Accounting for Share-Based Payments is Simplified: What Does it Really Mean for Compensation Committees?

New guidance provides more flexibility to companies with the goal of reducing the cost and complexity of the current accounting model.

Why the change?

The Financial Accounting Standards Board (FASB) recently made a number of targeted changes to the accounting standards for share-based payments to employees in both public and nonpublic companies. It is important to note that while seemingly extensive and complex, the changes do not alter the underlying accounting principles for share-based compensation.

The FASB’s goal in releasing new guidance is to remove complexity from the current accounting model without altering the fundamental concepts that were put in place a decade ago under FASB Statement No. 123R, Share-Based Payment. Some of the rule changes will provide companies an alternative accounting method that may prove easier and less costly than the current model. In other cases, companies will be required to adopt a new (and hopefully simpler) accounting approach. Although the goal is simplification, the changes are likely to affect reported net income by many public and private companies.

Will the change have an immediate impact on compensation plan design?

With one exception, the new guidance is unlikely to have an effect on the design of share-based compensation arrangements. This exception concerns the update for stock-for-tax withholdings, i.e., a net settlement or share repurchase feature under which shares to be issued upon option exercise are withheld or repurchased to meet the employer’s statutory tax withholding requirement. Currently, if the compensation arrangement permits withholding in excess of the minimum individual statutory tax rate, the share-based awards

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1 Accounting Standards update (ASU) 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, issued March 30, 2016.
are accounted for as liabilities, which can create volatility in compensation expense. For that reason, compensation plans and employment contracts typically either prohibit share withholdings entirely or limit share withholdings to the minimum individual statutory tax rate. Under the FASB’s simplified approach, companies will have the ability to withhold shares sufficient to cover up to the maximum individual statutory tax rate for the applicable tax jurisdiction without treating the share-based awards as liabilities. We expect companies to be interested in amending their compensation arrangements as a result of this change in the accounting standards.

**When is the new guidance effective?**

The new accounting guidance can be implemented in 2016, although it is not required until the first quarter of 2017 for a calendar-year public company (2018 financial statements for calendar-year nonpublic companies).²

*Pearl Meyer Observation: The new guidance cannot be adopted piecemeal—all the requirements of the new guidance must be implemented simultaneously which is likely to require both time and resources. While the new guidance should simplify accounting, transition may require process, system, and internal control changes within finance, tax, and HR departments. Furthermore, companies will likely want to understand the net income and EPS consequences of the new accounting guidance prior to adoption.*

**What are the changes (in a nutshell)?**

Because the goal was targeted improvements to simplify the overall accounting model for share-based payments to employees, the new guidance affects a cross section of largely unrelated topics. In total, there are seven³ specific changes: five apply to both public and nonpublic companies and two affect only nonpublic companies.

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² For public companies, the new guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual periods. For nonpublic companies, the effective date is annual reporting periods beginning after December 15, 2017 and interim periods within annual reporting periods beginning after December 15, 2018. Both public and nonpublic companies can adopt early in any interim or annual period for which financial statements have not yet been issued.

³ Technically, there are eight changes. However, one change eliminates guidance that was indefinitely deferred and thus does not affect current accounting.
Those changes are summarized in the following chart.

