Insights into PFRS 2

Modifications and cancellations of share-based payment arrangements with employees

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 PFRS 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 PFRS 2' series is aimed at demystifying PFRS 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, which are covered in our article **'Insights into PFRS 2 – Cash-settled share-based payment arrangements with employees'**, 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).

"This article explains and provides examples of the accounting treatment for modifications and cancellations of share-based payment arrangements with employees."

General principle

As we learned in our article, **'Insights into PFRS 2 – What is PFRS 2?'**, the general principle under PFRS 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 PFRS 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?
PFRS 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 PFRS 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 PFRS 2 – Equity-settled share-based payment arrangements with employees'**, 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?

PFRS 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 PFRS 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). PFRS 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 PFRS 2 – Equity-settled share-based payment arrangements with employees'**.

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 PFRS 2 – Equity-settled share-based payment arrangements with employees'**.

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.

Multiple modifications

An entity may make multiple modifications to the terms of a share-based payment award that result in the total fair value of the arrangement changing. Some of the changes may be favourable to the employee, while other changes are not (eg when an entity reduces the exercise price of a share option award, but also extends the vesting period). When there are multiple modifications to a share-based payment award, the following are some of the approaches observed in practice for determining whether the modifications are beneficial to the employee:

1 Treat the unit of account for the modifications as the total award: consider the net effects of all modifications to determine whether the combined effect is favourable (ie where the combined modifications result in an increase to the total fair value of a share-based payment arrangement, the entity would account for the net increase in fair value as a beneficial modification), or

2 Treat the unit of account for the modifications as each individual award if the number of equity instruments is reduced but there are other changes such that the total fair value remains the same or increases. If the unit of account is considered to be each individual award, the entity may apply a policy to either:
   - account for the modification as a cancellation of a portion of the award and an increase in fair value of the remaining awards, or
   - consider the net effect of all modifications and account for the changes as a beneficial modification (same outcome as treating the unit of account as the total award).

Example 8 – Multiple modifications

Company H 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 fair value of the options at the grant date is CU10 per option.

At the start of year three, Company H 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 and the fair value of the original options immediately before the modification is CU5 per option. However, the number of share options each employee is entitled to is reduced from 1,000 to 900.

All 10 employees satisfy the three-year service condition.

Analysis

The modification results in an increase to the total value of the share-based payment arrangement as the fair value before the modification (1,000 × 10 × CU5 = CU50,000) is less than the fair value after the modification (900 × 10 × CU8 = CU72,000). As a result, Company H recognises the grant date fair value of the original equity instruments plus the incremental fair value, calculated as the difference between the original and the modified award (both measured at the date of modification).

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	N/A	33,333	66,666
3	1,000 options x 10 employees x CU10 = CU100,000 – CU33,333 – CU33,333 = CU33,334	(900 options x 10 employees x CU8) – (1,000 options x 10 employees x CU5) = CU72,000 – CU50,000 = CU22,000	55,334	122,000

Modifications that give rise to a change in method of settlement

A modification may also give rise to a change in the method of settlement. For example, an equity-settled award may become cash-settled (or vice versa).

Accounting for changes from equity-settled to cash-settled award

PFRS 2 does not provide guidance on how to account for modifications that result in the classification of an award being changed from equity-settled to cash-settled. However, it does provide illustrative guidance on how to account for an equity-settled award that is subsequently modified to contain a cash alternative. This example can, by analogy, be applied in determining the treatment for a change from an equity-settled to a cash-settled award.

The change in the method of settlement (ie from equity-settled to cash-settled, or with a cash alternative added) constitutes a modification if the change was not specified as part of the agreement at the grant date, or if the entity triggers the change (eg by changing its past practice of settling in equity to settling in cash instead, when it has a choice of the settlement method). The general principle of modification accounting continues to be applied, where the entity shall at a minimum, recognise the value of services received measured at the grant date fair value of the original instruments over the original vesting period irrespective of the modification, unless the instruments do not vest because of the failure to satisfy a vesting condition (other than a market condition that was specified at grant date). At the date of modification, the entity recognises a liability for the cash alternative at an amount equal to the fair value of the liability at the date of modification, to the extent the specified services have been received. The liability is then remeasured from the date of modification until the date of settlement, with any changes in fair value recognised in profit or loss.

On our view, there are two potential approaches to account for the modification of an equity-settled award to a cash-settled award:

1 On the modification date, recognise the fair value of the liability (to the extent the vesting period has been completed) entirely as a reduction in equity, with any incremental fair value of the liability over the equity-settled award (both at the modification date) expensed over the remaining periods until settlement; or
2 On the modification date, recognise the fair value of the liability (to the extent the vesting period has been completed) as a reduction in equity only to the extent of the fair value of the original equity-settled award (at the modification date), with any excess on that date recognised in profit or loss; any remaining incremental fair value of the liability over the equity-settled award (both at the modification date) is expensed over the remaining periods until settlement.

