WHAT NEW FASB GUIDANCE ON STOCK COMPENSATION MEANS TO YOUR COMPANY

INTRODUCTION

NEW FASB GUIDANCE MEANS INCREASED INCOME AND EPS VOLATILITY

CHANGES TO SYSTEMS, PROCESSES AND MODELS WILL BE NEEDED TO COMPLY AND WILL PLAY A LARGE ROLE IN FORECASTS GOING FORWARD.

The Financial Accounting Standards Board ("FASB") has launched a tightly-focused initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. The goal of the simplification initiative is to identify, evaluate, and improve areas of Generally Accepted Accounting Principles ("GAAP") for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. In March 2016, the FASB announced changes to how Share Based Compensation will be accounted for on the Income Statement, Balance Sheet and Statement of Cash Flows. Accounting Standards Update ("ASU") 2016-09, *Improvements to Employee Share Based Payment Accounting* amends Accounting Standards Codification ("ASC") 718, *Compensation - Stock Compensation* most notably requires Excess Tax Benefits / (Deficits) to be recorded on the Income Statement as a component of Income Tax Expense rather than a change in Additional Paid-in Capital ("APIC") on the Balance Sheet. Additionally, in November 2016, the FASB proposed an amendment to the scope of modification accounting for share based payment arrangements to clarify when modification accounting should be applied.

The amendments within this update affect all entities, public and private, that issue share based payment awards to their employees. As a result of this change, companies can expect greater volatility in both Net Income and Earnings per Share ("EPS") upon adoption. To understand how this volatility will impact both internal and external stakeholders, companies must first understand the changes prescribed by the standard. This will require updates to systems of records, financial systems and financial models to report and leverage greater use of scenarios to forecast ranges for Net Income, EPS, and Cash Flow.

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What Changed?

ASU 2016-09's most significant impact on planning and reporting is the change to the accounting treatment for Excess Tax Benefits/(Deficits) on the Income Statement, Balance Sheet, and Statement of Cash Flows. Key provisions of ASU 2016-09 include the following:

When Do Companies Need to Adopt this Change?

For public companies, the amendments of ASU 2016-09 are effective for annual periods beginning after December 15, 2016. All other companies are provided a one-year extension and the amendments are effective for annual periods beginning after December 15, 2017. However, early adoption is permitted at any time, including interim periods, which some companies may find beneficial.

TYPE OF CHANGE	CURRENT GUIDANCE	NEW GUIDANCE
Share Based Compensation Tax Effects	Excess tax benefits/(deficits) are recorded as an increase/(decrease) to APIC on the Balance Sheet. Delayed recognition of windfall tax benefit until it reduces current taxes payment.	All excess tax benefits / (deficits) are recorded as an increase / (decrease) to income tax expense on the Income Statement as a discrete item in the period of vest or exercise.
Windfall / (Shortfall) Pool Tracking	Excess tax deficits are recorded to APIC to the extent of any current windfall pool. Any excess tax deficits in excess of the current windfall pool are recorded in income tax expense. Requires tracking of a Windfall / (Shortfall) Pool as a memo account.	All excess tax benefits and deficits are recorded to income tax expense. Windfall / Shortfall Pool Tracking no longer needed.
Earnings per Share	Expected excess tax benefits / (deficits) are included in the calculation of dilutive shares when applying the treasury stock method for computing the dilutive effect of share based compensation.	Expected excess tax benefits / (deficits) are no longer recognized in APIC and will not be included in the calculation of dilutive shares.
Statement of Cash Flow Presentation	Excess tax benefits are classified as an inflow from financing activities while excess tax deficits are classified as an outflow from operating activities.	All tax-related cash flows resulting from share based compensation will be reported as Operating activity.
Forfeitures	Companies must develop and apply forfeiture rate assumptions when an award is granted and update the assumption throughout the life of the award.	Companies may make a policy election to account for forfeitures as they occur instead of applying a forfeiture rate assumption at the time of grant.

Example:

See below for an example of how ASU 2016-09 would impact the Net Income and EPS of a company who grants stock options.