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<tr>
<th>Topic</th>
<th>Current Accounting Model</th>
<th>New Accounting Model</th>
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<tr>
<td>1. Tax withholdings via a net settlement or share repurchase feature</td>
<td>Tax withholding in excess of the <em>minimum</em> individual statutory tax rate for the applicable tax jurisdiction results in liability accounting for the share-based award.</td>
<td>Tax withholding in excess of the <em>maximum</em> individual statutory tax rate for the applicable tax jurisdiction results in liability accounting for the share-based award.</td>
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<td>2. Forfeitures of awards when the required service is not rendered</td>
<td>Compensation expense is based on the estimated number of awards that will vest, with appropriate adjustments to reflect changes in estimates and actual forfeitures that differ from estimates.</td>
<td>Two alternative accounting policies are permitted. Compensation expense is based either on: (a) the estimated number of awards that will vest, adjusted for changes in estimates and actual forfeitures (current accounting model) OR (b) actual forfeitures as they occur.</td>
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<td>3. Excess tax benefits or tax deficiencies that arise when an employee exercises an option or vests in a share of stock</td>
<td>When the tax deduction for a share-based award is greater than the accounting expense, an excess tax benefit is created. When the tax deduction is less than the accounting expense, a tax deficiency arises. The current accounting model requires excess tax benefits to be recorded directly to shareholders’ equity (additional paid in capital); excess tax deficiencies are offset against previously recorded excess tax benefits, if any, or recorded as an expense in the income statement. Additionally, excess tax benefits are not recognized until the tax deduction reduces taxes payable.</td>
<td>All excess tax benefits and excess tax deficiencies are recognized in the income statement as income tax benefit or expense in the period in which they occur. Excess tax benefits are recognized as a reduction of income tax expense regardless of whether the benefit reduces taxes payable in the current period.</td>
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4 In accounting parlance, the excess tax benefits that are currently recorded to additional paid in capital create an “APIC pool.” Under the current accounting model, this “pool” of excess tax benefits is available to absorb excess tax deficiencies that arise when the tax deduction is less than the expense that was recorded for accounting purposes. Only when there is no “pool” of tax benefits is an excess tax deficiency recorded as income tax expense. The new accounting model eliminates the complexities of the “APIC pool.” Under the new approach, both excess tax benefits and excess tax deficiencies are recorded in income.
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<td><strong>4.</strong></td>
<td><strong>Cash flow statement classification of excess tax benefits</strong></td>
<td>Classify as a financing cash flow.</td>
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<td><strong>5.</strong></td>
<td><strong>Cash flow statement classification of tax withholdings via a net settlement feature</strong></td>
<td>Not explicitly addressed. Practice varies.</td>
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<tr>
<td><strong>6.</strong></td>
<td><strong>Estimating the expected term of a stock option (nonpublic companies only)</strong></td>
<td>Current accounting requires companies to estimate the period of time that an option will be outstanding based on its specific facts and circumstances. The SEC staff has provided public companies with a practical expedient, often referred to as the “simplified method,” in certain circumstances.</td>
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<td><strong>7.</strong></td>
<td><strong>Change in accounting policy for measuring liability awards (nonpublic companies only)</strong></td>
<td>Current accounting permits nonpublic companies to make an accounting policy election to measure liability awards at either fair value or intrinsic value. A nonpublic company that elected fair value to measure liability awards can change its policy to intrinsic value only if intrinsic value is preferable.</td>
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<td>A nonpublic company that elected fair value to measure its liability awards may change its policy to intrinsic value without evaluating the preferability of the new policy.</td>
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**How does transition to the new guidance work?**

The method for transitioning from the current model to the new model varies. For some changes, the new model is applied prospectively, i.e., to transactions that occur after the date the new standard is implemented. Prior year financial statements are not affected by these changes. For other changes, the new model is applied retroactively, i.e., as if the new model had been in effect in prior periods. Prior year financial statements are affected by these changes but the result is that the information presented for multiple periods is more comparable.
As a compensation professional, what do I really need to focus on?

In our view, the most significant changes to understand include new guidance for (1) tax withholding requirements, (2) forfeitures, (3) excess tax benefits and the APIC pool, and (4) for nonpublic companies only, the practical expedient alternative for estimating the expected term of stock options, all of which are discussed in more detail below.

Why were companies formerly limited to minimum tax withholding requirements? And what are the implications of allowing for maximum tax withholding?

By way of background, the accounting model for share-based payments distinguishes between awards that are classified as equity and awards that are classified as liabilities. The amount of compensation for awards that are classified as equity is measured at grant date, making the amount that will be recognized as an expense each accounting period somewhat predictable. In contrast, awards that are classified as liabilities are re-measured every accounting period until the award is settled, creating uncertainty and volatility in the amount of expense reported in an accounting period. For this reason, companies are typically very sensitive to compensation arrangements that would result in the award’s classification as a liability.

Conceptually, a share-based award that permits a net settlement feature (or share repurchases) for purposes of tax withholdings would be a liability. However, the current accounting literature provides a narrow exception to this result: a net settlement feature in an award does not require the award to be classified as a liability so long as the allowable net share settlement (or share repurchase) does not exceed the number of shares required to meet the minimum tax withholding requirement for the individual employee in the applicable tax jurisdiction for that employee.

The FASB decided that the narrow exception to liability classification in the current literature is complex because it requires determining minimum withholding requirements on an employee by employee basis. In addition, it results in tension between the company’s compliance with the accounting rules and its compliance with its legal obligation to withhold at least the minimum. For these reasons, the FASB changed the accounting rules in two respects. First, under the new rules, stock-for-tax withholdings may be up to the maximum individual tax rate without resulting in liability classification. This aspect of the change alleviates the tension between the tax and accounting rules. Second, the company is required to determine only one maximum tax rate in each jurisdiction rather than determining a rate for each employee. This should significantly reduce complexity.