In our view, an entity should make an accounting policy choice to account for such differences under either of the two approaches listed above. However, this policy should be applied consistently to all such modifications.

Example 9 – Grant of shares, with a cash alternative subsequently added

At the beginning of year one, Company I grants 25,000 shares with a fair value of CU3 per share to its CEO, conditional upon the completion of three years of service. At the end of year two, the share price is CU4 and Company I adds a cash alternative to the grant, whereby the CEO can choose to receive either (i) the 25,000 shares or (ii) cash of CU5 per share on the vesting date.

Analysis

The addition of the cash alternative constitutes a modification for which Company I will need:

- To recognise the grant date fair value of the original equity instruments over the original vesting period;
- To recognise a liability at the date of modification at an amount equal to the proportion of the fair value of the liability that corresponds to the portion of the vesting period completed; and
- To remeasure the liability from the modification date until the settlement date.

The following illustrates the accounting treatment under both approaches.

Approach 1: Full amount of liability recorded as reduction in equity

Year	Calculation	Expense (CU)	Equity (CU)	Liability (CU)
1	Remuneration expense: 25,000 shares x CU3 × 1/3	25,000	25,000	–
2	Remuneration expense: 25,000 shares x CU3 × 2/3 – CU25,000	25,000	25,000	–
	Reclassification to liability: 25,000 shares x CU5 × 2/3	–	(83,333)	83,333
3	Remuneration expense: Original equity-settled award = 25,000 shares x CU3 – CU25,000 – CU25,000 Liability = 25,000 shares x CU5 – 83,333	25,000	(16,667)	41,667
	Allocation of modification date incremental fair value: Liability = 25,000 shares x CU5 = 125,000 Original equity-settled award = 25,000 shares x CU4 = 100,000 Incremental fair value = 125,000 – 100,000 = 25,000 × 1/1	25,000	25,000	–
	Adjust liability to closing fair value: 25,000 shares x CU5 = CU125,000 – CU83,333 – CU41,667	Nil	–	Nil
Total		**100,000**	**(25,000)**	**125,000**

Approach 2: Reduce equity by the fair value of the original equity-settled award and recognise the excess of the fair value of the liability over the fair value of the original award (at the modification date) in profit or loss

Year	Calculation	Expense (CU)	Equity (CU)	Liability (CU)
1	Remuneration expense: 25,000 shares x CU3 × 1/3	25,000	25,000	-
2	Remuneration expense: 25,000 shares x CU3 × 2/3 – CU25,000	25,000	25,000	–
	Reclassification to liability: Liability = 25,000 shares x CU5 × 2/3 Maximum reclassification from original equity-settled award = 25,000 shares x CU4 × 2/3	16,667	(66,666)	83,333
3	Remuneration expense: Original equity-settled award = 25,000 shares x CU3 – CU25,000 – CU25,000 Liability = 25,000 shares x CU5 – 83,333	25,000	(16,667)	41,667
	Allocation of modification date incremental fair value: Liability = 25,000 shares x CU5 = 125,000 Original equity-settled award = 25,000 shares x CU4 = 100,000 Incremental fair value recognised on modification date = 16,667 in Year 2 Incremental fair value = 125,000 – 100,000 – 16,667 = 8,333 × 1/1	8,333	8,333	--
	Adjust liability to closing fair value: 25,000 shares x CU5 = CU125,000 – CU83,333 – CU41,667	Nil	–	Nil
Total		**100,000**	**(25,000)**	**125,000**

Accounting for changes from cash-settled to equity-settled award

When an entity modifies a share-based payment award such that a cash-settled award becomes classified as an equity-settled award, the entity:

- Measures the equity-settled award at fair value on the modification date, recognising in equity an amount based on the extent of services that have been received;
- Derecognises the liability for the cash-settled award at the modification date; and
- Immediately recognises any difference between the carrying amount of the liability derecognised and the amount of equity recognised on the modification date in profit or loss.

This treatment shall also be applied where an equity instrument is identified as a replacement for a cancelled cash-settled award.

Example 10 – Modification that changes the classification from cash-settled to equity-settled

At the beginning of year one, Company J grants 1,000 share appreciation rights (SARs) that will be settled in cash to its 8-person executive team, on the condition that these executives will remain employed for the next four years.

At the end of year one, the Company estimates that the fair value of each SAR is CU20 and consequently, the total fair value of the cash-settled award is CU160,000. At the end of year two, the estimated fair value of each SAR is CU22 and consequently, the total fair value of the cash-settled award is CU176,000.

At the end of year two, Company J cancels the SARs and grants 1,000 share options to each executive as a replacement, on the condition that each executive continues to provide service for the next two years (ie the original vesting period is not changed). On this date, the fair value of each share option is CU24 and therefore the total fair value of the new grant is CU192,000. All of the employees are expected to and ultimately do provide the required service.

