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September 4, 2015

Mr. Russell Golden
Chair
Financial Accounting Standards Board
401 Merritt 7
P.O Box 5116
Norwalk, CT 06856-5116

Re: Comment Letter on Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

Dear Mr. Golden,

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update ("Proposed Update"), *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*.

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

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1 With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 133,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 151 countries, of whom more than 125,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 145 member societies in 70 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Proposed Update

The key changes suggested in the Proposed Update are as follows:[3]

- ***Estimating Expected Forfeitures:*** Entities would be permitted to make an accounting policy election to either estimate the number of forfeitures (current GAAP) or account for forfeitures when they occur.
- ***Accounting for & Cash Flow Classification of Excess Tax Benefits:*** Incremental current and deferred tax benefits or deficiencies of share-based payments at settlement or expiration would be recorded through the income statement instead of equity. The tax effects would be classified with other income tax effects, presumably in operating cash flows.
- ***Awards with Repurchase Features: Liability vs. Equity Classification:*** An award that is contingently redeemable for cash could be equity classified, with reclassification to a liability only required if the contingent event becomes probable – even if the employee controls its occurrence.
- ***Minimum Statutory Tax Withholding: Expanding the Exception & Cash Flow Classification:*** Entities would be allowed to withhold up to the maximum individual statutory tax rate without classifying the award as a liability. The cash flows associated with such withholdings would be classified as financing cash flows.
- ***Nonpublic Companies: Measuring Share-Based Payment Awards:*** Nonpublic entities would be allowed to use a practical expedient to determine the expected term of certain share-based awards. They would also be allowed to make an election to change the measurement basis for all liability-classified awards to intrinsic value.

Simplification: From who's Perspective?

The FASB developed the proposal as part of its "simplification" initiative to reduce the cost and complexity of financial reporting while improving or maintaining the usefulness of information reported to users of financial statements. The proposed changes are, however, areas of difficulty noted by public and nonpublic companies in terms of the reporting requirements and compliance costs in the Financial Accounting Foundation's (FAF) Post-Implementation Review (PIR) Report of FASB Statement No. 123(R), Share-Based Payment dated August 14, 2014.

The PIR states:

> *Either public or nonpublic entities, or both, have some level of difficulty understanding and/or applying Statement 123(R)'s requirements in the following areas:*
>
> - *Accounting for APIC pools (public and nonpublic entities)*
> - *Liability versus equity classification (public and nonpublic entities)*
> - *Minimum tax withholdings (public entities)*
> - *Estimating expected forfeitures (nonpublic entities)*
> - *Measuring share-based payment awards (nonpublic entities).*

[3] KPMG Defining Issues 15-28, *FASB Proposes Changes to Simplify Accounting for Share-Based Payments*, June 2015.

It appears that the Proposed Update has been issued primarily to address the concerns of preparers as expressed in the PIR report. The PIR report notes that FAS 123(R) provides decision-useful information to investors.

> *Information resulting from the application of Statement 123(R) generally provides investors with decision-useful information. Many investors factor both the recognized compensation cost associated with share-based payment awards in earnings and other information about share-based payments into their analyses. Investors use share-based payment information for many types of analyses, including understanding the nature of an entity's share-based payment awards and projections of an entity's future earnings and cash flows.*

In sum, the PIR report states:

> *We conclude that, overall, Statement 123(R) achieved its expected benefits as Statement 123(R) adequately resolved all of the issues underlying its stated need and increased the decision-usefulness of information in financial statements about SBC transactions.*

It also states that the "ongoing costs incurred by public companies to comply with Statement 123(R) are not significant when considered in totality."

We believe that the changes in the Proposed Update ought to be accompanied by outreach to investors – outlining the nature and pervasiveness of facts and circumstances that necessitate the proposed changes and articulating the implications of such changes. Unfortunately, the proposed amendments appear not to have been subject to a broad-based investor outreach. Additionally, the changes don't appear to have been framed in a manner that makes the case for the amendments backed up by investors' understanding of the implications and their agreement that the anticipated reporting outcomes would be a more faithful representation of the underlying economics.

We urge the Board to consider the implications of the proposal for investors. We consider each point in turn below.

Implications of Proposals
As we consider the proposals, we have organized our response by those we believe to be most important to investors.

