Lessons Learned:
ASU 2016-09 Implementation

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Agenda

- ASU 2016-09 Adoption Timeline
- Accounting for Income Taxes – APIC Pool Elimination
- Accounting for Income Taxes – EPS (Treasury Method)
- Forfeiture Rate
- Minimum Statutory Tax Withholding
- New Disclosure Example
- Forecasting
- Statement of Cash Flow Changes

Adoption Date Timeline

Public Companies:

Fiscal years starting AFTER December 15, 2016

(in most cases, FY17)

Private Companies:

Fiscal years starting AFTER December 15, 2017

(in most cases, FY18)

Companies with a calendar year fiscal year:

- Q1 FY17 is first reporting period under the new rules
- Ensure compliance with the updated rules
- Be prepared for questions

Stock Comp Amendments – ASU 2016-09

Area affected	Amendment	Transition
Accounting for income taxes	1) Excess tax benefits/deficiencies recognized as income tax expense/ benefit in income statement upon vesting/settlement 2) Excess tax benefits recognized regardless if benefit reduces taxes payable	Prospective Modified retrospective
Classification of excess tax benefits on cash flows	Operating cash flow	Prospective or Retrospective
Minimum statutory withholding	Withholding up to employee's maximum statutory rate	Modified retrospective
Classification of employee taxes paid on cash flows	Financing cash flow	Retrospective
Accounting for forfeitures	Accounting policy election: estimate or account for when occur	Modified retrospective

APIC Pool Elimination

Current Guidance versus Amendment

- “Windfalls” recognized in APIC
- Windfall pool tracking
- Shortfalls recognized as:
  (1) APIC, if sufficient pool, or
  (2) Tax expense

- All windfalls and shortfalls in tax expense

Rationale / Implications

- Tracking windfall pool is complex
- Under amendments, no need to maintain a windfall pool
- Volatility in income, EPS, effective tax rate

Windfall/Shortfall Calculation

A	B
Expense:	Tax Deduction:
Based on fair value	Taxable gain of employee or
booked over vesting period	Zero for forfeitures/expirations

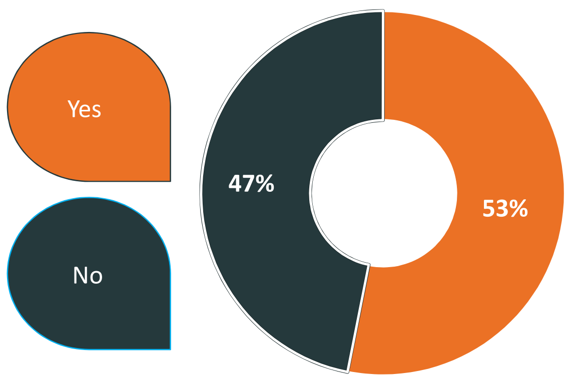
Compare A vs. B:

- If A is greater than B, then it's a shortfall
- If B is greater than A, then it's a windfall
- Under ASU 2016-09, difference between A & B is no longer an equity (APIC Pool) entry

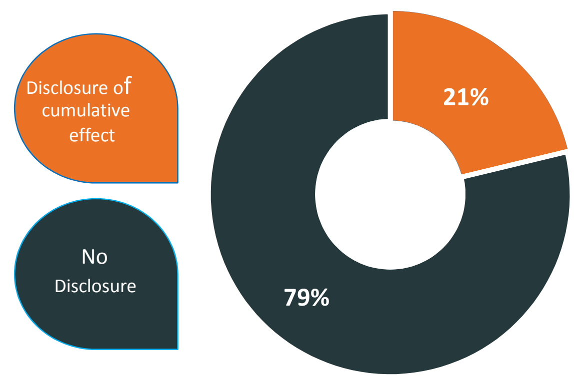
Early Adopter Study – Income Tax Accounting

- Of the 160 companies, 53% included footnote disclosure of the amount of excess tax benefit/deficiency recorded in the income statement during the period.
- This impact on income ranged from under $1 million to over $400 million. For some, there is no impact on income because the company is in a net operating loss position with a full valuation allowance.

Disclosure of P&L Impact of Windfalls



Disclosure of Cumulative-Effect Adjustment



Source: PwC's Stock Compensation Accounting Amendments: Early Adopters (August 2016)

Sample Impact of Tax Effect

Company	Period	Windfall Recognized	Impact on Net Income	Effective Tax Rate	Change in ETR
Microsoft	3Q'16	$376 M	**2.7%**	16.6%	**(12.1%)**
Alphabet Inc.	1Q'16	$211 M	**5.0%**	18.0%	**(18.6%)**
3M	1Q'16	$81 M	**6.4%**	26.8%	**(14.8%)**
Columbia Sportswear	2Q'16	$4.5 M	**19.0%**	20.3%	**(40.0%)**
McDonalds Corp	2Q'16	$43.8 M	**2.0%**	31.3%	**(4.2%)**
Target Corp	1Q'16	$17 M	**2.7%**	31.5%	**(5.7%)**

