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

At yesterday's meeting, the FASB tentatively decided to amend the scope of modification accounting in ASC 718,[1] and made tentative decisions on the related disclosures and transition.

Background

When ASU 2016-09[2] was issued in March 2016 under the Board's simplification initiative,[3] one of the changes to ASC 718 was related to the current exception to liability classification of an award when an employer uses 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 jurisdictions. 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.

As a result of 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. While this change may be made to existing awards, entities would not account for it as a modification of those awards pursuant to ASC 718-20-35-3.

Editor's Note: This conclusion was confirmed on the basis of discussions with the FASB staff. However, this accounting treatment applies 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, since a modification is defined broadly in ASC 718-20-20 as a "change in **any** of the terms or conditions of a share-based payment award" (emphasis added).

When an entity is applying modification accounting, if the original awards are expected to vest (on the basis of any service or performance conditions) on the modification date, a modification may result in incremental compensation cost. If the fair-value-based measurement of the awards does not change, the vesting requirements remain the same, and the classification of the awards is not changed, there is no accounting consequence to the modification for equity-classified awards. If, instead, the original equity-classified awards are not expected to vest on the modification date, an entity 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) if the entity is applying modification accounting.

For example, consider a share-based payment award that is classified as equity and has a fair-value-based measure of $10 on the grant date. An entity modifies the award to add a contingent repurchase feature for which the repurchase price is based on the fair-value-based measure of the award on the repurchase date. In this example, assume the addition of the contingent repurchase feature does not change the fair-value-based measurement of the award, the vesting requirements, or the classification of the award, and the fair-value-based measure on the modification date is $15 (both immediately before and after the modification). If the award is expected to vest before the modification, 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 $10. However, if the award is not expected to vest before the modification, any compensation cost to be recognized (if the award is expected to vest later or actually vests) will be based on the modification-date fair-value-based measure of $15.

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[1] FASB Accounting Standards Codification (ASC or the "Codification") Topic 718, *Compensation — Stock Compensation*.

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

[3] 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.

Under this project, the Board would consider whether this type of change to the terms of an award, as well as other similar types of changes, would be accounted for as a modification under ASC 718-20-35-3.

Scope of Modification Accounting in Topic 718

The FASB staff presented several alternatives to reduce the scope of transactions that would require modification accounting under ASC 718:

- *Alternative A* — Entities would not apply modification accounting under ASC 718 if (1) changes to awards are made as a result of newly effective amendments to the Codification or newly effective regulations and (2) those changes would not result in a change in total current fair value (or total calculated value or total intrinsic value, if such an alternative measurement is used), vesting requirements, or classification of the awards.
    - *Alternative A1* — Entities would not apply modification accounting under ASC 718 to changes to awards made *directly or indirectly* as a result of newly effective amendments to the Codification or newly effective regulations.
    - *Alternative A2* — Entities would not apply modification accounting under ASC 718 to changes to awards made *directly* as a result of newly effective amendments to the Codification or newly effective regulations.
- *Alternative B* — Entities would not apply modification accounting under ASC 718 in either of the following circumstances:
    - Changes to awards that do not affect the total current fair value (or total calculated value or total intrinsic value, if such an alternative measurement method is used), vesting requirements, or classification of the awards.
    - Changes to awards made solely to preserve the value of the awards after an equity restructuring.
- *Alternative C* — Entities would not apply modification accounting under ASC 718 to changes to awards that do not affect the total current fair value (or total calculated value or total intrinsic value, if such an alternative measurement method is used), vesting requirements, or classification of the awards.

Editor's Note: Under all the alternatives proposed by the FASB staff, entities would not apply modification accounting under certain circumstances if the change would not result in a change in total current fair value (or total calculated value or total intrinsic value, if such an alternative measurement is used), vesting requirements, or classification of the awards.

Under Alternatives B and C, a newly effective amendment to the Codification or newly effective regulation is not required. However, under Alternative B, entities would also not apply modification accounting if the change to the awards is made solely to preserve the value of the awards after an equity restructuring. Under this alternative, an entity that adds an antidilution provision associated with an equity restructuring would not be required to apply modification accounting even if the change is made in contemplation of an equity restructuring. Under current GAAP, such a change made in contemplation of an equity restructuring would require an entity to apply modification accounting, which could result in significant additional compensation cost.

The Board tentatively decided on Alternative C to address the scope of modification accounting.

Editor's Note: There was not much discussion during the meeting on Alternative A as the Board agreed with the FASB staff that such alternative would result in operational challenges (i.e., it may be difficult to determine whether changes to awards are made as a result of newly effective amendments to the Codification or newly effective regulations). Accordingly, the debate by the Board focused on Alternatives B and C. Ultimately, the majority of the Board tentatively decided on Alternative C as they had concerns about not applying modification accounting to circumstances in which an antidilution provision is added to the terms of awards in contemplation of an equity restructuring.

Recurring 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. The Board tentatively decided not to require additional disclosures.

Editor's Note: The Board's tentative decision to amend the scope of modification accounting would still require entities 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. For example, if an entity changes the settlement terms of its share-based payment awards but such change does not result in a change in fair value, vesting condition, or classification, under the Board's tentative decision, modification accounting would not be applied. However, that entity may still be required to disclose the change in settlement terms if it is a significant modification.

Transition

The Board tentatively decided that entities should apply the tentative decisions above prospectively to modifications after the effective date. In addition, the Board tentatively decided that transition disclosures will not be required.

Next Steps

The Board directed the FASB staff to draft a proposed ASU with a minimum comment period of 30 days. The proposal is expected to be issued in late November, with comments due by January 6, 2017.