<u>*Estimating Expected Forfeitures*</u>
Paragraph BC13 of the basis of conclusion states:

> *The Board considered, but ultimately rejected, an alternative that would require all entities to account for forfeitures when they occur. The Board rejected this alternative because estimating forfeitures generally provides a more accurate reflection of periodic compensation cost and some stakeholders already have incurred the cost to develop processes to estimate them.*

We agree that estimating forfeitures provides a more timely and accurate estimate of the cost of compensation expense than does recognizing forfeitures as they occur – particularly when the company has a history of employee turnover resulting in forfeitures – and a method of estimating such forfeitures exists. That the Board holds the aforementioned view, but nonetheless is proposing to allow companies the option to choose whether they estimate a forfeiture rate is inconsistent with the Board's stated objective to "maintain or improve the usefulness of the information provided to users of financial statements." We believe that it is a rare instance when an entity can't make an estimate of forfeitures as companies manage and monitor employee turnover rates. If entities have no track record upon which to base forfeitures and have a strong belief that employees (for example, because of the lucrative nature of the awards and the likelihood of monetization of the awards) will not leave, it could estimate a forfeiture rate of zero.

We find inconsistency in the Board's discussion of the subjective nature of the forfeitures as a reason not to require an estimate of forfeitures in Paragraph BC 11 with its discussion in Paragraph BC 12 where it notes that when such an estimate affects the ultimate amount of compensation expense recognized – as in the case of a business combination or a modification – an estimate of forfeitures must be made. The estimate is no less subjective in such circumstances.

Some may argue against the proposal to allow the option to not estimate forfeitures arguing that it would create greater volatility in earnings. We don't oppose the use of an option because of volatility, but because we don't believe it provides the most useful estimate of the ultimate expense and we are concerned by the impact optionality will have on comparability. We also don't see that this policy election will be required to be disclosed in a way that will draw investors' attention to this potential comparability concern.

We strongly urge the Board to reconsider allowing this accounting policy election for forfeitures.

<u>Accounting for & Cash Flow Classification of Excess Tax Benefits</u>
Changing Recognition of Excess Tax Benefits from Equity (APIC) to Income Statement: CFA Institute supports the proposal to recognize all excess tax benefits and tax deficiencies[4] as an income tax benefit or expense in the income statement, eliminating the additional paid-in capital (APIC) pool. Current practice requires excess tax benefits to be recognized in APIC and tax deficiencies to be recognized either as an offset to accumulated excess tax benefits in the APIC pool, if any, or in the income statement. The difference in accounting between excess tax benefits and deficiencies has never, in our view, been supported by a sound theoretical basis. Further, the APIC pool has, in our view, acted to shift the timing of the recognition of these economic events.

Excess tax benefits communicate that the intrinsic value of the option at exercise was greater than management's estimate of fair value in recognizing compensation expense. They are economically relevant for investors because they illustrate the options resulted in greater economic dilution than book dilution. Because the options were more dilutive than originally estimated, there was a tax benefit derived from this difference at exercise.

Because we believe that investors more thoroughly review the income statement than the rollforward of equity, we support including the excess tax benefits in the income statement. Given they represent a permanent different between the book and tax deductibility of the award they will impact the effective tax rate and draw the attention of investors, if significant. In the rollforward of APIC in the statement of stockholders' equity such excess tax benefits are highly visible. Our only concern with including the amount of excess tax benefits in the income statement is that the precise amount will not be as clearly discernable as it may be aggregated with other items in the effective tax rate. We think the excess tax benefits and the tax deficiencies which impact the effective tax rate should be identifiable to investors such that investors can evaluate their ongoing or sustainable impact on earnings of such items.

Overall we are supportive of eliminating the APIC pool and the recognition of tax consequences (excess tax benefits, tax deficiencies or the release of deferred tax assets resulting from the failure to exercise awards) associated with these compensatory arrangements through the income statement. We also agree with the Board's thinking in Paragraph BC7 with respect to removing the exception that resulted in delaying recognition of tax benefits in a period where it did not reduce taxes payable.

Classification of Excess Tax Benefits on Statement of Cash Flows: The Board proposes to clarify the presentation of such excess tax benefits on the statement of cash flows within the Proposed Update. The Board has concluded that the excess tax benefits are not separate cash flows and should be classified in the same manner as other cash flows related to income taxes. While the amendments to the Codification make it clear that such excess tax benefits would no longer be grossed up as hypothetical cash inflows and outflows in the statement of cash flows (see changes

[4] The difference between the deduction for tax purposes and the compensation cost recognized in the financial statements. An **excess tax benefit** is recognized when stock-based compensation expense is higher for tax purposes than book purposes. A **tax deficiency** is recognized when stock-based compensation expense is lower for tax purposes than book purposes.

in financing activities Paragraph 230-10-45-14(e) and operating activities Paragraph 230-10-45-17(c)) and that taxes broadly would be classified as operating cash flows as noted in Paragraph 230-10-45-17(c)), it is not explicit in the Basis for Conclusions that the tax consequences of these excess tax benefits are operating cash flows. Given this classification has changed and it must be inferred that all tax payments are operating cash flows in Paragraph 230-10-45-17(c)), we would ask the Board to be explicit in its articulation of the classification of these cash flows as operating cash flows in the Basis for Conclusions.