Accounting for Income Taxes - EPS

Current Guidance versus Amendment Example:

Assumed proceeds:

1. Exercise price
2. Average unamortized expense
3. *Windfall tax benefit*

Assumed proceeds:

1. Exercise price
2. Average unamortized expense
3. ~~*Windfall tax benefit*~~

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Third Party Software Changes

- Enter an ASU 2016-09 adoption date
  - Varies by company
- Reports run with a begin date on or after adoption date should reflect amendments
  - EPS
  - DTA – tax benefit entries

Forfeitures

Election must be made on adoption date

Estimate of forfeitures required

→

Policy election

Estimate forfeitures

or

Account for forfeitures when they occur

Rationale / Implications

- Tracking forfeiture estimates can be complex and costly
- Under either method, comp cost will be recognized for all awards that vest
- Actual forfeiture approach will result in greater expense earlier in award life

Forfeitures – Acquisitions

- ASU does not eliminate need to estimate forfeitures during an acquisition
  - Purchase price calculation to continue estimating forfeitures
- Example (adapted from ASC 805-30-55-11): $200 replacement equity issued
  - $100 FV allocated to purchase price
  - $100 FV post-combination expense
  - Company estimates 5% of converted awards will ultimately forfeit

    Purchase Price: $95 ($100 x 95%)

    Post-combination expense: $105
  - Recognized over the requisite service period (net of actual forfeitures)
- Thus -- processes and controls must still be in place to estimate forfeitures in acquisition replacement awards

Forfeitures – Modifications

- In a modification, the policy to account for forfeitures as they occur is applied subsequent to the modification assessment
- Example (adapted from ASC 718-20-55-121):
  - Jan. 1 2017 – 1,000 RSUs (grant date FV $10) with 4-year service-based vesting
  - December 12, 2017 – Company determines employee will be terminated June 30, 2018 in RIF
  - Modifies award on June 30, 2018 to accelerate vesting
  - FV on Modification Date = $17

Accounting Implications

- No reversal of previously recognized expense until June 30, 2018 (even though forfeiture became probable at December 12, 2017)
- Assess probability at modification date (June 30, 2018) – Type III Modification (improbable to probable)
- Recognize new value of $17,000 (1,000 RSUs x $17) as expense June 30, 2018

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Modified Retrospective

Actual Expense

- Expense accrued prior to adoption is $25,000
- $100,000 x 80% divided by 4 years
- $20,000 per year x 1.25 years

Without Estimating Forfeitures

- Expense accrued prior to adoption would have been $31,250
- $100,000 divided by 4 years
- $25,000 per year x 1.25 years

Cumulative Adjustment

- $31,250 - $25,000 = $6,250
- Increase to paid-in-capital
- Decrease to retained earnings

Minimum Statutory Tax Withholding Requirements

Current Guidance versus Amendment

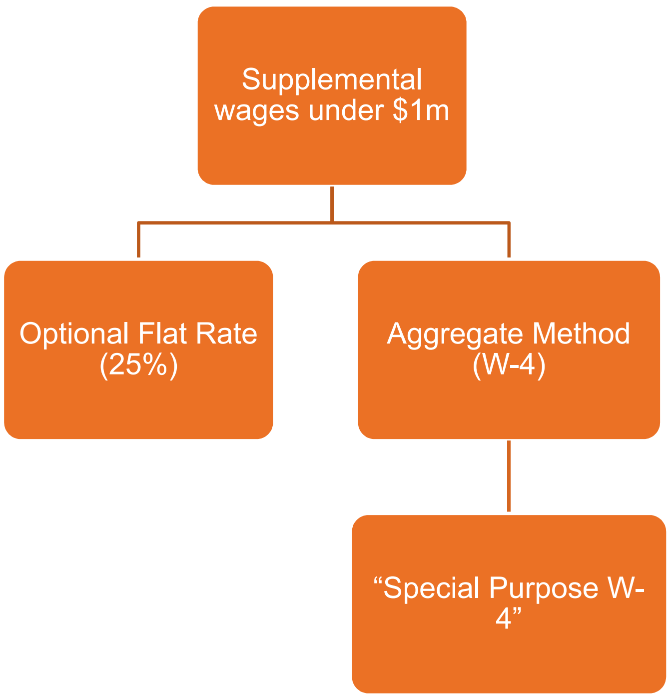
Does net settlement result in liability classification?

