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New Options for Share-Based Payment Accounting May be Attractive to Some Issuers

The new guidelines allow companies to opt out of estimating forfeitures, which can be an attractive option for smaller, private companies.

As part of the Financial Accounting Standards Board's (FASB) Simplification Initiative, the group has begun adding narrow scope projects to quickly improve US Generally Accepted Accounting Principles (GAAP). On June 8, 2015, the Board released an exposure draft with changes to six distinct areas that involve accounting for share-based payments, including:

- Accounting for income taxes upon settlement
- Classification of excess tax benefits on the cash flow statement
- Accounting for forfeitures
- Minimum statutory tax withholding requirements
- Classification of employee taxes paid on the cash flow statement when an employer withholds shares for tax purposes
- Classification for awards with repurchase features

The Board also released proposed provisions in two additional areas related to private companies. While all of these are important issues, this article will concentrate on forfeitures and how companies can assess their policy elections for share-based payments.

Background

Currently, FASB Accounting Standards Codification 718-10-35-3 states: "[A]n entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered… The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change."

As part of the simplification process change, entities with share-based payments are allowed to make a firm-wide accounting policy choice of Alternative A, which estimates the number of forfeitures at grant and adjusting the estimate as actual experience occurs, or Alternative B, which recognizes forfeitures as they occur without any application of a forfeiture rate.

Under either alternative, companies will true up or true down to the expense associated with the awards that actually vest. Right now, companies are required to apply Alternative A. Under Alternative A an entity determines the total award expense, reduces expense to recognize potential forfeitures, and then increases or decreases expense each period to account for actual forfeitures and the passage of time (i.e., true-up awards as they approach vesting). These fluctuations in expense are difficult to predict and can be hard to explain. Under Alternative B, entities would book more expense up front, but as actual forfeitures occur, the amount of expense recognized would decrease.

The Board said the proposed change would reduce the complexity and cost of preparing the forfeiture estimate. Companies that choose to adopt Alternative B will have a known maximum expense each period, which can be determined at grant. As time passes, the compensation expense will remain level (if no forfeitures) or decrease (if there are some forfeitures). This means there is still variability in expense but the variability will only act as a credit. This could be a powerful tool to help companies manage their compensation expense and changes between forecasts and actual numbers.

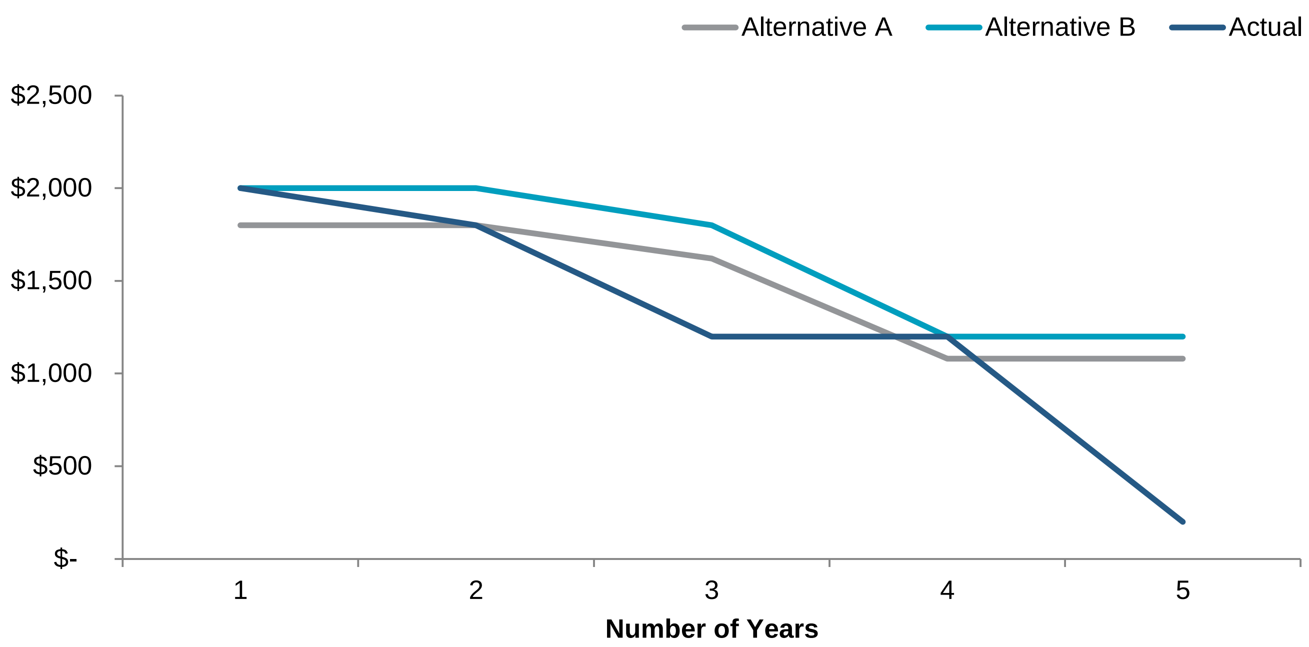
To illustrate the expense, consider an award issued to 10 employees with the following identical terms:

- 100 awards granted
- 5-year graded vesting (20% on each anniversary date)
- Fair value of $10.00
- 10% per annum forfeiture rate, and the company trues up at the end of every year

Each employee receives the same size award and the expense per employee is $1,000, or $200 per tranche, for a total compensation cost of $10,000 ($200 per year x 10 employees x 5-year vesting). The company will recognize $2,000 per year before application of a forfeiture rate and $1,800 per year with the assumed 10% forfeiture rate.

The chart below shows how expense moves under each alternative, as well as the actual expense. The derivation of the values in this chart is shown in the Appendix.

Sample Accounting Expense under Different Scenarios



The expense under Alternative B is always greater than the actual expense, meaning a credit is taken annually to true up expense. The expense under Alternative A fluctuates above and below the actual expense and shows when credits or charges are taken.

We anticipate that most large public companies will continue to apply a forfeiture rate as forfeiture estimates for these companies tend to be sophisticated and more consistent with actual experience. In the long-term, however, smaller companies may move to Alternative B (no forfeiture rate) to simplify their expense recognition, and knowing that if a change is coming, it's coming in the form of a credit. However, since we know forfeitures will occur, Alternative A still represents the truest representation of the compensation expense.

It is important to note that there are still events where an estimated forfeiture rate will be required. Alternative A will be required under 1) the replacement of awards in a business combination; and 2) modifications to an award.

Next Steps

The Board's proposed changes to the forfeiture rules will act to reduce some of the complexity related to accounting for share-based payments, particularly for private issuers. Companies with significant expense due to share-based payments may want to consider the financial impact of altering forfeiture recognition as well as the administrative, compliance and procedural modifications that would go along with such a change before deciding which alternative to elect.

To learn more about participating in a Radford survey, please contact our team. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

Appendix

Alternative A

Period	Expense Recognized During the Year	Number of Terminations	Actual Expense for the Year	True up/(down) Amounts
Year 1	$1,800 = $200 x 10 x (1-10%)	0	$2,000 = $200 x 10	$200 = $2,000 - $1,800
Year 2	$1,800 = $200 x 10 x (1-10%)	1	$1,800 = $200 x 9	$0 = $1,800 - $1,800
Year 3	$1,620 = $200 x 9 x (1-10%)	3	$1,200 = $200 x 6	$(420) = $1,200 - $1,620
Year 4	$1,080 = $200 x 6 x (1-10%)	0	$1,200 = $200 x 6	$120 = $1,200 - $1,080
Year 5	$1,080 = $200 x 6 x (1-10%)	5	$200 = $200 x 1	$(880) = $200 - $1,080
Total Expense			$6,400	
Credits Recognized				$(1,300)
Charges Recognized				$320

<u>Alternative B</u>

Period	Expense Recognized During the Year	Number of Terminations	Actual Expense for the Year	True up/(down) Amounts
Year 1	$2,000 = $200 x 10	0	$2,000 = $200 x 10	$0 = $2,000 - $2,000
Year 2	$2,000 = $200 x 10	1	$1,800 = $200 x 9	$(200) = $1,800 - $2,000
Year 3	$1,800 = $200 x 9	3	$1,200 = $200 x 6	$(600) = $1,200 - $1,800
Year 4	$1,200 = $200 x 6	0	$1,200 = $200 x 6	$0 = $1,200 - $1,200
Year 5	$1,200 = $200 x 6	5	$200 = $200 x 1	$(1,000) = $200 - $1,200
Total Expense			$6,400	
Credits Recognized				$(1,800)
Charges Recognized				$0

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