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Submitted via email (director@fasb.org)

Technical Director
File Reference No. 2015-270
Financial Accounting Standards Board
401 Merritt 7
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Re: Accounting Standards Update, *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

Cherry Bekaert LLP ("Cherry Bekaert" or the "Firm") appreciates this opportunity to provide the FASB with the Firm's view of the proposed amendments in Accounting Standards Update*, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.* Cherry Bekaert provides accounting and consulting services predominately to middle market private entities and smaller to mid-sized public entities whose financial reporting resources often face greater constraints than larger entities. Our clients continually weigh the costs of compliance with the benefits provided to the users of their financial reporting which typically are commercial banks and shareholders who are often members of management. Stock compensation offers smaller and middle market companies the ability to attract and incentivize talent with potentially greater returns than larger and more established companies while also minimizing cash expenditures. Many of these are resource restrained companies and thus stock compensation benefits these smaller and middle market companies. In general, we are supportive of the FASB's efforts to simplify the accounting of stock compensation and broadly support simplification efforts. Our responses to the questions posed in the exposure draft are provided below.

Question 1: Do you agree that the proposed amendments result in a reduction (or potential reduction) of cost and complexity while maintaining or improving the usefulness of information provided to users of financial statements? If not, why?

The Firm agrees that the proposed amendments will result in the reduction of compliance costs and complexity. The Firm believes that the reduction in costs will outweigh any benefits lost.

However, for many nonpublic entities, especially smaller and less complex entities, the greatest difficulty and costs associated with stock compensation is the need to obtain a valuation of the underlying shares. As such the Firm suggests that the Board consider providing private entities relief in this matter.

Many private companies lack the resources both in terms of internal qualifications to perform such a valuation and in terms of financial resources to employ third party valuation firms. This difficulty is exacerbated given the perceived benefit of expending such resources. For these smaller private companies the cost of obtaining internal or external capabilities is juxtaposed to the usefulness of noncash expenses to the users of their financial information which typically are commercial banks and shareholders, who often are members of management. Many debt covenants and loan applications already exclude noncash revenues and expenses including stock compensation. In addition, due to the illiquidity of a private entity's shares relative to a public entity's shares the shareholder's potential return is driven less by financial reporting and share prices and more by cash flows and the entity's ability to pay dividends or by the relative ownership interests should the entity be purchased. We believe that shareholders of private entities agree that the benefits from disclosures regarding potential dilution of ownership interest relative to the cost of providing those disclosures is more valuable than making fair value measurements of noncash compensation relative to the costs associated with making those measurements.

The Firm recognizes that the costs and difficulty of measuring stock-based compensation for private companies relative to the perceived benefits received cannot be alleviated solely through changes in financial reporting standards given IRC 409a and the burden of proof to demonstrate that options are not granted "in the money" should the entity and the grantee wish to avoid adverse tax consequences. However, IRC 409a does not prescribe valuation methods nor require a third party valuation firm be employed. Instead, in practice many private companies and the third party valuation firms they employ seek safe harbor in applying the AICPA's *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* guide. While this guidance is not authoritative, in practice it is often utilized, and its valuation principles are derived from FASB guidance in ASC 820, *Fair Value Measurement*. The Firm believes that the Board is in a unique position to influence practice in this respect and provide relief to many smaller and resource constrained private entities who might benefit most from the ability to grant incentivizing noncash compensation to attract talent without creating the burden of undue compliance costs.

The Firm believes that, consistent with the Board's decision in ASU 2011-08 *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment* and 2012-02 *Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*, that private entities who grant stock based compensation only be required to perform quantitative measurements of the value of their stock periodically (e.g. every 3 years) and should be allowed to perform qualitative review of previous assessments annually. Should a qualitative review suggest that a previous valuation's measurement is no longer valid then a quantitative valuation should be performed.

This suggested change would provide the greatest relief to private entities while also balancing the need for reliable and relevant reporting.

Question 2: Should excess tax benefits and tax deficiencies be recognized in the income statement? If not, why, and are there other alternatives that are more appropriate? Should an entity delay recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable? If yes, why?

The Firm believes that the tax impact of stock compensation should be deferred until the benefit is realized upon exercise and taxes payable are reduced. In addition, the Firm believes that the tax benefit should be recognized in comprehensive income instead of the income statement.

The Firm believes that the tax benefit should not be estimated at grant because the benefit doesn't outweigh the costs. The benefit would be slightly better adherence to the matching principle. However, this is to the detriment of reliability and relevancy.

The measurement of expected tax benefit involves many factors, many of which are outside of the entity's control and reflect events which occur many years removed for the actual grant date. Some of these factors include:

- Forfeitures caused by employee terminations;
- Exercise date by the employee;
- Employees' decision to make a disqualifying disposition;
- Employees IRS Section 83 election;
- Changes in the fair value of the entity's shares;
- Enacted tax rates and regulations;
- Future results of operations; and
- Future net operating loss carryforwards and other tax credits.

All these factors reduce reliability while significantly increasing the costs and complexity of estimating the tax benefit.