Awards with Repurchase Features: Liability vs. Equity Classification
As we understand it, an award that is contingently redeemable for cash could be equity classified, with reclassification to a liability only required if the contingent event becomes probable – even if the employee controls its occurrence.

Language of Paragraph 718-10-25-9: We would note that the guidance in Paragraph 718-10-25-9 and the articulation of the Board's views and intent is not easily discernable. As written, we believe preparers and auditors are likely to misinterpret that the Board's intent is that awards both contingently issuable at the employee and the employers control would need to be assessed for probability of occurrence for liability classification. Further, we are concerned by retaining "(such as an initial public offering)" as the parenthetical example in Paragraph 718-10-25-9 that it continues to connote a contingency out of the employee's control – though that language has been removed – when in fact the FASB is allowing contingency both within and outside the employee's control to qualify for equity accounting. We would ask the Board to rewrite the entirety of that Paragraph 718-10-25-9 to more directly articulate their views as misinterpretation of the guidance ultimately impacts the information received by investors.

Concerns Broader Than Language: Irrespective of the language, our concern with this change is that more awards will be recognized utilizing the upfront fixed expense accounting associated with equity classification rather than the updated expense accounting of liability classification – when they will result in an outflow of cash resources of the entity – and that investors will be unaware of the cash consequence of the award's optionality until just before the cash is to be remitted to the employee. Said differently, employees may exercise their rights to cash without sufficient warning to investors of the potential dilutive impact to earnings per share, book value per share and the cash required to be remitted. The proposal also does not suggest that additional disclosures will be provided to ensure communication of such potentially adverse consequences to investors. We don't support this proposal. At a minimum, sufficient disclosure should be made of the potential cash consequences of the award.

We concur with the PIR report, which states that the appropriate classification of the financial instrument is essential.

> *Even though the liability versus equity classification guidance in Statement 123(R) is extensive and subject to much interpretation and judgment, our research indicates that the guidance is necessary to ensure appropriate classification of the financial instruments used for share-based payment awards that are often highly structured and contain multiple features.*

Minimum Statutory Tax Withholdings:

<u>*Expanding the Exception & Cash Flow Classification*</u>

Expanding the Exception: Presently, entities following US GAAP are allowed to account for stock-based compensation arrangements where there is an obligation of the employer to withhold tax equivalent to the minimum statutory withholding amount as an equity based (fixed expense) award despite the fact that the withholding represents, in substance, a repurchase of shares from the employee and an outflow of cash resources of the company to pay the tax authority (i.e., a partially cash settled award). This proposal would expand that exception to allow the employer to withhold up to the maximum individual statutory tax rate amount without classifying the awards as a liability. This expansion is meant to allow companies to more easily qualify for this accounting exception and result in fewer awards with real cash consequences to the entity, and its investors, from being classified as such.

Under IFRS such awards are, currently, bifurcated and the withholding amount recognized as a liability (i.e. under US GAAP such awards are classified entirely as liabilities) whose value is adjusted at each measurement date to fair value reflecting the potentially increasing expense of the award, the cash call represented by the liability and the potentially dilutive impact to book value per share. Recently, the IFRS Interpretations Committee (See July 2015 Agenda Papers 2 & 2A) discussed this issue and the potential treatment of such award as an equity based (fixed expense) award. However, as the example in Paragraphs 94 – 101 of the agenda papers illustrate, the instrument is ultimately bifurcated when the option is exercised and the tax must be withheld and paid. Under the new IFRS accounting, the potential increase in expense resulting from any appreciation in the intrinsic value of the award is recorded directly to equity (rather than reflecting the additional expense through earnings and earnings per share). Up until the point of exercise, investors are left unaware of the potential cash call and the dilution in book value per share. For that reason, we opposed the proposal to allowed "fixed equity accounting" for such awards.

Under US GAAP, we understand that when the company reduces cash, to remit the tax withheld upon exercise of the stock-based award, the amount is recognized directly as reduction in equity as in the case under the proposed revision to IFRS.

Overall, we oppose further expansion of this exception. Disclosures should be provided to investors to allow them insight into the cash, and dilution of book value, consequences of this exception.