Employer's minimum statutory withholding requirements → Employee's maximum statutory tax rate in applicable jurisdictions

Rationale / Implications

- Determining the 'minimum required rate' can be complex
- Creates tension with tax law, which requires *at least* minimum to be withheld
- Amendment reduces the complexity – single maximum rate typically known

FASB vs IRS – Net Settlement and Withholding



- No changes in Treasury regs
- Supplemental wages exceeding $1m
  - Mandatory withholding – 39.6%
- “Special Purpose W-4”
  - New W-4 to ‘temporarily’ increase withholding
  - Submit second revised W-4 to revert
- *Employees may not direct an employer to apply a particular rate of withholding*
- No additional guidance from IRS anticipated (based on PwC discussions with staff)

Non-GAAP Implications

- If non-cash stock compensation is removed from non-GAAP earnings measure, associated tax effects (including windfalls/shortfalls) should likewise generally be removed
- SEC Staff Q&A on Non-GAAP Financial Measures (#102.11)

Question: How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

Answer: A registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, **the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability.** In addition, adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained. [May 17, 2016] [emphasis added]

From the Street – Earnings Guidance

- Windfall/shortfall volatility creates disclosure challenges
  - Forecasting and disclosing anticipated windfalls/shortfalls in future periods

- Monitoring and updating forecasted earnings
  - Impact to forecasted Effective Tax Rate
  - Impact to forecasted EPS

- Judgment in forecasting assumptions
  - Changes in stock price movement or exercise assumption
  - Assumptions about performance condition outcomes
  - Uncertainty in future corporate tax rates

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From the Street – Earnings Guidance

Clorox Updates Fiscal Year 2017 EPS Outlook for Revised Tax Rate Assumptions:

Clorox continues to anticipate delivering 2 percent to 4 percent sales growth in fiscal year 2017, reflecting about 2 percentage points of benefit from the RenewLife acquisition, partially offset by about 2 percentage points of unfavorable foreign currency exchange rates. Excluding the impact of 2 percentage points from unfavorable foreign currency exchange rates, the company continues to anticipate fiscal year sales to grow between 4 to 6 percent.

Clorox continues to anticipate EBIT margin expansion for fiscal year 2017 to be in the range of 25 to 50 basis points, primarily driven by lower selling and administrative expenses, which are expected to be below 14 percent of sales.

Clorox now anticipates its effective fiscal year 2017 tax rate to be between 32 percent and 33 percent versus its previous assumption of 30 percent and 31 percent, reflecting a 2-point reduction versus year ago compared to the previously assumed 4-point reduction from adopting ASU 2016-09. The company's updated assumptions for its fiscal year effective tax rate reflect lower than anticipated exercises of Clorox stock options in the first quarter and the company's revised outlook for full-year stock option exercises. As noted, the company had previously communicated that the benefit to be realized from the adoption of ASU 2016-19 could vary significantly.

Net of all these factors, Clorox now anticipates fiscal year 2017 diluted EPS from continuing operations to be in the range of $5.23 to $5.43, **which includes the updated assumption of 10 to 15 cents of benefit to fiscal year EPS from adopting the accounting standards update**. **Excluding the benefit of adopting the accounting standards update, Clorox continues to anticipate fiscal year 2017 diluted EPS from continuing operations to be in the range of $5.13 to $5.28**.

From the Street – Earnings Guidance

Clorox Updates Fiscal Year 2017 EPS Outlook for Revised Tax Rate Assumptions:

Expectations For Sales Growth and EBIT Margin Expansion Remain Unchanged

- 2% to 4% sales growth (unchanged)
- 25 basis points to 50 basis points of EBIT margin expansion (unchanged)
- $5.23 to $5.43 diluted EPS range (**updated for ASU 2016-09 impact**)
- $5.13 to $5.28**, excluding ASU 2016-09 impact** (unchanged)

	FY17 Outlook	
	as of Aug. 3, 2016	as of Nov. 2, 2016
Diluted EPS, excluding ASU	$5.13 to $5.28	$5.13 to $5.28
ASU 2016-09 benefit	$0.25 to $0.30	$0.10 to $0.15
Diluted EPS Outlook	$5.38 to $5.58	$5.23 to $5.43

Forecasting Volatility – Tax Windfalls/Shortfalls

- In addition to impact on earnings forecasts, tax windfall/shortfall volatility impacts internal budgeting and forecasting
- Modeling can hedge against future uncertainty
- Developing key assumptions for dynamic model
  - Timing of settlements
  - Stock price movement
  - Performance condition outcomes
  - Forfeitures
  - Future tax rates
- See PwC's article – *Volatile earnings and effective tax rates are coming – how stock compensation tax effect modelling can help*

Statement of Cash Flows – Net Settlement

Current Guidance versus Amendment

No guidance on classification → Classified as a financing activity

Rationale / Implications

- Diversity in practice today

Considerations for Issuers

Some companies reflect these payments as operating cash outflows today. Determine whether adjustment will be needed upon adoption.

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Statement of Cash Flows – Excess Tax Benefits Classification

Current Guidance versus Amendment

Displayed gross as an operating outflow and a financing inflow → Combined with other income tax cash flows within operating cash

Rationale / Implications

- The current treatment is the only exception from single line presentation of taxes within operating cash flows

Questions?

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Thank You

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