In addition, as noted in the Firm's response to Question #1, the relevancy and importance of a noncash expense to many financial statement users such as lenders and private company shareholders, doesn't exceed the cost of making such a difficult estimate given the factors noted above and the costs associated with having to make these estimates on a grant-by-grant and tax jurisdiction-by-tax jurisdiction basis.

Moreover, the vast majority of stock options granted are qualified stock options and unless granted "in the money" or a disqualifying disposition occurs, there is no tax effect.

Lastly, the Firm believes that the recording of an excess tax benefit or deficiency is in substances a change in accounting estimate. The original estimate of the tax effect is made upon the grant of the award based on the factors noted above and the actual tax effect isn't known until exercise of the options or disposition of the restricted stock depending upon the employee's tax election. As such, the Firm believes that any excess tax benefit or deficiency should be treated no differently than any other change in accounting estimate and recognized prospectively in the income statement in accordance with ASC 250.

Question 3: Should the effect on tax cash flows related to excess tax benefits be classified as an operating activity on the statement of cash flows? If not, what classification is more appropriate and why?

The Firm agrees that excess tax benefits be classified as an operating activity. Conceptually, the Firm believes that any tax effect of stock compensation should be classified in the same manner as the stock compensation which caused the tax effect which most likely would be classified as an operating activity.

However, the Firm believes that stock compensation should be shown net of any tax benefits. The Firm acknowledges and agrees with ASC 230-10-45-7 that generally gross presentation of cash receipts and payments is more relevant than net presentation. However, as also stated in ASC 230-10-45-7 and as applied in ASC 230-10-45-8 through 9 the Firm believes that net presentation should be allowed when net presentation is sufficiently useful to understanding the entity's operating, investing and financing activities. The Firm believes that because stock compensation expense is typically classified as an operating activity and entities are allowed and often do elect to make a policy decision not to present gross receipts and payments from operating activities but instead present cash flows from operating activities under the indirect method as allowed for under ASC 230-10-45-28 then it stands that any taxes associated with stock compensation, which typically classified as operating, should also be shown net.

Question 4: Should entities be permitted to make an accounting policy election either to account for forfeitures when they occur or to estimate forfeitures? If not, why?

The Firm agrees that entities should be permitted to make an accounting policy election whether to estimate forfeitures or account for them as they occur. The Firm believes that entities should be allowed to choose which method (estimating forfeitures or not) is appropriate for their industry and business. Our Firm expects entities in industries with higher turnover (e.g. retail) to elect to estimate forfeitures and those with low turnover to elect to account for forfeitures as they occur. The Firm does not believe that such an accounting policy election will result in significant lack of comparability within industries and any diminished comparability between industries would be far outweighed by the decreased cost of compliance.

Question 5: Is the proposed expansion of the exception to liability classification related to the amount withheld for employee's taxes appropriate? If not, is there another exception that is more appropriate and why?

The Firm agrees with the proposed expansion of the withholding amount allowed. The Firm does not believe that an employee's withholding election should affect an entity's classification of an award. The economic substance of both (compensation for services rendered through the issuance of shares or equity-linked instruments) is no different.

Question 6: Should the cash paid by an employer to the taxing authorities when directly withholding shares for tax-withholding purposes be classified as a financing activity on the statement of cash flows? If not, what classification is more appropriate and why?

The Firm believes that entities paying withholding taxes on stock compensation are in effect acting as agents of their employees and consistent with the Firm's response to Question #3, the Firm believes both: a) the tax effect of stock compensation should be classified in the same manner as the stock compensation which caused the tax effect, which most likely would be an operating activity; and b) stock compensation expense should be shown net any tax effect. See response to Question #3 for further details regarding the Firm's rationale.

Question 7: When assessing the classification of an award with a repurchase feature that can only be exercised on the occurrence of a contingent event, should a contingent event within the employee's control be assessed in the same manner as a contingent event outside the employee's control? If not, why should there be a difference in the assessment?

The Firm believes that the classification of an award with a contingent repurchase feature should be determined not by whether the contingent event is within the employee's control but whether the contingent event is within the entity's control. This approach is consistent with conceptual underpinnings of ASC 480 *Distinguishing Liabilities from Equity* and the liability classification criteria of ASC 815-40 *Derivatives and Hedging: Contracts in Entity's Own Equity*.

Though ASC 480 and ASC 815 exclude stock compensation to employees in their scopes, ASC 718-10-25-6 through 8 explicitly defers to ASC 480 when determining whether stock compensation should be classified as a liability whenever ASC 718 is not prescriptive. In addition, many of the concepts behind the ASC 718 liability classification criteria are derived from the same concepts as ASC 480. For example, stock compensation classified as a liability typically either does not subject the holder to the risks and rewards of ownership (ASC 480-10-25-9a) which mirrors the concept behind *Certain Obligations to Issue a Variable Number of Shares* in paragraph ASC 480-10-25-14 and various paragraphs in ASC 815 or typically conveys to the holder the right to receive, or potentially receive, cash at the <u>holder's</u> discretion (ASC 718-10-25-15) which, in part, mirrors the concept behind *Obligations to Repurchase an Issuer's Equity Shares by Transferring Assets* in paragraph ASC 480-10-25-8 which requires instruments, not in the form of share, be classified as liabilities if the repurchase is contingent upon an event that is not solely within the <u>issuer's</u> control. Additionally, the criteria in ASC 718-10-25-15 which requires the entity to have the ability to deliver shares mirrors the concept in ASC 815-40-25-10 which requires an entity be able to deliver unregistered shares (which isn't permitted by SEC regulations for employee stock compensation) and that the entity have sufficient authorized shares.

