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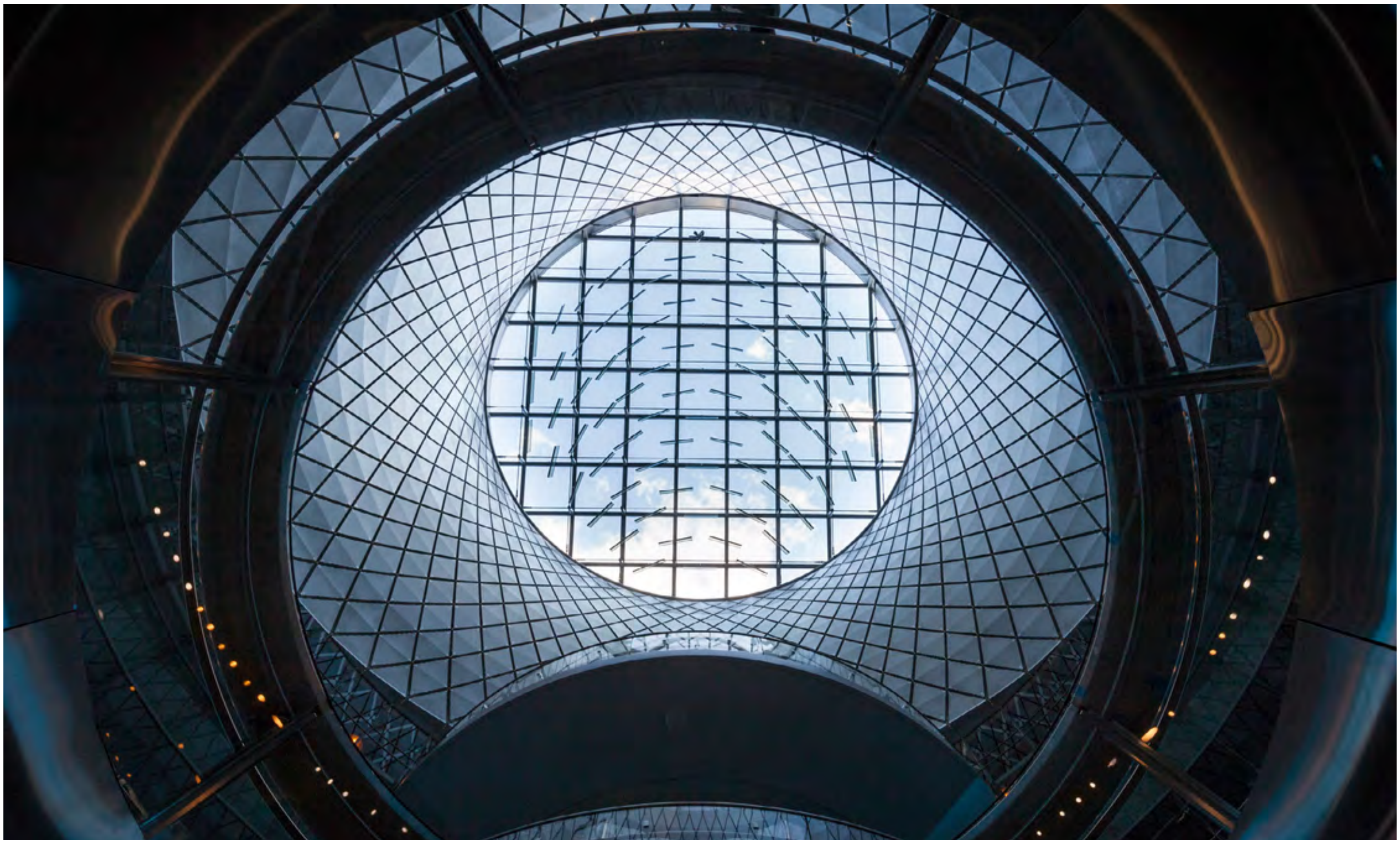

In This Issue

FASB Proposes to Amend the Scope of Modification Accounting for Share-Based Payment Arrangements

by Sandie Kim and Jonathan Margate, Deloitte & Touche LLP

On November 17, 2016, the FASB issued a proposed ASU[1] that would amend the scope of modification accounting for share-based payment arrangements. The proposed ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under ASC 718.[2] Specifically, an entity would not apply modification accounting if the fair value,[3] vesting conditions, and classification of the awards are the same immediately before and after the modification.