ASSUMPTION TYPE	ASSUMPTION
# of Options	10M
Vesting	3 Years
Grant Price	$20.00
Fair Value	$10.00
Est. Share Price at Exercise	$37.61

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PRIOR GUIDANCE	FY 1	FY 2	FY 3	FY 4
Net Income	$ -	$(23.33)	$(23.33)	$(23.33)
Basic Shares Outstanding		250.00	250.00	252.04
Dilutive Shares Outstanding	-	250.00	0.87	-
Basic Shares Outstanding		250.00	250.87	252.04
Earnings Per Share	$ -	$(0.09)	$(0.09)	$(0.09)
NEW	**FY 1**	**FY 2**	**FY 3**	**FY 4**
Net Income	$ -	$(23.33)	$(23.33)	$(0.50)
Basic Shares Outstanding		250.00	250.00	254.24
Dilutive Shares	1.36	1.79	3.04	-
Total Shares Outstanding	251.36	251.79	253.04	254.24
Earnings Per Share	$ -	$(0.09)	$(0.09)	$(0.00)
DIFFERENCE	$ -	$ -	$ -	$(0.09)

Huron's Opinion / Recommendation

While all companies must adopt this ASU by the effective date, it could be beneficial for certain companies to adopt early. The updated guidance means Net Income and EPS will become more variable going forward with the dilutive effects of share based compensation becoming more meaningful to companies as excess tax benefits/(deficits) will directly impact Net Income and not APIC. Companies with a rising long-term share price or valuation, and forecasted Excess Tax Benefits, should consider early adoption as the decrease to Income Tax Expense could outweigh the increase in dilutive shares outstanding and ultimately increase EPS. Companies with a depressed long-term share price, and forecasted Excess Tax Deficits, should delay adoption until the effective date and proactively anticipate and plan for the changes ahead of adoption.

To determine the impact of the new guidance on a company's current and future financial statements, companies should leverage integrated financial statement models and detailed share based compensation models, including the application of the appropriate valuation methodology to anticipate future share price. This should be done regardless of whether GAAP or Non-GAAP guidance on measures is given externally.

Leveraging scenarios, valuation methodologies and robust share based compensation models will allow companies to properly value the company, reasonably understand when options will vest, predict exercises, and forecast ranges of the associated impacts on the financial statements and EPS. This proactive modeling will help financial planning and treasury groups message more accurate forecasts to both internal and external stakeholders.

Next Steps

Companies should review internal processes, systems and models and consult their audit and consulting partners to assess whether early adoption is beneficial and how to implement the changes. Companies should then update both their financial close and forecasting processes to incorporate all amendments prescribed by ASU 2016-09. Additionally, close attention should be paid to the FASB's proposed amendments to modification accounting as they finalize their recommendations.

Huron's Value-Added Proposition

With over 500 successful budgeting, forecasting, treasury, long range planning, financial close and ERP projects, Huron is the recognized market leader in helping organizations optimize their processes, manage liquidity and create value-added models to assist in the planning process. Huron has a proven track record in facilitating development of enterprise-wide analytical systems that drive decision-making and help companies better their processes.

Creating financial models that incorporate planning and valuation requirements requires innovative and capable professionals. Our consultants possess the understanding of company-specific performance drivers, trends in the industry, and technical applications for effective, dynamic models. Our expertise in finance and technology allows Huron to assess, centralize and streamline an institution's models, systems and processes to maximize performance. For more information on Huron's service offering and expertise, please visit www.huronconsultinggroup.com/expertise/enterprise-solutions.

Please contact Huron if you have any questions, would like an assessment or help with integrating this type of logic within your processes, models and systems of record.

Questions

Huron clients who have questions regarding the implementation of these changes should reach out to their engagement team, partner or the authors listed to the right.

FASB (Financial Accounting Standards Board). (n.d.). Accounting Standards Codification (ASC) Compensation-Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting. Retrieved June 16, 2016, from FASB Accounting Standards Codification database.

This document is not an exhaustive list of changes resulting from the Accounting Standards Update and is purely focused on what Huron views as the most impactful changes for companies planning and forecasting models and processes. Huron advises all companies looking to adopt this policy early to consult with their audit partner.

ABOUT THE AUTHOR

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Curtis Gratz is a Director based out of Huron's Chicago office with over eleven years of experience in consulting. Mr. Gratz's consulting experience is focused on providing solutions to FP&A, Treasury, Corporate Development and other groups within organizations. Specific items that Mr. Gratz focuses on are financial process changes, finance transformation, strategic planning, business valuation, impairment testing, acquisition and divestitures, corporate development, sales and operations planning, capital forecasting, workforce planning and other. Mr. Gratz has worked with companies within industries such as utilities, real estate, financial services, diversified foods, CPG, retail, hospitality, manufacturing, mining, broadcasting, airline, higher education, telecommunications, healthcare, distribution, insurance, human resources and others. Through past experiences Mr. Gratz is adept at assessing existing finance processes, identifying opportunities for improvement, developing road maps for implementing recommendations, and helping clients realize those future state visions via value-added software and process solutions. Mr. Gratz can be reached at cgratz@huronconsultinggroup.com as well as at 773.608.9500.

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