CONNOR GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054

P: (650) 300 5101
F: (650) 396 8071

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Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2016-360

Dear Ms. Cosper:

Connor Group, Inc. is pleased to provide our comments on the FASB's Exposure Draft, *Compensation—Stock Compensation* (Topic 718). Connor Group was founded in 2005 and is a technical accounting advisory firm built of Big 4 alumni and industry executives. We currently have over 150 accounting professionals and over 500 clients, and specialize in helping our clients solve complex technical accounting issues under both U.S. GAAP and IFRS. Our clients represent industries such as technology, software, internet, cloud services, life sciences and manufacturing, amongst others. Many of our clients are emerging growth mid-cap or small-cap public entities, companies aspiring to become public in the near future, or high-growth private companies.

We have included below our response to Question 1 that the Board posed in the "Questions for Respondents" in the Exposure Draft.

Comments on Question for Respondents

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 appreciate the Board's issuance of this Exposure Draft that addresses concerns raised from constituents. We do not believe that this Exposure Draft is necessary to reach those conclusions. We believe that modification accounting is meant to be applied for changes in terms and conditions of awards that reflect a change in the transfer of value from the employer to the employee. This is stated in the Basis for Conclusions of the predecessor to ASC 718—FAS 123(R), *Share Based Payments,* as follows:

> B182. In reconsidering the accounting for a modification of the terms of an award of employee share based compensation, the Board reaffirmed the conclusion that such transactions generally are transfers of value from the entity to its employees that give rise to additional compensation cost.

We believe that an administrative change to an award plan, for example, revising tax withholding rates, would not require the application of modification accounting—even in the absence of this Exposure Draft.

However, we believe that modification accounting should be simplified by the Board in a conceptual manner to avoid counterintuitive accounting impacts and complexity instead of adding certain exceptions—only to find later that another exception is needed.

We believe the issuance of this Exposure Draft was caused by the existence of two modification methods in ASC 718:

- An incremental expense method, which includes a floor based on grant date fair value plus any incremental fair value related to the new award. This is used for Types I and II modifications.
- A new measurement date method, which ignores the initial grant date fair value by recording expense equal to the fair value of the new award. This is used for Types III and IV modifications.

Awards may be deemed improbable of vesting based on expectations regarding performance measures and/or future employee status. Consequently, the issue arose for whether a new measurement date should be applied to these for a change in tax withholding rates.

To address this issue, we believe a better approach might be to simplify the modification framework by eliminating one of the above methods, specifically, the new measurement date method, and solely applying the incremental expense method in all circumstances.

Specifically, we recommend the Board consider adopting the following principles:

- Clarify that modification accounting should apply when the terms of an award are changed to create transfers of value from the entity to its employees giving rise to additional compensation cost (consistent with the above paragraph *B182*).
- For <u>all</u> modifications, incremental compensation cost should be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the modified award immediately prior to the modification date (*ASC 718-20-35-8)*. This method would apply regardless of the probability of awards vesting or the number of awards expected to vest.

Our reasoning for the above view follows:

1. The transfer of value concept would help constituents understand when a modification occurs and is consistent with the Basis for Conclusions in FAS 123(R), which was codified as ASC 718.

2. As we understand, the new measurement date method originated as an exception from the primary modification framework, as is apparent from ASC 718-20-35-3.b ("*Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date <u>unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied</u>…*") and paragraphs B184 and B191 through B193 of FAS 123(R). It appears the Board considered, and various respondents at the time supported, using the incremental value method for all modifications. This would have aligned this aspect of FAS 123(R) with the requirements of IFRS 2. However, it appears the Board adopted the new measurement date method because "*judging whether it is probable that a performance condition will be satisfied is fundamental to applying the modified grant-date method*". In other words, as we understand it, the Board argued that it is the very judgment that the award is deemed not probable of vesting that leads the company to modify the vesting terms. Therefore, companies should not encounter difficulties making

judgments about such probabilities. Paragraph B184 also implies the Board likely considered that when an award is improbable of vesting, an employee may be willing to accept a replacement award that has a lower fair value than the original award had at the grant date.