The concepts underpinning ASC 480 and ASC 815 are that financial instruments classified as equity subject the holder to the risk and rewards of equity ownership and the issuer of such financial instruments need not be required, or potentially required outside of the issuer's control, to transfer assets such as cash. This concept should be applied consistently whenever possible. Thus the Firm believes that the <u>issuer's</u> ability to control a contingent event and not the <u>holder's</u> ability is a more prudent differentiating factor.

Question 8: Is the practical expedient for nonpublic entities to estimate the expected term of all awards with performance conditions that affect vesting or service conditions appropriate? If not, are there other practical expedients that are more appropriate and why? Should the expedient be limited to nonpublic entities?

The Firm agrees that nonpublic entities should be granted a practical expedient to estimating expected term. However, the Firm believes that the proposed practical expedient should mirror the simplified method used by public entities as prescribed by SAB 110. The currently proposed practical expedient does not appear to be identical or the explanation of the practical expedient in paragraph ASC 718-10-30-20A appears to only pertain to cliff vesting. This actual or perceived difference could result in undue confusion and complexity among prepares and practitioners. Furthermore, the Firm believes that the implementation guidance in proposed paragraph ASC 718-10-55-50A should include a mathematical illustration similar to footnote 77 in SAB 110. In addition, the example should including both cliff and graded vesting.

In practice, many public entities, especially the far more numerous smaller filers, use the simplified method prescribed in SAS110. The Firm believes that given the accounting resource limitations and reduced risk to the public posed by nonpublic entities that the financial reporting requirements of nonpublic entities should be equal to or less burdensome.

Moreover, many private entities, albeit erroneously, apply the simplified method in SAB 110. By codifying this practical expedient the Board would be eliminating diversity in practice between public and nonpublic entities and simplifying the accounting for nonpublic entities thus reducing the cost of compliance while simultaneously increasing comparability.

The Firm believes that this practical expedient should be granted to nonpublic entities because as previously noted the SEC has already promulgated a practical expedient in SAB 110 and in practice many nonpublic and public entities already employ this approach. However, the Board should be cognizant to converge the criteria necessary for using the simplified method under SAB 110 (e.g. insufficient history, significant changes in grants, etc.) with the criteria necessary for public entities to employ the practical expedient. The currently proposed criteria for nonpublic entities in ASC 718-10-30-20B should remain the only criteria for nonpublic entities.

Question 9: Should nonpublic entities be allowed to make a one-time election to switch from measuring liability-classified awards at fair value to intrinsic value? If not, why? While not proposed, should the Board consider making the ability to elect intrinsic value an ongoing election alternative for nonpublic entities?

The Firm believes that the measurement of stock based compensation should be consistent. For nonpublic entities either both equity and liability classified awards should be measured at fair value or both should be measured at intrinsic value and the decision should be an accounting policy election.

If equity classified awards are not allowed to be measured at intrinsic value then the Firm does not believe that nonpublic entities should be granted either a one-time or ongoing election to measure liability classified awards at intrinsic value. To allow liability classified awards to be measured at intrinsic value and not equity classified awards introduces unnecessary complexity and would likely result in an understatement of liability classified awards relative to equity classified awards given that most incentive awards are granted with an exercise price equal to the fair value on the date of grant thus resulting in little to no intrinsic value initially whereas an equity classified awards with the same exercise price, contractual term and vesting would have fair value.

Question 10: Are the transition requirements for each area appropriate? If not, what transition approach is more appropriate?

The Firm believes that for nonpublic entities the transition method for all areas of this amendment should be the prospective approach. Consistent with the Firm’s response to Question #1, the Firm believes that users of nonpublic entities’ financial statements, typically commercial banks and shareholders, who often are also members of management, are more concerned about cash measurements and the additional cost of applying the retrospective approach doesn’t outweigh the benefit to these users. Moreover, the Firm believes that having different transition methods for the different areas of this amendment increases confusion and complexity.

Question 11: How much time will be necessary to adopt the amendments in this proposed Update? Should the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

The Firm believes if nonpublic entities are allowed to apply the prospective approach to all areas then the time necessary to adopt these amendments would be minimal given that they simplify current guidance. If a cumulative-effect adjustment is required for some areas, as currently proposed, then nonpublic entities should be granted an additional year to implement these amendments compared to public entities.

We appreciate the opportunity to submit our views to you. If you have any questions about our comments, please contact me at (813) 251-9235.

Sincerely,

Raymond R. Quinton

Technical Director, Professional Practices