Insights into MFRS 2

Modifications and cancellations of share-based payment arrangements with employees - Part 1

Share-based payments have become increasingly popular over the years, with many entities using equity instruments or cash and other assets based on the value of equity instruments as a form of payment to directors, senior management, employees and other suppliers of goods and services.

While the general accounting principles have remained largely unchanged since the introduction of MFRS 2 'Share-based Payment' in 2004, share-based payments is an area that is not well understood in practice and entities often have difficulty in applying the requirements to increasingly complex and innovative share-based payment arrangements.

Our 'Insights into MFRS 2' series is aimed at demystifying MFRS 2 by explaining the fundamentals of accounting for share-based payments using relatively simple language and providing insights to help entities cut through some of the complexities associated with accounting for these types of arrangements.

Following the grant date of a share-based payment arrangement, an entity may modify or cancel the existing arrangement for various reasons. This article explains and provides examples of the accounting treatment for modifications and cancellations of share-based payment arrangements with employees. This article applies only to share-based payment arrangements that are classified as equity-settled transactions. Cash-settled transactions are already remeasured to fair value at the end of each reporting period and at the settlement date, and therefore no specific guidance on modifications or cancellations is required.

However, this article does address situations where an equity-settled transaction is modified to a cash-settled transaction.

In addition, this article focuses on share-based payment transactions with employees. Where modifications and cancellations are made to share-based payment arrangements with non-employees, the same principles apply except that all references to the grant date should be read as references to the measurement date instead (ie the date the entity receives the goods or services from the non-employee).

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General principle

As we learned in our article, **'Insights into MFRS 2 – What is MFRS 2?'**, the general principle under MFRS 2 is that an entity must recognise, at a minimum, the value of the services received – measured at the grant date fair value of the equity instruments granted – unless those equity instruments do not vest because of a failure to satisfy a service condition or non-market performance condition that was specified at the grant date. This principle applies regardless of whether there has been a modification or cancellation, meaning that an entity cannot reduce the cost that it recognises under the original terms or conditions of an award by modifying or cancelling the award.

Modifications

An entity may modify one or more of the terms and conditions of a share-based arrangement, such as the exercise price, number of instruments granted or vesting conditions. A common modification is when an entity reduces the exercise price of share options in response to a declining share price, because without the reprice the effectiveness of the award as a motivator for employee retention and performance may be lost.

How should modifications be accounted for under MFRS 2?
In addition to recognising the grant date fair value in accordance with the general principle above, an entity must also recognise the effects of any modifications that increase the total fair value of a share-based payment arrangement or that are otherwise beneficial to the employee.

What types of modifications are beneficial to the employee?
MFRS 2 describes the following types of modifications that are beneficial to the employee:

Type of beneficial modification	Example
Modifications that **increase the fair value** of the equity instruments granted, measured immediately before and after the modification	A reduction in the exercise price or an adjustment to a market condition that makes it easier to meet
Modifications that **increase the number of equity instruments** granted	A grant of additional share options
Modifications to **vesting conditions** (other than market conditions) in a manner that is beneficial to the employee	A reduction in the service period or removal of non-market performance conditions

How should beneficial modifications be accounted for?

The following table summarises the accounting treatment for the types of beneficial modifications outlined in MFRS 2:

Type of beneficial modification	Accounting treatment
Increase in the fair value of equity instruments granted	Continue to recognise the grant date fair value of the original equity instruments over the shorter of the original vesting period remaining and the modified vesting period remaining. In addition, recognise the incremental fair value, being the difference between the fair value of the original award and fair value of the modified award (both measured at the modification date), over the remainder of the modified vesting period (see Example 1 below).
Increase in the number of equity instruments granted	Continue to recognise the grant date fair value of the original equity instruments over the shorter of the original vesting period remaining and the modified vesting period remaining. In addition, recognise the fair value of the additional equity instruments granted, measured at the date of modification, over the remainder of the modified vesting period (see Example 2 below).
Modification of non-market vesting conditions in a manner that is beneficial to the employee	When the service period of an award is reduced there is generally no incremental fair value at the modification date; however, typically the change is still beneficial to the employee. If so, the grant date fair value of the original equity instruments is recognised over the reduced service period (ie calculate the cumulative amount to be recognised at each period end based on the elapsed portion of the new service period). For modifications of other non-market performance conditions beneficial to the employee, the modification date fair value is not impacted. Instead, account for the effects of the modification using the modified grant date method – ie by using the original grant date fair value but adjusting the number of equity instruments expected to vest under the modified non-market performance conditions (see Example 3 below).