However, with the past 10 years of companies using the modification framework, we believe practice has demonstrated these considerations may no longer hold true. For example, in our experience a change in either service or performance conditions that will render the award probable of vesting aims to address a problem the award holders have that precludes them from capturing the value of the original award, not the fair value on the modification date. In our experience in these circumstances, the fair value on the modification date carries little weight in either the companies' or the employees' decision-making process, unless the award is significantly out of the money. If that is the case, a more likely outcome is to reprice the award, or alternatively and more likely, an entity may simply choose to leave alone the existing awards (which will eventually be canceled, unvested and out of the money), and grant new ones.

Let us hypothetically assume that the employees rationalized accepting the new awards with a lower fair value that are probable of vesting in lieu of awards that are not probable of vesting but had a higher fair value at the grant date. If this were the case, one would expect negotiations to occur to determine the appropriate relationship between the modified vesting terms and the reduction in the fair value of the award. However, we are not aware of any such negotiations in practice. In our view, this provides strong support for our observation that employees are primarily concerned with capturing the value of the original awards they had received.

3. In many instances where vesting conditions for awards improbable of vesting are modified, there is little if any relationship between the fair value of the award on the modification date and the fact that the vesting conditions are modified. In most cases we have seen, the vesting conditions are modified due to reasons unrelated to what the fair value of the award is on the specific date of the modification.

   For example, if the modification is to add a change in control acceleration provision to service-based awards, it is rare that the value of the award on the modification date has weight in the decision making, other than as an on-off switch (i.e., whether the award is in or close to being in the money such that it can be of any value). Further, such modifications apply equally to both the outstanding awards that are expected to vest, and those that are not, e.g., due to forfeitures or closing of a change in control. Neither the entities nor the holders look at these two categories of awards differently. Thus, it does not seem right to arrive at different accounting conclusions depending on whether the awards were expected to vest.

   As another example, for repricing modifications, while the value on the modification date is important, using the new measurement date method (as would be required for awards not probable of vesting) would not appear to align with the substance of the transaction. We believe repricing modifications are driven primarily by the desire to add incremental value to the original award that has lost value. Conversely, whether an award is probable of vesting as of the repricing date is a transient assessment that could change at any point, and thus would be secondary for both the company and the employees to a permanent change such as a change in the award's exercise price.

4. Award modifications are normally applied to all or broad pools of awards and are driven by business judgments made by companies usually to promote general employee motivation and retention

and/or in a business combination or sale of a business. Thus, these decisions do not necessarily align well with the accounting judgments of whether the individual modified awards were or were not probable of vesting prior to the modification. As noted above, probability assessments can be volatile, are subject to frequent changes, and apply on an employee-by-employee basis, unlike the permanent broad scale changes usually introduced by the modifications of the terms. This further illustrates that probability assessments are less relevant to modification accounting than other factors.

5. The new measurement date method results in amounts in the financial statements that preparers find complex to calculate, and both preparers and users alike find this difficult and often meaningless to interpret. Conversely, having one modification method will significantly simplify the accounting, and the resulting amounts will be easier to explain to investors and other users. Entities oftentimes do not have a process or a need to assess whether the individual awards (as opposed to a broad pool of awards) are probable of vesting as of the modification date. This need only arises in order to follow the requirements of ASC 718 to segregate between Type I and II, on one hand, and Type III and Type IV, on the other hand, of the modifications. Furthermore, our experience has shown that, more frequently than not, performance conditions are designed to be probable of vesting.

