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ASU 2016-09, Improvements to Employee Share-Based Payment Accounting

On March 30, 2016, the FASB issued Accounting Standards Update (ASU) 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC 718, Compensation – Stock Compensation.

ASU 2016-09 simplifies the accounting for share-based payments in several key areas, summarized as follows:

Income Taxes

Eliminates the separate tracking requirements created by deductions in excess of compensation cost (windfalls) and tax deficiencies (shortfalls), which were historically tracked in "memo accounts," and not recorded through the income statement. All tax effects related to share-based payments will now be recorded through the income statement, as windfall tax benefits will be recognized at the time of settlement. We expect the volatility of income tax expense to increase as a result of this simplification, and we expect this to create a positive impact on net income after taxes by increasing the deferred income tax benefit in most cases. The example below (Exhibit A, page 3) demonstrates how the deferred income tax benefit could be increased:

- ABC Company grants 800,000 nonqualified stock options on 1/1/16 with a $3 exercise price, which is equal to the grant-date stock price. The options are considered an equity award, and the grant date fair value is $1.50. The options have 3-year cliff vesting.
- On January 1, 2019, 800,000 options vest and are exercised. The price of stock is $5 on January 1, 2018.
- ABC Company is expected to have a large enough taxable income to cover any deductions for all tax periods, and its applicable tax rate is 40%.

Earnings per share will be diluted because excess tax benefits will no longer be recognized through additional paid-in capital (APIC).

Income tax benefits from dividends on stock awards will be recorded in the income statement, as opposed to APIC.

Forfeitures

Entities will be permitted to make an accounting policy election to either estimate forfeitures each period, as currently required, or to account for forfeitures as they occur. This will simplify accounting for many early-stage companies with few employees and low turnover. However, certain events may create a need to estimate forfeitures, such as a replacement award in a business combination.

Minimum Statutory Tax Withholding Requirements

Certain jurisdictions have minimum statutory withholding rates that vary by an employee's income level, which creates complex withholding situations for many companies to navigate. Under current guidance, if a company withholds taxes in excess of the employer's statutory minimum rate, the entire award must be recognized as a liability. ASU 2016-09 will allow employers to withhold the maximum statutory rate in jurisdictions with variable individual income tax rates, while still allowing the award to be classified as an equity award.

Nonpublic Entity-Only Simplifications

In considering the needs of private companies, the FASB included two provisions in ASU 2016-09 available to nonpublic entities. The first provision is a practical expedient for determining the expected term of share-based awards. The second provision allows for a one-time opportunity to change the measurement basis for all liability-classified awards to intrinsic value.

Effective Dates

- Public entities: Annual reporting periods beginning after December 17, 2017
- Nonpublic entities: Annual reporting periods beginning after December 17, 2018

Early adoption is permitted

Exhibit A

	Current Accounting	New Accounting
Compensation Cost	$800,000 options x $1.50 = $1.2 million $400,000 per year over three years	No change
Annual Deferred Tax Asset Recognized	$400,000 x 40% = $160,000	No change
Treatment of Taxes Upon Settlement	Deferred tax asset (DTA) on 12/31/18 = $1.2 million x 40% = $480,000	No change
	Tax deduction: $5 (stock price upon exercise) - $3 (exercise price) x 800,000 options - $1.6 million	No change
	Current tax benefit: $1.6 million x 40% = $6.4 million	No change
	Accounting for windfall benefit: Credit to APIC ($1.6m tax deduction - $1.2m book compen-sation cost = $400,000)	Accounting for windfall benefit: Credit to income tax expense for $1.6 million
	Pool of windfall tax benefits: Increased by $1.6 million	No windfall pool

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