**Pearl Meyer Observation**: We expect companies whose compensation arrangements currently limit net settlement terms to the minimum statutory tax rate to be interested in changing this aspect of their compensation arrangements. This change could be done “prospectively,” i.e., for new awards, but it could also be done for existing awards.
Some companies may not currently permit tax withholdings via net share settlements either because of the complexity of the accounting rules or the negative consequences of inadvertently exceeding the minimum withholding limit. These companies may find the new accounting model more practical and may want to consider adding a net settlement feature for tax withholdings to their compensation arrangements, either for new awards or for both new and existing awards.

Changes to existing compensation arrangements to take advantage of this more practical accounting rule can be done at any time after the new standard is adopted. The accounting standard does not require that a change to the net-settlement terms of compensation arrangements be concurrent with the effective date of the new standard. However, it’s important to keep in mind, as mentioned above, that the new guidance cannot be adopted piecemeal to apply to only the tax withholding elements—all the requirements of the new guidance must be implemented simultaneously.

While we can all agree that new guidance on accounting for forfeitures is simpler, what are the implications of this change?

In accounting parlance, “forfeitures” represent awards that do not vest because the employee fails to render the required service. Under the accounting model for share-based payments to employees, no expense is recognized for forfeited awards. For example, assume Employee A receives an award of 100 shares of stock and the shares cliff vest after five years of service. If Employee A voluntarily resigns after, say, three years of service, no expense is ultimately recorded for those 100 shares.

The current accounting model requires companies to estimate expected forfeitures and to incorporate that estimate into the amount of compensation expense that is recorded over the period that employees provide service. As that estimate of expected forfeitures changes, companies are required to revise the amount of expense reported. Further, a “true-up” is required to reflect the difference between actual and estimated forfeitures. Gathering the information needed to support estimates, monitoring activity in order to assess the need to revise prior estimates, and tracking information in order to record the necessary “true-up” can be a time-consuming and potentially complex process.

The new guidance permits companies to elect a simpler policy of accounting for forfeitures when they occur. Under this acceptable alternative, no estimates or revisions of estimates or true-ups would be needed. In the example above, expense related to the award to Employee A would be recognized as Employee A provides service. At the time Employee A resigns, thereby forfeiting the 100 shares, the company would simply reverse the cumulative compensation expense recorded to date related to that award. The FASB considered requiring all companies to follow this simpler approach but ultimately decided to allow companies to choose between the current accounting model (which generally results in a more accurate reflection of periodic compensation expense) and the simpler model.
**Pearl Meyer Observation:** Both public and nonpublic companies are likely to find the new alternative accounting policy for forfeitures simpler and less costly. Accounting for forfeitures only when they occur eliminates the need for management to make estimates and provide their auditors with documentation to support their judgments. There also is no need to monitor for possible changes in events or circumstances that would require an update to estimated forfeitures and to create a robust system of internal controls around this estimate. Actual forfeitures will have to be tracked on a timely basis, however, so that the necessary adjustment can be made to income when the forfeiture occurs.

Importantly, the simpler model has the potential to result in somewhat unpredictable adjustments to income. The current accounting model, while a bit cumbersome, mitigates the effect of forfeitures on compensation expense by effectively pro-rating forfeitures over the entire vesting period. The simpler model recognizes the full effect of forfeitures as they actually occur.

**What is an “APIC pool” and do I really need to understand it?**

The concept of an APIC pool as it relates to excess tax benefits is confusing and hard. While FASB simplified the concept, elimination of the APIC pool may have the consequence of creating additional earnings volatility. The following provides background to demonstrate the impact of changing this complex accounting concept.

The amount of compensation expense for accounting purposes is typically measured at grant date (referred to as the “book expense”). When a company reports book expense in pretax income, it will also report a corresponding tax effect that is computed as the amount of the book expense multiplied by the company’s tax rate. In most cases, this tax effect—a tax benefit—is deferred because the tax rules require the deduction to be reported when the share vests or the option is exercised. As a simple example, if the book expense is $100 and the tax rate is 35%, the company will report a pretax expense of $100 and a tax benefit (reduction income tax expense) of $35. The “other side of the journal entry” for the $35 tax benefit is a deferred tax asset. That asset will remain on the company’s balance sheet until the deduction is reported in the tax return.

In contrast, the amount of compensation expense that is reported by the company as a deduction on its tax return is typically measured on the date the share vests or the option is exercised (referred to as the “tax expense”). In many (but not all) cases, the amount of the tax expense related to the share-based award will be greater than the amount of the book expense because the company’s stock price will have increased since the grant date. Following the above example, if the value of the award on the date it vests is $300, the tax expense will exceed the book expense by $200, providing the company with a substantially larger tax benefit than the $35 that is sitting in deferred tax assets. Specifically, the excess tax benefit in
this simple example is $70 (total tax benefit of $300 x 35% = $105 less the $35 tax benefit in deferred tax assets = $70 of excess tax benefits). In short, when the tax expense is more than the book expense, the company receives an “excess tax benefit”. And when the tax expense is less than the book expense, the result is an “excess tax deficiency.”