Comments on the proposed ASU are due by January 6, 2017. For ease of reference, the proposal's questions for respondents are reprinted in the appendix of this *Heads Up*.

1 FASB Proposed Accounting Standards Update (ASU), *Scope of Modification Accounting*.
2 FASB Accounting Standards Codification (ASC or the "Codification") Topic 718, *Compensation — Stock Compensation*.
3 If the measurement of the awards in the financial statements is based on calculated value or intrinsic value, the comparison before and after the modification would be based on such an alternative measurement method instead of fair value.

Background

When ASU 2016-09[4] was issued in March 2016 under the Board's simplification initiative,[5] it made a change to ASC 718 regarding the exception to liability classification of an award related to an employer's use of a net-settlement feature to withhold shares to meet the employer's statutory tax withholding requirement. Under ASU 2016-09, the net settlement of an award for statutory tax withholding purposes does not result, by itself, in liability classification of the award as long as the amount withheld for taxes does not exceed the *maximum* statutory tax rate in the employee's relevant tax jurisdiction(s). Before an entity adopts ASU 2016-09, the exception applies only when no more than the number of shares necessary for the *minimum* statutory tax withholding requirement to be met is repurchased or withheld.

Upon adopting ASU 2016-09, some entities may change the net-settlement terms of their share-based payment arrangements from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. Some constituents questioned whether this change, if made to existing awards, would require the application of modification accounting under ASC 718-20-35-3.

Editor's Note

On the basis of discussions with the FASB staff, we believe that the change discussed above would not require the application of modification accounting. However, this accounting treatment would apply only in these narrow circumstances (i.e., solely to change the net-settlement provisions from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate for statutory tax withholding purposes) and should not be analogized to other situations.

After the aforementioned discussions, the FASB staff performed research on whether the Board should change the scope of the modification guidance in ASC 718 because a modification is defined in ASC 718-20-20 as a "change in **any** of the terms or conditions of a share-based payment award" (emphasis added). Since the definition of the term "modification" is broad, there may be diversity in practice related to which types of changes to share-based payment awards result in the application of modification accounting. For example, some entities may apply modification accounting only if the change is substantive. In contrast, some entities may apply modification accounting broadly to all changes unless the change is solely administrative.

When an entity applies modification accounting to equity-classified awards and the original awards are expected to vest (because of any service or performance conditions) on the modification date, a modification may result in incremental compensation cost. The fair-value-based measurement of the awards immediately before the modification is compared to the fair-value-based measurement of the awards immediately after the modification. If the fair-value-based measurement after the modification is higher than it is before the modification, incremental compensation cost is generally recognized over any remaining requisite service period. If, instead, the original awards are not expected to vest on the modification date, an entity generally recognizes any compensation cost for the modified awards on the basis of the revised fair-value-based measurement on the modification date (as opposed to the original grant-date fair-value-based measurement).

[4] FASB Accounting Standards Update No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*.

[5] The simplification initiative is the Board's effort to reduce the cost and complexity of current U.S. GAAP while maintaining or enhancing the usefulness of the related financial statement information.

Example 1

Entity A grants employees restricted stock units that are classified as equity and have a fair-value-based measure of $1 million on the grant date. Entity A subsequently modifies the awards to add a contingent repurchase feature on the underlying shares for which the repurchase price is based on the fair value of the shares on the repurchase date. Assume that the addition of the contingent repurchase feature does not change the fair-value-based measurement of the awards or the classification of the awards, and the fair-value-based measure on the modification date is $1.5 million (both immediately before and after the modification). In addition, there are no other changes to the awards, including the vesting conditions. If A applies modification accounting and the awards are expected to vest on the modification date, there is no accounting consequence associated with the modification, and any compensation cost will continue to be based on the grant-date fair-value-based measure of $1 million. However, if A applies modification accounting and the awards are not expected to vest on the modification date, any compensation cost to be recognized (if the awards are subsequently expected to vest or actually vest) will be based on the modification-date fair-value-based measure of $1.5 million.

