Changes to Accounting for Employee Share-Based Payment

ASU 2016-09 May Increase Volatility of Diluted EPS

By Josef Rashty

In March 2016, FASB issued Accounting Standards Update (ASU) 2016-09, *Improvements to Employee Share-Based Payment Accounting.* The new guidance [codified under Accounting Standards Codification (ASC) Topic 718, "Compensation—Stock Compensation"] changes how companies account for certain aspects of stock compensation and is effective for public business entities (PBE) for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, it is effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. The new guidance permits early adoption for any interim or annual period.

The new guidance has the following two key provisions: 1) entities must record all excess tax benefits (windfalls) and tax deficiencies (shortfalls) as income tax benefits or expenses in their earnings (they were previously reflected in additional paid-in capital), and 2) entities have the option to elect an accounting policy to either estimate the number of granted stock awards forfeitures (similar to previous guidance) or account for them as they occur on an actual basis.

The focus of this article is the impact of these two provisions on calculations of diluted earnings per share (EPS). This article argues that the guidance may increase the volatility of diluted EPS calculations under certain circumstances.

Calculating Earnings per Share

EPS is one of the most complicated and important measures that PBEs present in their quarterly and annual reports. ASC Topic 260 provides accounting guidance for the calculation and reporting of EPS in PBEs.

Topic 260 defines two measures for the calculation and presentation of EPS:

- Basic EPS is calculated by dividing income available to common shareholders by the weighted-average number of common shares outstanding.
- Diluted EPS adjusts basic EPS for the hypothetical issuance of all potentially dilutive securities. The dilutives effect of call options, warrants, and stock compensation awards are calculated using the treasury stock method.

The treasury stock method is a method of recognizing the use of proceeds that could be obtained upon the hypothetical exercise of dilutive securities in computing diluted EPS. It assumes that proceeds would be used to repurchase common stock at the average market price during the period. The hypothetical shares repurchased under the treasury stock method reduce the number of shares outstanding in the denominator of diluted EPS; companies usually take into account the stock compensation awards that are considered dilutive. Antidilutive shares are excluded from the number of shares outstanding in calculations of dilutive EPS.

The assumed proceeds for the hypothetical repurchase of shares consist of the following (ASC 260-10-45-29):

- The total amount, if any, employees must pay upon the exercise of stock awards (this provision is applicable to stock options, but not to restricted stock units)
- The average amount of stock compensation attributed to future services and not yet recognized (average unrecognized stock compensation)
- The amount of excess tax benefits or deficiencies reflected in additional paid-in capital, if any.

Exhibit 1
Journal Entries

	Subject	Previous Guidance	New Guidance
1	Recording total stock compensation expense for first and second years.	Compensation expense $100 APIC $100	No change.
2	Recording the tax benefits for total compensation for two years ($100 × 40%).	Deferred tax assets $40 Deferred tax benefits $40	No change.
3	Reversing journal entry 2 upon exercise of stock awards.	Deferred tax benefits $40 Deferred tax assets $40	No change.
4	Calculating and recording tax expense.	Taxes payable $200[1] Current tax expense $40[2] APIC $160[3]	Taxes payable $200 Current tax expense (earnings) $200

1. Taxes payable for $500 intrinsic value at exercise date times 40% tax rate.
2. Reduction in earnings for the original fair value ($100) times 40% tax rate.
3. Excess tax benefits calculated as excess value $400 ($500 less $100) times 40% tax rate.
APIC=additional paid-in capital

The stock compensation expense is usually calculated based on the fair value of the stock awards at the time of grant, and it is allocated over the vesting period of the awards granted. Companies usually record a deferred tax asset for any tax-deductible stock awards (e.g., nonqualified stock options) corresponding to the fair value of the awards granted as they record their stock compensation expense.

Under previous guidance, any tax deduction was generally based on the intrinsic value of the stock awards at the time of exercise (e.g., nonqualified stock options awards), the fair value of the stock awards upon vesting (e.g., restricted stock units), or the fair value of the stock awards upon settlement (e.g., stock-settled stock appreciation rights). Thus, there would usually be a difference between the deferred tax assets accrued and the amount of taxes determined at the time of exercise (vesting or settlement) of the awards. If taxes were greater than originally recognized, an excess tax benefit or a windfall was recognized; otherwise, a tax deficiency or shortfall was recorded.