Analysis

Applying the requirements of PFRS 2.B44A, the following amounts are recognised:

Year	Calculation	Expense for the period (CU)	Cumulative expense (CU)	Equity (CU)	Liability (CU)
1	8 executives x 1,000 SARs x CU20 × 1/4	40,000	40,000	N/A	40,000
2	Remeasurement before modification: 8 executives x 1,000 SARs x CU22 × 2/4 – CU40,000	48,000	88,000	N/A	88,000
	Derecognition of liability and recognition of equity-settled award: 8 executives x 1,000 options x CU24 × 2/4 – CU40,000 – CU48,000	8,000	96,000	96,000	(88,000)
3	8 executives x 1,000 options x CU24 × 3/4 – CU40,000 – CU48,000 – CU8,000	48,000	144,000	48,000	0
4	8 executives x 1,000 options x CU24 – CU40,000 – CU48,000 – CU8,000 – CU48,000	48,000	192,000	48,000	0
	Total	**192,000**		**192,000**	**0**

Cancellations and settlements

How do forfeitures differ from cancellations?

A forfeiture occurs when there is a failure to meet a vesting condition attached to an award. As discussed in our article, **'Insights into PFRS 2 – Equity-settled share-based payment arrangements with employees'**, service conditions and non-market performance conditions are taken into account when estimating the number of equity instruments that are expected to vest. For awards that are forfeited as a result of a service or non-market performance condition not being met, the entity reverses any share-based payment expense recognised on a cumulative basis. Importantly, the definition of a 'service condition' in PFRS 2 clarifies that if employment is terminated, no matter the reason, then the service condition is not met and the award is considered forfeited. Therefore, whether the employee resigns or is terminated by the entity, the failure to complete the service period constitutes a forfeiture and any share-based payment expense previously recognised is reversed.

In contrast, a cancellation or settlement is when an existing share-based payment arrangement is terminated for reasons other than by forfeiture. Cancellations can also occur when either the entity or the employee chooses not to meet a non-vesting condition – for example, an entity may cancel a share-based payment plan due to difficult economic circumstances, or an employee may choose not to pay contributions towards the exercise price of a share-based payment arrangement.

How should a cancellation be accounted for?

When a share-based payment arrangement is cancelled or settled during the vesting period, an entity accounts for it as an acceleration of any unvested portion of the share-based payment on cancellation – that is, any remaining amount that would have otherwise been recognised over the remainder of the vesting period shall be recognised immediately in profit or loss.

PFRS 2 is unclear on whether the amount that would have otherwise been recognised over the remainder of the vesting period should reflect:

- the maximum number of options that could have vested under the arrangement (eg if an entity cancels a share-based payment arrangement whereby it granted 100 options to 100 employees subject to a service condition of three years, the total amount that could have vested is 100 options x 100 employees x grant date fair value of the option, regardless of the number of options that the entity expects will ultimately vest); or
- the number of equity instruments that the entity ultimately expects will vest at the date of cancellation (eg if an entity cancels a share-based payment arrangement whereby it granted 100 options to 100 employees subject to a service condition of three years and where it expected that only 80 employees will remain employed at the end of year three, the total amount that is ultimately expected to vest is 100 options x 80 employees x grant date fair value of the options).

In our view, it is appropriate for an entity to make an accounting policy choice to account for cancellations under either one of the two approaches listed above. However, this policy should be applied consistently across all share-based payment arrangements.

Example 11 – Cancellation of a share-based payment award

At the beginning of year one, Company K 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.

During year two, the Company determines that the target sales of 50,000 units by the end of year three is too onerous and therefore cancels the plan. At the cancellation date, all 10 employees were still employed, and Company K expected that all 10 employees would remain employed at the end of year three.

Analysis

Company K recognises the total amount of the award that has not yet been charged to profit or loss in year two.

Year	Calculation (original award)	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 = CU100,000 – CU33,333	66,667	100,000

How should payments made as compensation for the cancellation of share-based payment arrangements be accounted for?

When an entity compensates employees for the cancellation of an award, it recognises the unvested portion of the share-based payment immediately as described above. Additionally, the compensation payment is treated as the repurchase of an equity interest and is deducted from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess is recognised as an expense.

However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

Example 12 – Cancellation of a share-based payment award – compensation payment made to employee

At the beginning of year one, Company L 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. The fair value of the share options is CU10 per option at the date of grant.

During year two, Company L cancels the award. However, to compensate the sales team for the cancellation, Company L pays each employee CU7 per share option. The fair value of the share options at the date of cancellation is CU5 per share option. All 10 employees remained employed.