Where beneficial modifications give rise to additional amounts to be recognised (ie as a result of an increase in fair value or an increase in the number of equity instruments granted), those additional amounts shall be recognised as follows:

- If the modification occurs during the vesting period, recognise the incremental fair value granted over the period from the modification date until the date that the modified equity instruments vest.
- If the modification occurs after the vesting period, recognise the incremental fair value granted immediately, or over the additional vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to the modified equity instruments.

Example 1 – Increase in fair value of the equity instruments granted

Company A grants 1,000 share options to 10 employees with a three-year service condition and market condition that a share price of CU25 must be achieved by the end of year three for the employee to receive the award. The current share price is CU18 and the fair value of the options at the grant date is CU10 per option.

By the end of year one, the share price has fallen to CU12. As a result, at the start of year two, Company A modifies the market condition to achieve a share price of CU20 instead of CU25. The fair value of the modified options immediately after the modification is CU8 per option, whereas the fair value of the original options immediately before the modification is CU6 per option.

During years one and two, no employees leave, and Company A expects all employees to remain employed over the remaining service period.

By the end of year three, two employees leave.

Analysis

The modification of the market condition results in an increase in the fair value of the equity instruments granted on the date of modification (CU8 vs CU6 per option). Consequently, Company A continues to recognise the grant date fair value of the original equity instruments over the remainder of the original vesting period. The incremental fair value for each award, calculated as the difference between the fair value of the modified award and the original award at the date of modification (CU8 – CU6 = CU2), is recognised over the period from the date of modification (ie start of year two) and the date that the modified equity instruments vest (ie end of Year 3).

The only amounts that are not recognised are those relating to instruments which are not expected to, and ultimately do not vest, because of the failure to satisfy a non-market vesting condition (ie the three-year service condition). In this example, two employees leave in year three before satisfying the service condition.

Year	Calculation (original award)	Calculation (incremental fair value)	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	N/A	33,333	33,333
2	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	1,000 options x 10 employees (CU8 – CU6) x 1/2 = CU10,000	43,333	76,666
3	1,000 options x 8 employees x CU10 = CU80,000 – CU33,333 – CU33,333 = CU13,334	1,000 options x 8 employees x (CU8 – CU6) = CU16,000 – CU10,000 = CU6,000	19,334	96,000

Example 2 – Increase in the number of equity instruments granted

Company B grants 1,000 share options to 10 employees with a three-year service condition and market condition that a share price of CU25 must be achieved by the end of year three. The current share price is CU18 and the fair value of the options at grant date is CU10.

By the end of year one, the share price has fallen to CU12. As a result, at the start of year two, Company B modifies the arrangement so that each employee is entitled to another 100 options if the vesting conditions are satisfied. The fair value of these additional options at the date of modification is CU8.

During years one and two, no employees leave, and Company B expects all employees to remain employed over the remaining service period.

By the end of year three, two employees leave.

Analysis

The modification results in an increase in the number of equity instruments granted. Consequently, Company B continues to recognise the grant date fair value of the original equity instruments over the remainder of the original vesting period. The modification-date fair value of any additional options granted (CU8) is recognised from the date of modification (ie start of year two) until the date that the modified equity instruments vest (ie end of year three).

The only amounts that are not recognised are those relating to instruments that are not expected to and ultimately do not vest because of the failure to satisfy a non-market vesting condition (ie the three-year service condition). In this example, two employees leave in year three before satisfying the service condition.

Year	Calculation (original award)	Calculation (incremental fair value)	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	N/A	33,333	33,333
2	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	100 options x 10 employees x CU8 × 1/2 = 4,000	37,333	70,666
3	1,000 options x 8 employees x CU10 = CU80,000 – CU33,333 – CU33,333 = CU13,334	100 options x 8 employees x CU8 = CU6,400 – CU4,000 = CU2,400	15,734	86,400

Example 3 – Modification to non-market performance conditions beneficial to the employee

At the beginning of year one, Company C grants 1,000 share options to all 10 members in its sales team, conditional upon the employees remaining in the Company's employ for three years and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is CU10 per option at the date of grant.

At the end of year one, Company C's management determines that the sales target of 50,000 units by the end of year three is too onerous. As a result, early in year two, Company C reduces the sales target to 40,000 units.

At the end of each reporting period, Company C expects all employees to remain employed over the three-year service period. No employees left the Company by the end of year three.

Analysis

The reduction in the non-market performance condition from a sales target of 50,000 units to 40,000 units is a modification that is beneficial to the employee. Consequently, Company C accounts for this modification using the modified grant date method – ie by adjusting the number of equity instruments expected to vest.

For illustrative purposes, assume the following:

At the end of year one, Company C's management determines that it is unlikely that the options will vest as the non-market performance condition of sales of 50,000 units by year three is too onerous. As discussed in our article, **'Insights into MFRS 2 – Equity-settled share-based payment arrangements with employees'** which will be released later, this non-market performance condition is accounted for by adjusting the number of awards expected to vest (which, in this example, is expected to be zero).