Also under previous guidance, all excess tax benefits were reflected in additional paid-in capital (APIC), and tax deficiencies were recognized in APIC to the extent that there is a sufficient "APIC pool" accumulated from the previously recognized excess tax benefits. Otherwise, they were reflected in earnings.

ASU 2016-09 requires that all excess tax benefits/windfalls and tax deficiencies/shortfalls be reflected in earnings. The main objective of the new guidance is to simplify tax accounting aspects of stock compensation awards by eliminating the APIC pool.

Consider the following example: Entity A issues stock awards to its employees at the beginning of the first year with a fair value of $100. The awards will be vested in two years, and the tax rate is 40%. The intrinsic value of the award at the end of the second is $500.

The journal entries to record these transactions are shown in *Exhibit 1;* the fourth entry indicates that, even though that the new guidance reduces the complexity of tax accounting for stock compensation by eliminating of the APIC pool, it may create some volatility in earnings and EPS.

Exhibit 2
Impact of New Guidance on EPS Calculation of Stock Awards

	Election to reflect actual forfeiture (instead of estimates)	Reflection of excess tax benefits in earnings instead of APIC	Reflection of excess disqualifying dispositions of tax benefits in earnings	Elimination of delay in recognition of windfalls due to insufficient taxes payable balance
NQSOs	Shifts earnings from one period to the next and possibly increases EPS numerator in certain periods. Does not affect EPS denominator (either for number of shares outstanding or amount of average unrecognized compensation)	Increases/decreases numerator for the amount of any windfall/shortfall Eliminates buyback of shares for any excess tax benefits less deficiencies under treasury stock method. Therefore, may increase or decrease denominator.	Not applicable	Increases numerator for the amount of any windfalls due to their faster recognition.
ISOs	Identical to NQSOs	Not applicable	Increases numerator of EPS calculation for the amount of excess disqualified disposition tax benefits.	Not applicable
ESPPs	Identical to NQSOs	Not applicable	Identical to ISOs	Not applicable
RSUs	Identical to NQSOs	Identical to NQSOs	Not applicable	Identical to NQSOs.
SARs	Identical to NQSOs	Identical to NQSOs	Not applicable	Identical to NQSOs.

APIC=additional paid-in capital
EPS=earnings per share
ESPP=employee stock purchase plans
ISO=incentive stock options
NQSO=nonqualified stock options
RSU=restricted stock units
SAR=stock appreciation rights

Key Differences in the Treatment of Tax Windfalls

Two key differences clarify the impact of the earnings volatility due to the different treatment of excess tax benefits. First, under previous guidance, excess tax benefits were recognized in APIC, and tax deficiencies were recognized either as an offset to APIC or in earnings. The new guidance eliminates the APIC pool and all excess tax benefits and deficiencies are reflected in earnings. As a result, under the new guidance, greater volatility in earnings is likely to occur due to the timing of stock compensation expense recognition and its associated income tax impact (Exhibit 1, journal entry 4).

Second, under previous guidance, excess tax benefits were deferred until the benefit was realized through a reduction to current income taxes payable. (This is not illustrated in the journal entries in the previous section.) This delayed, or possibly indefinitely postponed, recognition of any excess tax benefits. The new guidance, however, eliminates this requirement.

Under the new guidance, companies recognize all excess tax benefits and deficiencies in earnings. Therefore, this treatment affects the net income or the numerator of the EPS calculation, as discussed above. These excess tax benefits and deficiencies are discrete items in the period that they are reported, and not included in the estimate of a company's annual effective tax rate.

Furthermore, excess tax benefits and deficiencies (reflected in APIC) also affect the calculation of the number of shares outstanding under the treasury stock method, since such tax benefits and deficiencies are excluded from the calculation of assumed proceeds for the hypothetical repurchase of shares. As a result, the denominator of the diluted EPS calculation is also affected.

Forfeiture Estimates

Under previous guidance, companies were required to estimate the number of stock awards that were expected to vest to determine total stock compensation expense. The new guidance, however, permits the companies to continue to apply this method and true it up as stock awards are actually forfeited; as an alternative, they may adjust the stock compensation expense for the actual forfeited awards when the forfeitures occur.

The new guidance allows for a one-time accounting election policy. Companies are required to make this election at the entity level for all grants to all their employees using a modified retrospective transition method, with a cumulative-effect adjustment to retained earnings.