   Further exacerbating the complexities associated with the use of the new measurement date method is the existing diversity in practice. Some practitioners believe modification accounting should be applied at the individual share level. Thus, these practitioners see a grant of a service-based option to purchase 1,000 shares as effectively 1,000 individual grants, some of which are expected to be forfeited (and would not be probable of vesting) if the entity has an expected forfeiture rate of over 0%, and others are probable to vest. Note these practitioners champion this approach whether or not the entity in question uses straight-line or graded vesting approach to recognize stock compensation expense.

   Under this approach, the shares expected to be forfeited on each individual grant become subject to a new measurement date upon modification. This requires entities to undertake a large amount of complex data analysis, as the affected awards usually have multiple vesting tranches, differing vesting schedules and conditions, different strike prices and could be subject to different forfeiture rates. This analysis also usually involves making complex and sometimes arbitrary judgments about whether any options vesting or being forfeited in a given period were probable of vesting as of the modification date. As noted above, companies usually do not have a need to make these judgments except as required by ASC 718 to distinguish between different types of modifications. In the case of Type IV modifications, such need would not typically arise until a significant period of time after the modification has occurred, adding to the challenges if the judgments are not made contemporaneously.

   Collecting and properly analyzing this data requires significant time and costs and creates potential calculation errors. None of the existing automation solutions for stock awards that we are aware of have capability to handle these calculations.

6. Dodd Frank Act has resulted in longer vesting periods for both service and performance awards granted to senior management to reduce risk-taking behavior. For some companies, senior management awards may encompass a large population of total employee awards. Consequently, Types III and IV modifications may occur more frequently, and their impact on the entity's results of operations may be relatively high. This further elevates the risk of errors due to the accounting

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complexities, as well the potential for significant decreases or increases in compensation expense as compared to the grant date fair value, which, as we noted above, likely does not properly reflect the substance of the underlying compensation arrangements and motivations of the parties.

As a result, we observe that the new measurement date method in most instances does not appear to lead to outcomes that are meaningfully preferable to what would result from applying the incremental expense method. In fact, the opposite is likely true in many instances. Consequently, for all the reasons noted above, we believe that it would be preferable to retain just one method, and that the incremental expense method is preferable to the new measurement date method, in accounting for stock award modifications. We recommend this change as a good project to add to the Board's simplification initiative that will likely be welcomed by the industry.

We recognize that some Types III and IV modifications may be triggered by a combination of significant changes in both the stock price and the company performance. As such, for these modifications, one could argue the existing new measurement date method would be more appropriate. However, we find that in practice such modifications are rare, and under the Dodd Frank Act, likely would not be acceptable for public registrants, for example, if they involve stock award repricing or reducing performance metrics. Accordingly, we believe the benefits of applying the incremental value method to all types of modifications exceeds the burden of potential inconsistency related to these few Types III and Type IV modifications.

If the Board does not wish to proceed with the above ideas and finalizes the Exposure Draft, we have the following comments with respect to the first question the Board posed.

- There are portions of the Exposure Draft's Basis for Conclusions that further clarify the proposed Standard and, therefore, those clarifications should be included in the final Standard. Examples are found in BC9, BC10, and perhaps BC13 and BC14. Many times, the Basis for Conclusions gets "lost" or is hard to find under the Codification.
- The example in BC11 should be reworded as it contrasts the fair value of the award after the modification with the original award's grant-date fair value. However, it is meant to illustrate the provisions of ASC 718-20-35-2A, which requires to compare the fair value of the award after the modification with the original award's fair value immediately prior to the modification.

We would be pleased to respond to any questions the FASB or its staff may have concerning our comments.

Sincerely,

Connor Group, Inc.

Accounting Standards and Professional Practice group
• Aleks Zabreyko, Partner aleks.zabreyko@connorgp.com (650) 353-7044
• Denis Kozhevnikov, Partner denis.kozhevnikov@connorgp.com (650) 521 3099
• Brooke Richards, Director brooke.richards@connorgp.com (203) 241 1421
• Caroline Yan, Manager caroline.yan@connorgp.com (314) 484 7945