At the end of year two, due to the reduced sales target of 40,000 units, management now believes it is probable that the instruments will vest.

At the end of year three, total sales of 43,000 units were achieved, meaning the non-market performance condition was met.

The amounts to be recognised are therefore as follows:

Year	Calculation	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	N/A – management is of the view that the non-market performance condition will not be satisfied; therefore, no amount is recognised.	N/A	N/A
2	1,000 options x 10 employees x CU10 × 2/3 = CU66,666 – CU0 = CU66,666	66,666	66,666
3	1,000 options x 10 employees x CU10 = CU100,000 – CU66,666 = CU33,334	33,334	100,000

Example 4 – Modification to service period

At the beginning of year one, Company D grants 1,000 share options to all 10 members in its sales team, conditional upon the employees remaining in the Company's employ for five years. The fair value of the share options is CU10 per option at the date of grant.

At the start of year two, the Company reduces the service period from five to three years.

Assume that management expects all employees to satisfy the revised vesting conditions.

At the end of year three, all 10 employees remain employed.

Analysis

The reduction in the service period from five to three years constitutes a modification of a non-market vesting condition beneficial to the employee. Consequently, the grant date fair value of the original equity instruments is recognised over the revised vesting period from the date of modification.

The amounts to be recognised are therefore as follows:

Year	Calculation	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 10 employees x CU10 × 1/5 = CU20,000	20,000	20,000
2	1,000 options x 10 employees x CU10 × 2/3 = CU66,666 – CU20,000 = CU46,666	46,666	66,666
3	1,000 options x 10 employees x CU10 = CU100,000 – CU46,666 – CU20,000 = CU33,334	33,334	100,000

Similar to Example 4 above, an employer may also modify the service period when an employee has left (either voluntarily or involuntarily) before meeting the service condition, but the employer does not want the employee to lose the benefit of the share-based payment. In such cases, the employer may decide to change the arrangement at its discretion to allow the employee to retain the awards, despite the employee not having completed the originally required service period. In our view, the facts and circumstances of the change may affect whether such a change should be accounted for as (i) a forfeiture of the original award (such that any previously recognised cost is reversed) and grant of a new award (which would be recognised based on the new award's grant date fair value), or (ii) as a modification to accelerate the vesting of the original award (such that the remainder of the original award's grant date fair value is recognised immediately, along with further accounting considerations if there is any incremental fair value at the modification date).

What types of modifications are not beneficial to the employee?

MFRS 2 identifies the following types of modifications that are not beneficial to the employee:

Type of beneficial modification	Example
Modifications that **decrease the fair value** of the equity instruments granted, measured immediately before and after the modification	An increase in the exercise price
Modifications that **decrease the number of equity instruments** granted	The cancellation of a portion of an employee's share options
Modifications to **vesting conditions** (other than market conditions) in a manner that is not beneficial to the employee	An increase in the service period or addition or modification of non-market performance conditions that are more onerous

How should modifications that are not beneficial to the employee be accounted for?

The following table summarises the accounting treatment for the types of modifications that are not beneficial outlined in MFRS 2:

Type of non-beneficial modification	Accounting treatment
Decrease in fair value of the equity instruments granted	Continue to recognise the grant date fair value of the original equity instruments over the remainder of the original vesting period and ignore the effect of the decrease in the fair value of the equity instrument.
Decrease in the number of equity instruments granted	Recognise the reduced number of equity instruments as a cancellation (see below for a discussion of the accounting treatment for cancellations).
Modification of non-market vesting conditions in a manner that is not beneficial to the employee	Continue to recognise the grant date fair value of the original equity instruments over the remainder of the original vesting period. The effects of the non-beneficial modifications to non-market vesting conditions are disregarded.

Example 5 – Decrease in fair value of the equity instruments granted

Company E grants 1,000 share options to 10 employees with a three-year service condition and market condition that a share price of CU25 must be achieved by the end of year three. The current share price is CU18 and the fair value of the options at the grant date is CU10 per option.

At the start of year two, the current share price is CU24 and therefore Company E modifies the market condition to achieve a share price of CU30 instead of CU25. The fair value of the modified options immediately after the modification is CU8 per option. The fair value of the original options immediately before the modification is CU12 per option.

During years one and two, no employees leave, and Company E expects all employees to remain employed over the remaining service period.

During year three, two employees leave. The share price is CU23 at the end of year three, and therefore the modified market condition of attaining a share price of CU30 was not achieved.

