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2016-360
Comment Letter No. 12

Ms. Susan M. Cospers
Technical Director
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6 January 2017

Proposed Accounting Standards Update, Compensation – Stock Compensation (Topic 718), Scope of Modification Accounting (File Reference No. 2016-360)

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Compensation – Stock Compensation (Topic 718), Scope of Modification Accounting* (the proposal), issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective to reduce the cost and complexity of applying modification accounting in Accounting Standards Codification (ASC or Codification) 718. We believe that the proposal would contribute to that objective and clarify which modifications should result in an accounting consequence. However, we recommend that the Board include in the proposed amendments the guidance that is now in the proposal's Background Information and Basis for Conclusions section on how the amendments would be operationalized.

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Our responses to questions in the proposal are set out in the Appendix to this letter.

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Appendix – Responses to questions raised in the Proposed ASU

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?

We agree with the proposed amendments and believe they would clarify which changes to a share-based payment award's terms or conditions require an entity to apply modification accounting under ASC 718, *Compensation – Stock Compensation*. We observe that the proposed amendments would permit entities to add a provision to allow withholding of shares in an amount up to the maximum statutory tax rates in an employee's jurisdiction without applying modification accounting in order to avail themselves of the exception to liability classification in ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*. Further, the proposed amendments would provide a framework for which entities could evaluate whether modification accounting is required for modifications that would be necessary as the result of new accounting standards, laws or regulations.

We note that paragraph BC14 of the proposal says an entity might be able to determine whether a modification would affect any of the inputs to the value calculation when evaluating criterion (a) of ASC 718-20-35-2A, instead of estimating the value immediately before and after the modification. If none of the inputs are affected by the modification, the entity likely could conclude that the value immediately before and after the modification would not change. We believe this practical expedient would improve application of the amendment and, because the BC section of the ASU would not be codified, recommend that the Board include this expedient in ASC 718-20-35-2A to specifically address how criterion (a) could be operationalized.

Additionally, paragraph BC11 suggests that any change to an award that is improbable of vesting would fail criterion (a) of proposed paragraph 718-20-35-2A. We believe evaluating criterion (a) in this manner would significantly reduce the usefulness of the proposed amendments. If this is not the Board's intent, we recommend amending paragraph BC11 in the proposal as follows (new text is underlined, and deleted text is struck out):

"For the purpose of assessing the criterion in paragraph 718-20-35-2A(a), an entity would evaluate whether the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the award changes immediately before and after the modification and not whether the compensation cost recognized changes a new measurement date would occur if modification accounting were to be applied." ~~For example, consider a circumstance in which an entity changes the terms or conditions of an award. If the entity concludes that the change results in a Type IV modification (improbable to improbable), the entity might have no change in compensation cost that would be recognized on the modification date. However, the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) typically would change because there is a new measurement date for the award for a Type IV modification. Consequently, the entity would apply modification accounting under paragraph 718-20-35-2A.~~

Finally, as discussed in paragraph BC13, changes to award terms or conditions can result in a new measurement date for awards that were not probable of vesting as of the modification date. The new measurement date affects disclosures and, in certain fact patterns, the recognition of compensation cost. Diversity in practice exists regarding the unit of account that is used when determining whether an award was probable of vesting. Some stakeholders make this evaluation on an award-by-award basis, meaning that if each award is individually probable of vesting, the modification is considered a Type I or Type II modification for all awards. Other stakeholders evaluate a modification at the plan level, meaning that if there is a forfeiture rate for the entire plan, the modification is considered a combination of a Type I or Type II modification and a Type III or Type IV modification.

While this diversity in practice existed before ASU 2016-09 was issued, it was not a significant issue because entities did not recognize compensation cost for Type IV modifications, unless the forfeiture estimates change subsequent to the modification. However, if an entity elects to account for forfeitures as they occur upon adoption of ASU 2016-09, compensation cost for all awards, including those that were improbable of vesting and have a new measurement date, would be recognized until the time of forfeiture. This change in the accounting for forfeitures has elevated the significance of this diversity in practice, since it could result in some entities recognizing a significantly different amount of compensation cost until the time of forfeiture, if any, from other entities with the same accounting policy election under ASU 2016-09.

For example, assume an entity that early adopts ASU 2016-09 elects to account for forfeitures as they occur and grants to employees 10,000 options that vest over a four-year service period. The entity subsequently modifies the awards to reduce the exercise price. Before the entity adopted ASU 2016-09, the forfeiture rate was 10%. Also assume the grant date fair value was \$2, the fair value immediately prior to modification was \$5 and the fair value immediately after the modification was \$6 (i.e., the incremental value from the modification was \$1).

If the modification occurred at the end of year 1 and no forfeitures had yet occurred, entities that evaluated probability of vesting on an award-by-award basis would determine that there is \$2.50 per option of remaining total compensation cost to be recognized (\$1 incremental value of modified option + \$1.50 unrecognized compensation cost for original option). Those entities would record compensation cost in year 2 of \$8,333 (10,000 awards x \$2.50 remaining total compensation cost/3-year remaining service period) because each employee was expected to continue providing service and vest in his or her award.

However, entities that evaluated the probability of vesting at the plan level determined that a Type I modification and Type IV modification occurred would record significantly higher compensation cost in year 2. Those entities would determine that there is \$5.50 per option of remaining total compensation cost to be recognized for the 1,000 awards that were improbable of vesting (\$6 modification date fair value - \$0.50 compensation cost previously recognized). Compensation cost recognized in year 2 would be \$9,333 ((9,000 awards probable of vesting x \$2.50 remaining total compensation cost/3-year remaining service period) + (1,000 awards improbable of vesting x \$5.50 remaining total compensation cost/3-year remaining service period)).

This existing diversity in determining the unit of account when evaluating the probability of vesting could now potentially result in significant differences in the amount and timing of compensation cost recognized, especially for entities that choose to recognize forfeitures when they occur upon adoption of ASU 2016-09, in the absence of specific consideration by the Board. Because this issue pertains to modification accounting (the subject of the Proposed ASU), we recommend that the Board either clarify what unit of account should be used when applying the modification guidance in ASC 718 or add a policy election that would require disclosure if material.

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?

We do not believe that new or different disclosures should be required. However, it is not clear whether the requirement in ASC 718-10-50-2h(2) to disclose certain information about “significant” modifications would include any modification that meets the criteria in ASC 718-20-35-2A. We recommend that the Board clarify in the Codification whether “significant” modifications include only modifications with a material financial statement effect or any modification that materially affects the benefits provided to the grantee, as discussed in paragraph BC21 of the Basis for Conclusions.

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

We believe that the transition requirements would be appropriate. We also support allowing entities to use a retrospective transition method. Since a retrospective transition method would be more costly to apply, we don't believe it should be required since the benefits may not outweigh the costs. However, if an entity wants to apply the proposal to past modifications to improve comparability between periods or between companies, we would not be opposed to this transition method.

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.

We believe that early adoption should be permitted since entities may begin looking to the amendments immediately when determining what changes to awards would result in an accounting consequence (i.e., the application of modification accounting). If the Board considers our recommendation to allow entities to choose a retrospective transition method, entities other than public business entities may need additional time to adopt. If the Board decides to only allow prospective application, the proposed amendments could be effective upon issuance of a final ASU.