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FASB Amends the Scope of Modification Accounting for Share-Based Payment Arrangements

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On May 10, 2017, the FASB issued ASU 2017-09,[1] which amends the scope of modification accounting for share-based payment arrangements. The 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.

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

[1] FASB Accounting Standards Update No. 2017-09, *Scope of Modification Accounting*.
[2] FASB Accounting Standards 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.
[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.

maximum statutory tax rate in the employee's relevant tax jurisdiction(s). Before an entity adopts ASU 2016-09, the exception applies only when the entity repurchases or withholds no more than the number of shares necessary for the *minimum* statutory tax withholding requirement to be met.

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 they would be required to apply modification accounting under ASC 718-20-35-3 if they changed existing awards in this manner. On the basis of discussions with the FASB staff, we noted in our April 21, 2016, *Heads Up* that if entities made such a change, they would not be required to apply modification accounting.

The FASB staff subsequently conducted research on whether the Board should change the scope of the modification guidance in ASC 718 given that ASC 718-20-20 defines a modification as a "change in **any** of the terms or conditions of a share-based payment award" (emphasis added). As a result of that broad definition, there may be diversity in practice regarding the types of changes to share-based payment awards to which an entity applies modification accounting. For example, some entities may apply it only to substantive changes while others may apply it broadly to all changes other than solely administrative ones. Accordingly, to provide clarity and reduce diversity, cost, and complexity, the FASB issued ASU 2017-09.

The effect of an entity's application of modification accounting depends on whether the original awards are expected to vest, and such effect could be significant. If the 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, the entity may incur incremental compensation cost. The entity compares the fair-value-based measurement of the awards immediately before the modification with 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, the entity generally recognizes incremental compensation cost over any remaining requisite service period. If, instead, the original awards are not expected to vest on the modification date, the 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).

Examples 1 and 2 below illustrate the effects of an entity's application of modification accounting depending on whether the original awards are expected to vest.

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. Before the awards vest, A subsequently modifies them to provide dividend participation during the vesting period. Assume that the addition of dividend participation changes the fair-value-based measurement of the awards and that the fair-value-based measure on the modification date is $1.5 million immediately before the modification and $1.6 million immediately after it. In addition, there are no other changes to the awards (including their vesting conditions or classification). If A applies modification accounting, and the awards are expected to vest on the modification date, A would recognize incremental compensation cost of $100,000 over the remaining requisite service period (for a total of $1.1 million of compensation cost). 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 do vest) will be based on the modification-date fair-value-based measure of $1.6 million.

Example 2

Entity B grants employees restricted stock units that are classified as equity and have a fair-value-based measure of $1 million on the grant date. Before the awards vest, B subsequently modifies them to add a contingent fair-value repurchase feature on the underlying shares. Assume that the addition of the repurchase feature **does not** change the fair-value-based measurement of the awards or their classification and that 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 their vesting conditions). If B applies modification accounting, and the awards are expected to vest on the modification date, there is no accounting consequence associated with the modification because there is no increase in the fair-value-based measurement; any compensation cost will continue to be based on the grant-date fair-value-based measure of $1 million. However, if B 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 do vest) will be based on the modification-date fair-value-based measure of $1.5 million.

In accordance with the ASU's provisions (see discussion below), B would not apply modification accounting because the fair-value-based measurement, vesting conditions, and classification of the awards are the same immediately before and after the modification. Accordingly, irrespective of whether the awards are expected to vest on the modification date, any compensation cost recognized will continue to be based on the grant-date fair-value-based measure of $1 million.

Key Provisions of the ASU

Scope of Modification Accounting

The ASU limits the circumstances in which an entity applies modification accounting. When an award is modified, an entity does not apply the guidance in ASC 718-20-35-3 through 35-9 if it meets all of the following criteria:

- "The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified."
- "The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified."
- "The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified."

The ASU also removes the guidance in ASC 718 stating that modification accounting is not required when an entity adds an antidilution provision as long as that modification is not made in contemplation of an equity restructuring.

Editor's Note

We do not expect practice to change as a result of the Board's removal of the guidance in ASC 718 on an entity's addition of an antidilution provision to awards. If an entity adds such a provision but does not contemplate an equity restructuring, the fair-value-based measurement of the awards would generally remain the same. Accordingly, as long there are no other changes to the awards that would affect vesting or classification, the entity does not apply modification accounting. If the entity contemplates an equity restructuring, however, it applies modification accounting and may need to recognize significant incremental compensation cost.