Interesting accounting debates arose over how to account for these excess tax benefits and deficiencies. Should they be reported in income? Should they be excluded from income and recorded directly to shareholders’ equity? Should deficiencies be accounted for the same as benefits? When issuing FASB Statement No. 123R in 2005, the FASB concluded that excess tax benefits should be excluded from income and reported as a direct addition to equity (specifically, to additional paid in capital, or APIC). The FASB also decided that excess tax deficiencies should be reported in income (an increase to tax expense) but only to the extent that the deficiencies exceeded the cumulative amount of benefits that had been recorded in APIC. Accountants refer to the “pool” of cumulative excess tax benefits, net of any deficiencies, as the “APIC pool.”

The complexities underlying the APIC pool were so multifaceted that it was a ripe for reconsideration by FASB in its project to simplify the rules. The new accounting rules eliminate the APIC pool. Instead, all excess tax benefits and tax deficiencies will be reported in income (as reductions or increases in income tax expense).

Unlike forfeitures, where companies can choose between alternative accounting policies, all companies will be required to account for excess tax benefits and deficiencies as adjustments to income tax expense.

Pearl Meyer Observation: Although the new accounting model is easier to explain and eliminates some of the complexity in the share-based payment model, transitioning to the new accounting model for excess tax benefits and deficiencies may not be that simple. Companies will still need to identify and measure excess tax amounts and public companies with quarterly reporting requirements will need to set up processes that allow this to happen on a timely basis so that the appropriate adjustments to income tax expense can be made on a quarterly basis. Additionally, income tax expense—and thus net income—will be unpredictable because the timing of these excess tax effects is driven by either employee exercise patterns or employee vesting schedules. Companies that make extensive use of share-based awards in their compensation programs and experience significant volatility in their stock price are likely to see some amount of volatility in their quarterly and annual results as a result of the new accounting.
Why should nonpublic companies care about the new practical expedient for estimating the expected term of stock options?

Companies using Black-Scholes to value stock options are required to estimate when the stock option will be exercised, i.e., the expected term of the option. Making these estimates requires some objective evidence (such as past history) and judgment. To help newly public companies with little in the way of past history, the SEC staff has permitted the use of a simplified method for estimating expected term in limited circumstances. However, the SEC staff guidance was specific to public companies and thus was not a part of the official accounting literature for nonpublic companies. In its simplification project, the FASB decided to address this difference between public and nonpublic companies by creating a practical expedient specifically for nonpublic companies.

The FASB’s new practical expedient to estimating the expected term of stock options for nonpublic companies is modeled after the simplified method for public companies permitted by the SEC staff. However, there are some differences that may provide additional relief for nonpublic entities.

For example, the FASB’s practical expedient for nonpublic entities can be applied to more types of stock option awards. In addition, the new guidance from the FASB allows a nonpublic company to adopt the practical expedient as its accounting policy. By comparison, public companies can use the SEC staff simplified method only when certain restrictive conditions are met. Therefore, even nonpublic companies that may have been analogizing to the simplified method permitted by the SEC staff guidance may find the FASB’s new guidance helpful.

What should I take away from these changes and discuss in my committee meetings?

The complexities of FASB standards render the new guidance difficult to digest for non-accountants. However, committee members should be informed that the fundamentals for accounting for share-based payments to employees have not been materially changed. From a compensation perspective, the most significant takeaways include:

- **Tax Withholdings**: Consideration should be given as to whether plan documents should be amended to permit more flexibility in stock-for-tax withholding. While such a change may offer a benefit to executives, companies must be mindful that this accounting change cannot be adopted in isolation—the standard must be changed for all the other accounting revisions as well.
- **Forfeitures**: The new alternative approach to accounting for forfeitures has the potential to result in somewhat unpredictable adjustments to income by recognizing the full effect of forfeitures as they actually occur.
- **Excess Tax Benefits**: Under the new guidance, income tax expense and net income may be more unpredictable because the timing of these excess tax effects is driven by either employee exercise patterns or employee vesting schedules. Companies with both
large equity programs and volatile stock prices are likely to see more volatility in their quarterly and annual results.

- Estimates of a Stock Option’s Expected Term (Nonpublic Companies): When valuing stock options, nonpublic companies can now make an accounting election that simplifies the estimate of a stock option’s expected term.

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