Analysis

The modification of the market condition results in a decrease in the total fair value of the equity instruments granted on the date of modification (CU8 vs CU12 per option). MFRS 2 requires an entity to disregard the effects of any modifications that are not beneficial and therefore Company E continues to recognise the grant date fair value of the original equity instruments over the remainder of the original vesting period. The only amounts that are not recognised are those relating to instruments that are not expected to and ultimately do not vest because of the failure to satisfy a non-market vesting condition (ie the three-year service condition).

Year	Calculation	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	33,333	33,333
2	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	33,333	66,666
3	1,000 options x 8 employees x CU10 = CU80,000 – CU33,333 – CU33,333 = CU13,334	13,334	80,000

Note that even though the original market condition of attaining a share price CU25 was not achieved at the end of year three (and assuming that only two employees failed to satisfy their service conditions), the total cumulative remuneration expense of CU80,000 is still recognised, as market conditions are only taken into account in determining the grant date fair value of the equity instruments granted. The treatment of market performance conditions for equity-settled transactions was discussed in our article **'Insights into MFRS 2 – Equity-settled share-based payment arrangements with employees'** which will be released later.

Example 6 – Decrease in the number of equity instruments granted

Company F grants 1,000 share options to 10 employees with a three-year service condition and market condition that a share price of CU25 must be achieved at the end of year three. The current share price is CU18 and the fair value of the options at grant date is CU10 per option.

At the start of year two, the current share price is CU24 and therefore Company F modifies the arrangement so that each employee is only entitled to 800 options instead of 1,000 options, provided the vesting conditions are satisfied.

Company F expects all employees to remain in employment over the three-year service period, and by the end of year three, no employees have left.

Analysis

The reduction in equity instruments is accounted for as a cancellation and vesting is accelerated in year two for the 200 options ((1,000 options – 800 options) * 10 employees) that the employees are no longer entitled to as a result of the modification.

Year	Calculation (original award)	Calculation (cancelled awards)	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 10 employees x CU10 × 1/3 = CU33,333	N/A	33,333	33,333
2	800 options x 10 employees x CU10 × 1/3 = CU26,667	200 options x 10 employees x CU10 = CU20,000 – CU6,667 = CU13,333	40,000	73,333
3	800 options x 10 employees x CU10 = CU80,000 – CU26,666 – CU26,667 = CU26,667	N/A	26,667	100,000

Example 7 – Modifications to non-market vesting conditions in a manner that is not beneficial to the employee

At the beginning of year one, Company G grants 1,000 share options to each of the six members of its executive team, conditional upon the executives remaining in their employ for three years, and the Company achieving cumulative net earnings of CU100,000 during the three-year period. The fair value of the share options is CU5 per option at the date of grant.

During year two, Company G increases the net earnings target to CU150,000. By the end of year three, the Company has only achieved cumulative net earnings of CU120,000 and therefore the share options are forfeited. All six members of the executive team have remained in service for the three-year period.

Analysis

Because the modification to the performance condition made it less likely that the share options will vest, which was not beneficial to the executive team, Company F disregards the modified performance condition when recognising the services received. Instead, the Company continues to recognise the services received over the three-year period as per the original vesting conditions and the grant date fair value, as if this condition had not been modified.

In other words, since this is a non-market performance condition, the result is that the Company continues to recognise the original grant date fair value if it continues to believe that the original non-market vesting conditions will be met. As a result, Company F ultimately recognises cumulative remuneration expense of CU30,000 over the three-year period (6 employees x 1,000 options x CU5).

Year	Calculation (original award)	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)
1	1,000 options x 6 employees x CU5 × 1/3 = CU10,000	10,000	10,000
2	1,000 options x 6 employees x CU5 × 1/3 = CU10,000	10,000	20,000
3	1,000 options x 6 employees x CU5 = CU30,000 – CU10,000 – CU10,000 = CU10,000	10,000	30,000

Conversely, Company F would reverse any cumulative expense that was recognised if it no longer expects the revised non-market performance condition to be met. The treatment of non-market performance conditions for equity-settled transactions was discussed in our article **'Insights into MFRS 2 – Equity-settled share-based payment arrangements with employees'** which will be released later.

As another example, assume that instead of modifying the performance target, Company F had increased the number of years of service required for the share options to vest from three years to 10 years. In this situation, Company F would still recognise the services received from the six executives who remained in service over the three-year vesting period – ie without taking into account the revised service condition when recognising the expense (the outcome is the same as the scenario per the table above). This results in the recognition of an expense for the original award for any employees who do not leave before year three, even though some of those employees may ultimately leave before Year 10 and not be entitled to anything. This outcome is because such a modification makes it less likely that the options will vest, which would not be beneficial to the executive team.

How we can help

We hope you find the information in this article helpful in giving you insight into aspects of MFRS 2. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.