In addition, upon an equity restructuring, it is not uncommon for an entity to make employees "whole" (in accordance with a preexisting nondiscretionary antidilution provision) 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 equity restructuring even if the intrinsic value remains the same. Under the ASU, an entity compares the intrinsic value before and after a modification in determining whether to apply modification accounting only "if such an alternative measurement method is used"; thus, if an entity uses a fair-value-based measure to calculate and recognize compensation cost for its share-based payment awards, it would still be required to apply modification accounting when the fair-value-based measurement has changed, even if the intrinsic value is the same immediately before and after the modification.

Example 3

Entity C grants employees stock options that are classified as equity and recognizes compensation cost on the basis of the fair-value-based measurement of the awards on the grant date. Upon a spin-off of one of its subsidiaries, C subsequently modifies the awards. The modification does not change any vesting conditions or the classification of the awards as equity.

Entity C's share-based payment plan has a preexisting nondiscretionary antidilution provision (i.e., the provision 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 stock options granted to each employee is different before and after the modification even though the intrinsic value is the same.

Under the ASU, C 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, C 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 do 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.

If an entity modifies its awards and concludes that it is not required to apply modification accounting under the ASU, it must still consider whether the modification affects its application of other guidance. For example, under ASC 718-10-35-9 through 35-14, if an entity modifies an award after the holder is no longer an employee, the modification may be subject to other U.S. GAAP (unless the modification is made solely to reflect an equity restructuring that meets certain criteria).

Clarifications Related to the Fair Value Assessment

The ASU clarifies how an entity would calculate fair value under ASC 718-20-35-2A(a) in determining whether modification accounting is required.

Determining Whether a Fair Value Calculation Is Required

ASC 718-20-35-2A(a) states, "If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification."

Editor's Note

In paragraph BC16 of the ASU, the Board noted that it does not expect that an entity will always need to estimate the fair-value-based measurement of a modified award. An entity might instead be able to determine whether the modification affects any of the inputs used in the valuation technique performed for the award. For example, if an entity changes the net-settlement terms of its share-based payment arrangements related to statutory tax withholding requirements, that change is not likely to affect any inputs used in the method performed by the entity to value the awards. If none of the inputs are affected, the entity would not be required to estimate the fair-value-based measurement immediately before and after the modification (i.e., the entity could conclude that the fair-value-based measurement is the same).

Considering Whether Compensation Cost Recognized Has Changed

In paragraph BC13 of the ASU, 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.

Editor's Note

If an entity makes a modification that changes the fair value of an award, modification accounting would be applied. The Board clarified that the entity's assessment does not take into account whether the compensation cost recognized has changed. For example, if the modification changes the fair value of the award but it is not probable that the award will vest both immediately before and after the modification (a "Type IV improbable-to-improbable" modification), there may be no change in compensation cost recognized on the modification date because there is no compensation cost before and after the modification (compensation cost is recognized only if it is probable that the award will vest). However, modification accounting would be required (and a new measurement determined as of the modification date) because the fair value has changed.

Determining the Unit of Account

In paragraphs BC19 and BC20 of the ASU, the Board discusses the unit of account to apply in the determination of whether an award's fair value is the same immediately before and after the modification. The discussion addresses questions from stakeholders about whether an entity should compare the value of an award immediately before and after a modification on the basis of (1) "the total instruments in an award to an employee that are modified" or (2) "each individual instrument awarded to an employee that is modified." The Board indicates that the unit of account to apply in the fair value assessment should be consistent with that applied under other guidance in ASC 718 and with the definition of an award in the ASC master glossary. That is, an entity should use as the unit of account the total of all modified instruments in the award rather than each individual modified instrument awarded to the employee.

Editor's Note

The ASC master glossary defines an award as follows:

> The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award.

Example 4

Paragraph BC19 of the ASU provides an example in which an entity grants an employee 10,000 stock options. After the grant date, the stock options become significantly out of the money, so the entity modifies the award by lowering the options' exercise price and reducing their quantity to 5,000. The entity's intent is for the value of the original and modified awards to be the same.

If the entity were to compare the fair-value-based measurement of a single stock option in the original award immediately before the modification with the fair-value-based measurement of a single stock option in the modified award immediately after the modification, the fair-value-based measure per stock option immediately before the modification would be less than the fair-value-based measure per stock option immediately after the modification. If a single stock option were the unit of account, the entity would be required under the ASU to apply modification accounting. However, the assessment is linked to the ASC master glossary's definition of an award. Although the award is this example contains multiple instruments, the unit of account on which the entity performs the fair value assessment is the total of all modified instruments awarded to the employee. Accordingly, the entity compares the fair-value-based measurement of the original 10,000 stock options with the fair-value-based measurement of the modified 5,000 stock options.