If companies elect this provision, they may create additional volatility due to two factors. First, if forfeitures of stock awards occur unevenly throughout the vesting period, it may create volatility between different periods, even though total forfeitures for the whole period may remain the same. Second, under previous guidance (e.g., ASC 260-10-55-70), forfeiture estimates only affected the numerator of the EPS calculation, while components of the denominator (number of shares outstanding and average unrecognized

compensation) used actual forfeitures. Under the new guidance, however, PBEs can recognize actual forfeitures in both the numerator and denominator. Therefore, even though the numerator of the EPS calculation might change, the denominator would remain the same.

Stock Compensation Awards

Different types of stock compensation awards will have various effects on the calculation of diluted EPS, as discussed below.

Stock options. These awards give the employees (or the holders) the right, but not the obligation, to buy (or call) a certain number of shares at a predetermined price during a specific period of time. There are generally two kinds of stock options: nonqualified (NQSO), which cause companies to recognize the related compensation expense and record the related tax benefits equal to the compensation expense multiplied by the company's tax rate; and incentive (ISO), which do not ordinarily result in any tax benefits when companies record the compensation expense.

If there is a difference between the tax expense originally accrued and the amount of taxes determined at the time of the exercise of an NQSO, excess tax benefits will be created (see the journal entries in *Exhibit 1*). Companies reflect NQSOs' excess tax benefits at the time of their exercise in APIC under the previous guidance and in earnings under the new guidance.

ISOs do not create any excess tax benefits, since companies do not record any tax benefits when they originally record their stock compensation expense. When an employee disposes of ISOs within two years of the grant date or within one year of the exercise date, however, the company receives a tax deduction equal to the difference between the options' original fair value and the exercise price on the date that the disqualifying disposition has taken place.

Employee stock purchase plans (ESPP). An ESPP is a contractual promise that permits an employee to acquire an employer's stock at a future date under the terms and conditions established on the grant date. These awards are designed to promote employees' stock ownership by providing them with convenient means (usually through a payroll deduction) to acquire a company's shares.

ESPPs have the same accounting treatment as ISOs and do not result in any tax benefits upon recognition of stock compensation expense, and therefore companies do not record the tax effects of the ESPP grant unless there is a disqualifying disposition.

Restricted stock units (RSU). These awards represent a promise by companies to deliver shares to their employees at a future date if certain vesting conditions are met. Companies record the related tax benefits equal to the compensation expense multiplied by the company's tax rate when they record the compensation expense (similar to NQSOs).

The tax deduction for RSUs is generally measured as the restrictions lapse (i.e., the RSUs are vested). At that time, companies determine their excess tax benefits/windfalls or deficiencies/shortfalls based on the prevailing stock price at the time of vesting. The tax accounting treatment of RSUs is identical to that of NQSOs, with the exception that any excess tax benefits occur at the time of vesting rather than exercise.

Stock appreciation rights (SAR). These awards represent a contract that gives the employees the right to receive an amount of stock or cash that equals the appreciation in a company's stock market value from the stock award grant date to the settlement date. There are two kinds of SARs: cash-settled, where settlement of stock appreciation is in cash rather than stock; and stock-settled, where the stock appreciation is settled through grant of additional shares of stock. Cash-settled SARs do not impact the denominator of the diluted EPS calculation; stock-settled SARs, on the other hand, are equity-based awards under ASC Topic 718. Companies record the compensation expense (based on fair value at the grant date) and recognize the corresponding deferred tax asset. Thus, the income tax treatment and implications of stock-settled SARs are similar to those of NQSOs, with the exception that the amount of windfalls/shortfalls is determined at the time of settlement rather than exercise.

Exhibit 2 summarizes the impact of the new guidance on the EPS numerator and denominator for each type of stock award discussed above.

Pennies Make an Impact

ASU 2016-09 provisions on accounting for excess tax benefits and deficiencies and the election to reflect forfeitures on actual basis have a corresponding effect on computation of diluted EPS. The impact on diluted EPS calculations is not only on net income (the numerator) but also on the number of shares outstanding (the denominator). In some cases, the impact may not be material, but in others, the impact may be material enough to move the diluted EPS by a few pennies in one direction or the other. The materiality impact of the new guidance on diluted EPS depends on the equity structure of the company and the total number of shares, as well as the number of stock compensation awards outstanding and their corresponding unrecognized compensation amounts.

Any comparative analysis of financial statements for diluted EPS should take the impact of this new guidance into consideration. ❑

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