FASB Simplifies Accounting for Share-based Payments

The 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

Key Facts

- Entities record all excess tax benefits and tax deficiencies as an income tax benefit or expense in the income statement. Entities classify excess tax benefits as an operating activity in the statement of cash flows.
- Entities elect an accounting policy to either estimate the number of forfeitures (current U.S. GAAP) or account for forfeitures when they occur.
- Entities can 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 is classified as a financing activity in the statement of cash flows.
- Nonpublic entities can use a practical expedient to determine the expected term of certain share-based awards. They also can elect to change the measurement basis for all liability-classified awards to intrinsic value when they adopt the ASU.

The FASB decided not to finalize its proposal to require an entity to assess whether a contingent event that triggers a repurchase feature is probable of occurring, even if the contingent event is within the employee’s control.

Key Impact

- The FASB intends for the ASU to reduce the cost and complexity of accounting for share-based payments. However, some changes will increase volatility in reported earnings.


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## Excess Tax Benefits and Deficiencies

### Accounting and Cash Flow Classification for Excess Tax Benefits and Deficiencies

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

### Current U.S. GAAP

- 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.

### The ASU

- 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 are deducted on the income tax return. 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.

- 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 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.

### 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.

The ASU eliminates the requirement to track APIC pools, but increases the volatility in reported earnings.

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

KPMG Observations

Greater volatility in reported earnings likely will 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 will face difficult judgments about whether to record full or partial valuation allowances when they record deferred taxes for excess tax benefits.

Forfeitures

Forfeitures of Awards That Do Not Vest

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>The ASU</th>
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</thead>
<tbody>
<tr>
<td>• Entities are required to estimate the number of awards that will vest when determining compensation cost.</td>
<td>• Entities can elect to continue to apply current U.S. GAAP or to reverse compensation cost of forfeited awards when they occur.</td>
</tr>
<tr>
<td>• Replacement awards in a business combination that are expected to be earned are allocated between precombination service, which is added to goodwill, and postcombination service, which is recorded as compensation cost.</td>
<td>• If entities recognize forfeitures when they occur, the amount allocated to precombination service in a business combination is reduced by the estimated forfeitures and the amount allocated to postcombination service is not reduced.</td>
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</table>
The measurement basis is updated to its current fair value if an award previously expected to be forfeited is modified so that it is expected to be earned.

- If entities recognize forfeitures when they occur, the measurement basis also is revised if an award previously expected to be forfeited is modified but still is expected to be forfeited. The revised compensation amount is recognized until the forfeiture actually occurs.

### Transition Requirements

Entities that elect to recognize forfeitures as they occur will record a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption.

### KPMG Observations

E lecting to account for forfeitures as they occur will create greater volatility in earnings if forfeitures occur unevenly throughout the vesting period. This election applies to all types of awards, including shares, share options, and employee stock purchase plans.

The election applies to forfeitures for failing to meet service conditions. Compensation cost continues to be based on the best estimate of the outcome of awards with performance conditions.

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

### Tax Withholding Requirements and Cash Flow Classification

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

#### Current U.S. GAAP

- Entities account for an entire award as a liability when they withhold more than the statutory minimum.

#### The ASU

- Entities can withhold up to the maximum individual statutory tax rate in the applicable jurisdiction and classify the entire award as equity.

The ASU lets entities repurchase a greater number of an employee’s shares for tax withholding purposes without resulting in liability classification in contrast to current U.S. GAAP.
- There is no guidance on the cash flow statement classification of withholding shares to meet withholding requirements. Most entities include the cash flow in financing activities in the statement of cash flows.
- Cash paid when remitting cash to the tax authorities must be classified as a financing activity in the statement of cash flows.

### Transition Requirements

Entities 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 will 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 will be applied retrospectively.

### KPMG Observations

The ASU allows 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 result in implementation complexities if some employees do not authorize higher-than-required withholdings.

### Practical Expedients for Nonpublic Entities

#### Expected Term and Intrinsic Value Measurements

The ASU gives the option to use the simplified method to determine the expected term for awards with service conditions. The simplified method computes the expected term as the midpoint between the requisite service period and the contractual term of the awards.

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>The ASU</th>
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<tr>
<td>• Entities are required to estimate the expected term that an option will be outstanding. There are no special provisions to determine the expected term for awards with performance conditions.</td>
<td>• Entities can elect to use a simplified method to determine the expected term. This method effectively assumes that exercise occurs evenly over the period from vesting until expiration.</td>
</tr>
<tr>
<td>If the simplified method is elected, it applies to awards with service conditions and for performance conditions that are probable of achievement. If meeting the performance condition is not probable, nonpublic entities are required to use the awards’ contractual term if the service period is implied. If the service period is explicitly stated, the simplified method is required.</td>
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<td>At initial adoption of accounting guidance on share-based payments, nonpublic entities have an option to measure all liability-classified awards at intrinsic value. Some nonpublic entities were not aware of that option.</td>
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<td>Permits a one-time policy election to change from measuring all liability-classified awards at fair value to intrinsic value without considering preferability.</td>
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**Transition Requirements**

Nonpublic entities that elect the practical expedient to determine the expected term of an award 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 record a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption.

**KPMG Observations**

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

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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 those 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.

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