Accounting for Income Taxes Implications of Changes to Accounting for Share-Based Payments

The Financial Accounting Standards Board ("FASB") recently issued an Accounting Standards Update ("ASU") intended to improve the accounting for share-based payment transactions as part of its simplification initiative.[1] This article is intended to summarize the accounting for income taxes implications of changes to accounting for share-based payments under U.S. generally accepted accounting principles ("U.S. GAAP").

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On March 30, 2016, the FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, as part of its initiative to reduce complexity in accounting standards. While the FASB intends for the ASU to reduce the cost and complexity of accounting for share-based payments, some changes could increase volatility in reported earnings. The areas of simplification in the ASU involve multiple aspects of accounting for share-based payment transactions, including accounting for income taxes consequences, a policy election on accounting for forfeitures, the impact of tax withholding on the classification of awards as either equity or liabilities, and the classification of tax withholding in the statement of cash flows, among other changes. This article solely focuses on the changes to the accounting for income taxes guidance included in the ASU; however, the impacts associated with accounting for the other non-income taxes related components of the ASU may also have accounting for income taxes consequences.[2]

[1] FASB Accounting Standards Update 2016-09, *Improvements to Employee Share-Based Payment Accounting*, March 30, 2016, and the FASB's Current Projects – Simplification Initiative, both available at www.fasb.org

[2] Refer to KPMG's Department of Professional Practice Defining Issues April 2016, No. 16-11 for a complete overview of ASU 2016-09, available at www.kpmg-institutes.com

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Generally, the exercise or vesting of nonqualified awards may result in ordinary income for the employee and a deduction for tax purposes for the employer equal to the intrinsic value of the award at that date.[3] In most instances, there is a difference between the amount and timing of compensation cost recognized for financial reporting purposes and compensation cost that is ultimately deductible for income tax purposes. As a consequence, ASC 718 requires that deferred taxes be recognized on temporary differences that arise with respect to the recognition of compensation cost for financial reporting that ordinarily results in a future tax deduction to the employer. The deferred tax asset related to compensation cost for financial reporting is not adjusted for changes in the intrinsic value of the award. Upon exercise or vesting of an award, the difference between the deduction for tax purposes and the compensation cost recognized for financial reporting creates an excess tax benefit (windfall) or tax deficiency (shortfall).

A comparison of current U.S. GAAP to the ASU is included below.

Accounting and Cash Flow Classification for Excess Tax Benefits and Deficiencies	
Current U.S. GAAP	***ASU 2016-09***
• Excess tax benefits are recognized in additional paid-in capital (APIC) on the balance sheet. 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 are recognized as an income tax benefit or expense in the income statement. The APIC pool is eliminated. • Excess tax benefits and deficiencies are recognized in the period they become deductible on the income tax return (generally when exercise, delivery or vesting occurs). They are not anticipated when determining the annual estimated effective tax rate. Instead, they are discrete items in the reporting period in which they occur.

[3] The amount and timing of deductions for share-based payments is dependent on the underlying tax law in the jurisdiction to which it relates.

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Current U.S. GAAP	***ASU 2016-09***
• Recognition of excess tax benefits is deferred until the benefit is realized through a reduction of current income taxes payable.	• The requirement to delay recognition of excess tax benefits until they are realized is removed.
• 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 in the statement of cash flows.	• Excess tax benefits are recorded along with other income tax cash flows as an operating activity in the statement of cash flows.

KPMG Observations

Greater volatility in reported earnings could occur because all effects associated with differences between the expenses and their income tax deduction will be recognized in the income statement. The volatility results from changes in the share price and the timing of exercise of share options and vesting of share awards.

The formula used for calculating diluted earnings per share under the treasury stock method no longer includes the estimated excess tax benefits and deficiencies that were recorded in APIC. Because that amount now represents future earnings, it is excluded from the calculation.

The ASU specifies that tax benefits and deficiencies also apply to awards under employee stock ownership plans.

Some entities could face difficult judgments about whether to record full or partial valuation allowances when they record deferred taxes for excess tax benefits.

Companies with net operating loss carryforwards related to excess stock compensation deductions will no longer have to maintain the tax benefits off-balance sheet.

The term *Excess Tax Benefits* has been removed from the Master Glossary of the Accounting Standards Codification.

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Potential Indirect Impacts on Accounting for Income Taxes

Companies should also consider potential indirect accounting for income taxes consequences as a result of other changes included in the ASU. For example, if a company elects to reverse compensation cost of forfeited awards when they occur, the change in total compensation cost would also change the deferred tax asset initially recorded. The indirect effects may require revisions to existing policies and processes which support the accounting for share-based payments and should be considered in determining the manner and impact upon adoption.

Effective Date

The ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities. It is effective for all other entities for fiscal years beginning after December 15, 2017, and interim periods within years beginning after December 15, 2018. Early adoption is permitted in any interim or annual period provided that the entire ASU is adopted.

Even if an entity early adopts the amendments after the first interim period, the adoption date is as of the beginning of the year for the issues adopted by the cumulative-effect and prospective methods. Any adjustments to previously reported interim periods of that fiscal year should be included in the year-to-date results. If those previously reported interim results appear in any future filings, they are reported on the revised basis.

Transition Requirements

The recognition of excess tax benefits and deficiencies and changes to diluted earnings per share are applied prospectively.

For tax benefits that were not previously recognized because the related tax deduction had not reduced taxes payable, entities record a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption, net of any valuation allowance required on the deferred tax asset created by the transition guidance (modified retrospective transition).

Entities may apply the presentation changes for excess tax benefits in the statement of cash flows using either a prospective or retrospective transition method.

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The elimination of the APIC pool does not have a direct financial reporting consequence at the time of adoption or subsequent to adoption.

Disclosure Requirements prior to Adoption

In the periods prior to adoption, a public entity should consider the following disclosures:

- Brief description of the new standard, the date adoption is required and the date the registrant plans to adopt (if earlier)
- Discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined
- Discussion of the impact of adoption or a statement that the impact is not known or reasonably estimable
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard

Disclosure Requirements upon Adoption

In the first interim and annual period of adoption, an entity shall disclose both of the following:

- The nature of and reason for the change in accounting principle
- The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

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The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

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