Cash Flow Classification: The proposal seeks to clarify that the cash flows associated with regard to such withholdings would be classified as financing cash outflows. The Board notes in Paragraph BC 19 that the basis for this classification is that such withholding is akin to a share repurchase. We find this accounting classification inconsistent with the conclusion that the entire award described above should be accounted for as a fixed equity based award reflected as compensation expense (an operating expense). If the withholding associated with the award is considered a share repurchase agreement for statement of cash flow classification purchases, it would seem most appropriate that it be bifurcated and accounted for as such – a liability for recognition and measurement purposes – not as an equity based compensation arrangement. As currently proposed compensation expense is recognized for 100% of the award on a fixed basis and then book value is reduced for another 50% (i.e. assuming a tax rate of 50% for federal, Medicare and state taxes) of the award's intrinsic value at exercise.

Overall: We note that the proposal does not address how the broadening of this exception would be beneficial for investors. In performing a cost/benefit analysis we think the costs/benefits to investors should be incorporated into the analysis. The potential adverse consequences to investors, such as the opaque nature of the entity's cash outflow under this treatment, do not seem to have been considered.

Nonpublic Companies: Measuring Share-Based Payment Awards

CFA Institute generally opposes different reporting standards based on ownership (public, private, not-for-profit), size, or industry. Transactions and economic activities that are similar should be reported similarly in financial statements—irrespective of the nature of the underlying ownership structure of the entity engaging in the transaction.

In view of the decision-usefulness of such information, we concur with the following statement in the PIR report:

> *Although nonpublic entity stakeholders may have difficulty applying Statement 123(R)'s measurement requirements, our research and analyses suggest that these requirements help ensure that the primary objective of Statement 123(R)—recognizing the effects of share-based payment transactions in earnings to ensure decision-useful information is provided to investors—is not compromised.*

The PIR report also says:

> *Statement 123(R) is often more difficult for nonpublic entities to understand and apply as intended primarily because of the complexity of the financial instruments they use for share-based payment awards and their lack of internal expertise.*

Given that many companies are choosing to retain their nonpublic status for longer and there is a proliferation of IPOs in the "private IPO market" we are less sympathetic to the notion that such instruments are too complex or too difficult for private companies to value. Before issuing such instruments, ascertaining how they will be measured and their dilutive impact on existing shareholders would seem to be necessary and essential elements of good financial management. Accordingly, creating exceptions based upon nonpublic status seems to be supporting less informed financial decision-making.

That said, we do not oppose the practical expedient provided with respect to the term of the option so long as this difference and the term of the option is disclosed. Investors can then adjust valuations should they believe the term may be inappropriate.

As it relates to the practical expedient to utilize an intrinsic value approach over a fair value approach for a liability based award because certain nonpublic companies were not aware of the option, we disagree with the proposal as it appears more focused on preparer cost rather than user based decision-usefulness. Such entities have heretofore demonstrated an ability to derive a fair value for such awards. If entities have a demonstrated ability to derive the fair value, it would only seem to decrease decision-usefulness of the information by allowing them to switch to an intrinsic value approach which will likely result in less expense recognition given such values do not incorporate forward-looking elements. Paragraph BC 32 notes that a preferability assessment would not be required if the proposal is passed. We think the cost/benefit analysis should be considered as a substitute for this analysis and we think it would be difficult to substantiate that the intrinsic value increases the decision-usefulness of the information to users.

Transition and Effective Date

The table below represents the transition approaches for the various proposals as we understand them:

Proposed Amendment	Transition Approach
Estimating Expected Forfeitures	Cumulative Effect
Accounting for Excess Tax Benefits	Prospective/Cumulative Effect
Cash Flow Classification of Excess Tax Benefits	Retrospective
Minimum Statutory Tax Withholding: Expanding the Exception	Cumulative Effect
Minimum Statutory Tax Withholding: Cash Flow Classification	Retrospective
Awards with Repurchase Features: Liability vs. Equity Classification	Cumulative Effect
Nonpublic Companies: Practical Expedient for Expected Term	Prospective
Nonpublic Companies: Intrinsic Value for Liability Awards	Cumulative Effect

Investors generally prefer retrospective adoption as it provides trend information. As proposed, only the cash flow presentation items would be adjusted retrospectively with cumulative effect type of adjustments for items currently in the process of being recognized and measured and prospective adoption for other items. Overall, it will be challenging for investors to assess the impact of such changes on earnings trends for several years with this plethora of approaches.

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Thank you again for the opportunity to comment on the FASB Proposed Update. If you or your staff have questions or seek further elaboration of our views, please contact either Mohini Singh, ACA, by phone at +1.434.951.4882, or by e-mail at mohini.singh@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

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