Example 5

Entity D grants an employee 1,000 equity-classified stock options. All 1,000 options are granted at the same time and contain the same terms and conditions. In accordance with the definition of "award" in the ASC master glossary, the employee's award consists of 1,000 options. After the grant date, the options become significantly out of the money, so D decides to reprice 500 of the stock options by reducing the exercise price for those 500 options. However, D retains the original exercise price for the other 500 options. Accordingly, the 500 modified options are now the "award" as well as the unit of account in D's assessment of whether it must apply modification accounting. Because the fair-value-based measurement of the 500 modified options has increased, D applies modification accounting. However, because the other 500 stock options were not modified, that award is not subject to modification accounting and continues to be recognized on the basis of its grant-date fair-value-based measure.

While all 1,000 stock options were the "award" and the unit of account when granted, only the 500 modified stock options are the "award" and the unit of account in the modification accounting assessment because they were the only instruments modified. In accordance with the ASC master glossary, "[r]eferences to an award also apply to a portion of an award."

Determining Whether the Fair Value Is the Same

In determining whether the fair value of an award is the same immediately before and after a modification, some practitioners have expressed uncertainty about whether the fair value must be *exactly* the same (i.e., a binary assessment) or whether they can apply judgment on the basis of the significance of the change in fair value. The Board decided not to provide guidance on the use of judgment in this assessment, observing that entities must use judgment to apply other aspects of ASC 718 and do so without specific guidance. Accordingly, an entity may need to use judgment in certain circumstances to determine whether the fair value of an award is the same immediately before and after a modification.

Editor's Note

While in many circumstances it may be clear whether the fair value of an award is the same immediately before and after a modification, an entity may need to use judgment when such value is not exactly the same. For example, an entity may reasonably conclude that the fair value is the same when a difference is de minimus and the facts and circumstances indicate that the intent of the modification is to retain the original fair value.

Example 6

Entity E grants an employee 1,000 equity-classified stock options. After the grant date, the options become significantly out of the money. With the intent of retaining the fair value of the original award, E decides to replace the 1,000 stock options with 423 restricted stock units. The fair-value-based measure of the 1,000 stock options immediately before the modification is $100,000, and the fair-value-based measure of the 423 restricted stock units is $100,010. The difference is de minimus and solely attributable to E's having rounded up the 423 restricted stock units, which it does because it is precluded from issuing fractional shares. Accordingly, E concludes that the fair value of the award is the same immediately before and after the modification.

Examples From the ASU's Basis for Conclusions

The ASU's Basis for Conclusions 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 (1) changes to awards for which modification accounting generally would not be required and (2) those for which it generally 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	• Repricings of stock options that result in a change in value • Changes in a service condition • Changes in a performance condition or a market condition • Changes in an award that result in a reclassification of the award (equity to liability or vice versa) • Addition of an involuntary termination provision in anticipation of a sale of a business unit that accelerates vesting of an award

Editor's Note

Share-based payment plans commonly contain clawback provisions that allow an entity to recoup awards upon certain contingent events (e.g., termination for cause, violation of a noncompete provision, material financial statement restatement). Under ASC 718-10-30-24, such clawback provisions are generally not reflected in estimates of the fair-value-based measure of awards. Accordingly, we believe that the addition of a clawback provision to an award would typically not result in the application of modification accounting because such clawbacks generally do not change the fair value, vesting conditions, or classification of an award.

Example 7

Entity F grants 100,000 equity-classified stock options to its CEO. A year after the grant date, F modifies the award to add a well-defined, objective, and nondiscretionary clawback provision related to a material restatement of F's financial statements. Entity F concludes that the modification does not change the fair value, the vesting conditions, or the classification of the award. In assessing whether the award's fair value changes as a result of the modification, F determines that the addition of the clawback provision does not affect any of the inputs used in the valuation technique since clawback provisions are generally not reflected in estimates of the fair-value-based measure of awards. As a result, F concludes that it is not required to apply modification accounting.

Disclosure

ASC 718 currently requires entities to disclose information about significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications. The ASU generally does not require disclosure of additional information; however, because some significant modifications may not result in incremental compensation cost, the Board decided to add a requirement to disclose "lack of" incremental compensation cost resulting from such modifications.

Editor's Note

Under the ASU, entities must continue 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. For example, if an entity makes significant changes to the settlement terms or other economic characteristics of its share-based payment awards but does not apply modification accounting because the changes do not affect the awards' fair value, vesting conditions, or classification, the entity must disclose the modification. The Board believes that disclosures about modifications provide useful information to users of financial statements, particularly if such changes substantively alter the economic characteristics of the awards.

Effective Date

For all entities, the ASU is effective for annual reporting periods, including interim periods within those annual reporting periods, beginning after December 15, 2017.

Early adoption is permitted, including adoption in any interim period.

Transition and Related Disclosures

The ASU's amendments should be applied prospectively to awards modified on or after the effective date. Transition disclosures are not required, because modifications typically are not recurring events for most entities.

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