside of the issuer's control.[2]

Statutory Tax Withholding Requirements and Cash Flow Classification for Tax Remittances

Minimum Statutory Tax Withholding Requirements and Cash Flow Classification for Cash Paid by an Employer

Current GAAP	Proposed GAAP
• Requires an entire award to be classified and accounted for as a liability when more than the statutory minimum is withheld.	• The threshold to qualify for equity classification would permit withholding up to the maximum individual statutory tax rate in the applicable jurisdiction.
• There is no guidance on the cash flow statement classification of cash paid by an employer when withholding shares to meet withholding requirements. Most entities include the cash flow in financing activities.	• Cash paid when remitting cash to the tax authorities would be required to be classified as a financing activity.

Transition Requirements

Entities would record a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption. For purposes of determining the cumulative-effect adjustment, entities would not be required to determine the effect on retained earnings for awards already settled.

The change in the presentation in the statement of cash flows would be applied retrospectively to all periods presented.

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[2] EITF Issue No. D-98, Classification and Measurement of Redeemable Securities, available at www.fasb.org.

There are two proposed provisions that are only available to nonpublic entities.

KPMG Observations

The amendment would allow entities to determine a single maximum rate for all employees in a jurisdiction (rather than determining an individual rate), which could simplify withholding processes.

Some jurisdictions place restrictions on an employer's ability to unilaterally withhold more than the required amounts, which may limit the extent to which this proposal could be implemented.

Practical Expedients for Nonpublic Entities

Expected Term and Intrinsic Value Measurements	
The expected term using the simplified method is computed as the midpoint between the requisite service period and the contractual term of the awards.	
Current GAAP	**Proposed GAAP**
• Entities are required to estimate the expected term (the period of time that an option will be outstanding). • There are no special provisions for determining the expected term for awards with performance conditions.	• Would permit a policy election to use a simplified method to determine the expected term for awards with service conditions. This method would effectively assume exercise occurs evenly over the period from vesting until expiration. • For awards with performance conditions that are probable of achievement, the simplified method would be permitted. If meeting the performance condition is not probable, nonpublic entities would be required to use the awards' contractual term.
• At initial adoption of accounting guidance on share-based payments, nonpublic entities have an option to measure all liability-classified awards at intrinsic value.[3] Some nonpublic entities were not aware of that option.	• Would permit a one-time policy election to change from measuring all liability-classified awards at fair value to intrinsic value without considering preferability.

[3] FASB ASC Topic 718, Compensation – Stock Compensation, available at www.fasb.org.

Expected Term and Intrinsic Value Measurements

Transition Requirements

Nonpublic entities that elect the practical expedient to determine the expected term of an award would apply the simplified method prospectively to all awards measured at fair value after the adoption date.

Nonpublic entities making the one-time accounting policy election to change the measurement of liability-classified awards from fair value to intrinsic value would record a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption.

KPMG Observations

The proposed practical expedient to determine the expected term could be useful for nonpublic entities that do not have relevant historical data to objectively determine the expected term of share options and share appreciation rights.

The proposed one-time policy change to measure liability-classified awards at intrinsic value would offer nonpublic entities another opportunity to make this policy election. The election would only be available upon initial adoption of the proposed ASU.

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