Key Provisions of the Proposed ASU

Scope of Modification Accounting

The proposed ASU would amend ASC 718 to limit the instances in which modification accounting is applied. Entities would account for the effects of a modification unless all of the following items are the same immediately before and after the modification:

- The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the award.[6]
- The vesting conditions of the award.
- The classification of the award as an equity instrument or a liability instrument.

In addition, as a consequential amendment, the proposal would remove the phrase "any of" from the definition of "modification." Under the proposed ASU, a modification would be defined as a "change in the terms or conditions of a share-based payment award."

Editor's Note

The Board considered, but ultimately rejected, the addition of a criterion stipulating that for modification accounting not to apply, the change must be made as a result of newly effective amendments to the Codification or newly effective laws or regulations. The FASB rejected this criterion, citing operability challenges (i.e., it may be difficult to determine whether changes to awards are made solely as a result of newly effective amendments to U.S. GAAP or newly effective laws or regulations).

[6] While the references herein are to fair value or fair-value-based measurement, if calculated value or intrinsic value is used to recognize share-based payment awards, that alternative measurement method would apply instead of fair value.

In addition, the Board considered but ultimately rejected proposing that an entity would not apply modification accounting if changes to awards are made solely to preserve the value of the awards after an equity restructuring. For example, if an entity added an antidilution provision associated with equity restructurings, it would not apply modification accounting, even if the change was made in contemplation of an equity restructuring. The Board rejected this alternative because there is incremental value conveyed when awards are amended to add an antidilution provision in contemplation of an equity restructuring. As a consequence, the current guidance in ASC 718 would continue to apply. That is, if an antidilution provision is added but an equity restructuring is not contemplated, modification accounting would not be applied. However, if an equity restructuring is contemplated, modification accounting would apply and there could be significant incremental compensation cost to recognize.

Upon an equity restructuring, it is not uncommon for an entity to make employees "whole," in accordance with preexisting nondiscretionary antidilution provisions, on an intrinsic-value basis when the awards are stock options. In certain circumstances, the fair-value-based measurement of modified stock options could change as a result of the restructuring even if the intrinsic value remains the same. The proposed ASU would allow a comparison of intrinsic value to be used to determine whether modification accounting is applied only "if such an alternative measurement method is used"; thus, if an entity measures and recognizes compensation cost for its share-based payment awards by using a fair-value-based measure, modification accounting would still be required in those circumstances in which the fair-value-based measurement has changed, even if the intrinsic value is the same immediately before and after the modification.

Example 2

Entity B has granted restricted stock units and stock options to its employees. The share-based payment awards are classified as equity, and compensation cost is recognized on the basis of the fair-value-based measurement of the awards on the grant date. Entity B subsequently modifies the awards upon a spin-off of one of its subsidiaries. The modification does not change any vesting conditions or the classification of the awards as equity. Entity B's share-based payment plan has a preexisting nondiscretionary antidilution provision (i.e., it was not added in contemplation of the spin-off) to make employees whole in the event of an equity restructuring. In addition, the fair-value-based measurement of the restricted stock units is the same immediately before and after the modification. However, the fair-value-based measurement of the stock options is different before and after the modification, even though the intrinsic value is the same. Under the proposed ASU, B would not apply modification accounting to the restricted stock units because the fair-value-based measurement, vesting conditions, and classification are the same immediately before and after the modification. Compensation cost for the restricted stock units will continue to be based on their grant-date fair-value-based measurement. However, B would apply modification accounting to the stock options because the fair-value-based measurement is not the same immediately before and after the modification. If the stock options are expected to vest at the time of the modification, B would determine whether any incremental compensation cost should be recognized by comparing the fair-value-based measurement of the stock options immediately before and after the modification. If the stock options are not expected to vest at the time of the modification, any compensation cost recognized (provided that the awards are subsequently expected to vest or actually vest) will be based on the modification-date fair-value-based measurement, which could be significantly different from the grant-date fair-value-based measurement.

The proposal's Basis for Conclusions provides additional clarity on the application of proposed ASC 718-20-35-2A(a), which requires that the fair value be the same immediately before and after the modification for modification accounting not to be applied. In paragraph BC11, the Board clarified that the evaluation should be based on whether the fair value has changed, not on whether the compensation cost recognized has changed. In addition, BC14 clarifies that a computation of the fair value before and after the modification is not expected in all cases. Rather, if the entity determines that the modification does not affect any of the inputs used in its value calculation, the entity most likely could conclude that the fair value would be the same immediately before and after the modification.

