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FASB Simplifies Accounting Rules for Stock-Based Compensation

The Financial Accounting Standards Board (FASB) recently amended ASC Topic 718 to simplify the accounting standards for stock-based compensation ("Amendment"). The Amendment is *not* a wholesale overhaul of Topic 718, but is narrowly crafted to modify several discrete areas of the standard that will affect public companies.

Notably, the Amendment will directly impact the tax administration of equity plans. Current accounting standards provide that an equity award will qualify for equity classification (i.e., resulting in fixed accounting treatment) if the fair market value of shares withheld to cover an employer's withholding obligations upon settlement of the award do not exceed the ***minimum*** statutory withholding requirement. If an equity plan permits share withholding in excess of this withholding requirement, equity awards granted under the plan currently would be subject to mark-to-fair value accounting (i.e., variable accounting). To avoid variable accounting, most equity plans routinely limit share withholding to the minimum withholding requirement.

Under the Amendment, an equity plan may now allow share withholding up to the *maximum* statutory withholding requirement while still avoiding variable accounting.

The Amendment may bring welcome relief to many high earners who receive equity grants. Due to the significant difference between the top marginal rate (i.e., 39.6% for federal income tax) and the minimum statutory withholding rate (i.e., generally 25% for federal tax withholding), an employee whose income is taxed at a rate greater than the minimum withholding rate could be required to pay quarterly estimated tax payments to make-up this difference, thereby avoiding potential tax underpayment penalties. The Amendment allows for a company to avoid this outcome by permitting share withholding up to the maximum withholding rates.

It is important to note that the Amendment does not require (but permits) companies to withhold shares up to the maximum statutory rate. A company may incur significant additional cash outflows to monetize shares withheld at to the maximum statutory rate. For this reason, some companies may choose to continue to withhold shares at the minimum rate or at some rate between the minimum and maximum rate. In light of this potentially adverse effect on cash flow, we recommend that equity plans grant the plan administrator discretion to withhold shares with a fair market value up to the maximum statutory withholding requirement.

The Amendment also made the following technical revisions to ASC Topic 718:

- **Forfeitures.** Under current GAAP, accruals of compensation cost related to share-based payments are required to reflect expected forfeitures. Under the Amendment, a company may continue to reflect expected forfeitures in compensation cost accruals or elect to account for forfeitures when they occur.

- **Classification of Employee Taxes Paid on Statement of Cash Flows When an Employer Withholds Shares for Tax-Withholding Purposes**. Currently, GAAP does not provide any guidance on classification of cash paid by an employer to the taxing authorities based on shares withheld to satisfy tax withholding obligations. Under the Amendment, such cash payments would be classified as a financing activity.

- **Accounting for Income Taxes**. Under current GAAP, a public company must determine whether the difference between the tax deduction and the recognized compensation cost for each equity award results in either an excess tax benefit or a tax deficiency. Excess tax benefits are recognized in additional paid-in capital; tax deficiencies are recognized either as an offset to accumulated excess tax benefits, if any, or in the income statement. Excess tax benefits are not recognized until the deduction reduces taxes payable.

  Under the Amendment, all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) would be recognized as income tax expense or benefit in the income statement.

- **Classification of Excess Tax Benefits on the Statement of Cash Flows**. Under current GAAP, excess tax benefits must be separated from other income tax cash flows and classified as a financing activity. Under the Amendment, excess tax benefits would be classified along with other income tax cash flows as an operating activity.

For public companies, the Amendment to ASC Topic 718 will become effective for annual reporting periods beginning after December 15, 2016, and interim reporting periods within such annual periods. Early adoption of the Amendment is permitted in any interim or annual period. If a company early adopts the Amendment in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. A company that elects early adoption must adopt all aspects of the Amendment in the same period.

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