Editor's Note

Paragraph BC11 includes an example of a change that results in a "Type IV" modification (improbable to improbable), which is a modification in which share-based payment awards are not expected to vest both immediately before and after the modification. In that example, there may be no change in compensation cost to be recognized on the modification date. That is, because the awards are not expected to vest immediately before and after the modification, no compensation cost is recognized before or upon the modification. However, in paragraph BC11, the FASB notes that the fair value "typically would change because there is a new measurement date for the award for a Type IV modification" and the entity "would apply modification accounting under paragraph 718-20-35-2A." This comment might suggest that even if incremental value is not conveyed upon a change to the terms of an award, because any compensation cost that could be recognized (if the award is subsequently expected to vest or actually vests) is based on the fair-value-based measurement on the modification date instead of the original grant date, modification accounting would be applied if the modification-date fair-value-based measurement is different from the grant-date fair-value-based measurement.

If this interpretation is applied to Example 1 above, the accounting would remain the same under the proposed ASU if the awards are not expected to vest immediately before the modification (i.e., modification accounting would be applied, and the revised fair-value-based measure of $1.5 million on the modification date would be used to recognize any compensation cost). However, we believe that the example in paragraph BC11 may conflict with the guidance in proposed ASC 718-20-35-2A(a) because the comparison in the proposed paragraph is fair value immediately before and after the modification (i.e., even if the original awards are not expected to vest, modification accounting would not be applied in Example 1 because the awards' fair-value-based measure of $1.5 million is the same immediately before and after the modification). Accordingly, while we believe that modification accounting would not be applied in Example 1 on the basis of proposed ASC 718-20-35-2A(a), even if the awards are not expected to vest, additional clarification of paragraph BC11 would be needed.

The proposed ASU's Basis for Conclusions also provides examples (that "are educational in nature, are not all-inclusive, and should not be used to override the guidance in paragraph 718-20-35-2A") of changes to awards for which the Board believes that modification accounting would not be required as well as those for which the Board believes that it would be required. The following table summarizes those examples:

Examples of Changes for Which Modification Accounting Would Not Be Required	Examples of Changes for Which Modification Accounting Would Be Required
• Administrative changes, such as a change to the company name, company address, or plan name. • Changes in net-settlement provisions related to tax withholdings that do not affect the classification of the award.	• Repricing of options that results in a change in value. • Changes in a service condition. • Changes in a performance condition or a market condition. • Changes in an award that results in a reclassification of the award (equity to liability or vice versa). • The addition of a change-in-control provision under which awards are immediately vested upon occurrence of the event.

Disclosures

ASC 718 currently requires entities to disclose a description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications. Under the proposed ASU, additional disclosures would not be required.

Editor's Note

Entities would still be required to disclose any significant changes to the terms or conditions of share-based payment awards that meet the definition of a modification under ASC 718-20-20, even if modification accounting is not applied under the proposed ASU. For example, under the proposed ASU, if an entity changes the settlement terms of its share-based payment awards but such a change does not result in a change in fair value, vesting condition, or classification, modification accounting would not be applied. However, the entity may still be required to disclose the change in settlement terms if the modification is significant.

Effective Date and Transition

The FASB plans to determine an effective date for the final guidance after considering stakeholder feedback on the proposed ASU. Entities would apply the proposed amendments prospectively to modifications on or after the effective date, and transition disclosures would not be required.

Appendix — Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for reference.

Question 1: Do you agree with the amendments in this proposed Update about when an entity is required to apply modification accounting? If not, why?

Question 2: Should new or different disclosures be included in Topic 718 as a result of the amendments in this proposed Update? If yes, what are those disclosures and why would they be useful to financial statement users?

Question 3: Are the transition requirements appropriate? If not, what transition approach is more appropriate and why?

Question 4: How much time would be needed to adopt the amendments in this proposed Update? Should the amount of time needed to apply the amendments in this proposed Update by entities other than public business entities be different from the amount of time needed by public business entities? Should early adoption be permitted? If yes to either question, please explain why.

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