Analysis

Company L recognises the total amount of the original award that has not yet been charged to profit or loss in year two. In addition, as the payment exceeds the fair value of equity instruments granted measured at the repurchase date (see calculation below), the excess is recognised in profit or loss so that ultimately, the grant date fair value of the original instrument plus any incremental increases in fair value of the instrument are expensed.

Year	Calculation	Remuneration expense for the period (CU)	Cumulative remuneration expense (CU)	Equity (CU)	Cash (CU)
1	1,000 options x 10 employees x CU10 × 1/3	33,333	33,333	33,333	N/A
2	Cancellation of original award:	66,667	100,000	66,667	N/A
	Difference between payment and fair value of equity instruments at repurchase date: 1,000 options x 10 employees x (CU7 – CU5) = CU20,000[1]	20,000	120,000	(50,000)	(70,000)
Total		**120,000**		**50,000**	**(70,000)**

[1] Payment exceeds the fair value of equity instruments remeasured on the repurchase date

How should replacement share-based payment arrangements be accounted for?

An entity may, upon cancelling an existing award, grant new equity instruments to employees. If the entity has designated these new equity instruments – on their grant date – as a replacement award for the cancelled award, the replacement award is accounted for as a modification to the existing agreement as discussed above.

The entity continues to expense amounts relating to the original award over the original vesting period as well as any incremental fair value, calculated as the difference in fair value between the original and replacement awards both measured at the date of modification (ie the date the replacement awards are issued). The fair value of the original awards that have been cancelled is their fair value, immediately before cancellation, less the amount of any payment made to the employee on cancellation that is accounted for as a deduction from equity.

If the entity does not determine that the new equity instruments have been granted as a replacement for the cancelled instruments, the new equity instruments are accounted for as a new grant.

Example 13 – Cancellation of a share-based payment award – replacement agreement issued

At the beginning of year one, Company M 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 start of year two, Company M cancels the award and on the same day, designates a replacement award, conditional upon the employee remaining employed until the end of year three. The fair value per share option under the replacement award is CU8. The fair value of the cancelled share options at the date of modification is CU6 per share option.

Company M expects all employees to remain employed at the end of each reporting period. All 10 employees were employed at the end of year three.

Analysis

Company M has identified the new award as a replacement for the existing award, and therefore the new award is accounted for as a modification. Consequently, the Company 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, calculated as the difference between the fair value of the replacement 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) until the date that the replacement equity instruments vest (ie end of year three), except for those which are not expected to and ultimately do not vest because of failure to satisfy a non-market vesting 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 10 employees x CU10 = CU100,000 – CU33,333 – CU33,333 = CU33,334	1,000 options x 10 employees x (CU8 – CU6) = CU20,000 – CU10,000 = CU10,000	43,334	120,000

If Company M had not identified the new arrangement as a replacement award, the impact would be as follows:

Year	Calculation (original award)	Calculation (new award)	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	Cancellation of original award: 1,000 options x 10 employees x CU10 = CU100,000 – CU33,333 = CU66,667	1,000 options x 10 employees x CU8 × 1/2 = CU40,000	106,667	140,000
3	N/A	1,000 options x 10 employees x CU8 = CU80,000 – CU40,000 = CU40,000	40,000	180,000

In some circumstances, an entity may not cancel or modify an award as it would not be beneficial to do so (eg adverse tax consequences would result). Consequently, an entity may create a new 'replacement' award that runs in parallel with the existing award but implements a measure to ensure that the employee can only receive the new award (such as mechanisms that only allow an employee to benefit from one of the awards). Where sufficient evidence exists to support that the new award is a replacement of the existing award, replacement accounting can be applied. Otherwise, the employee ceasing participation in the original plan should be accounted for as a cancellation.

Share-based payment arrangements with clauses specifying the treatment of awards upon the occurrence of future events

Often, share-based payment arrangements contain terms or conditions that specify how the awards are to be treated when certain events occur. For example, many arrangements contain clauses that indicate what happens when an employee resigns, is terminated with cause, or is terminated without cause (ie whether the employee is entitled to all or a portion of the awards that they were granted when one of these events occur). Another example is that share-based payment arrangements often contain clauses that specify how the awards are treated if the company is acquired by another party (eg whether they vest immediately or continue vesting in accordance with their original terms). In these cases, the accounting treatment should reflect the terms and conditions contained in the share-based payment arrangement.

Business Combinations

In a business combination, the acquirer often issues new share-based payment awards to the acquiree's employees to replace their existing awards. The accounting for these replacement awards is covered in PFRS 3 'Business Combinations' and differs depending on whether the acquirer was obliged to replace the awards or voluntarily chooses to replace the awards. An acquirer is obliged to replace the awards if the acquiree or its employees have the ability to enforce replacement. This is often as a result of the terms of the acquisition agreement, the terms of the acquiree's awards, or due to applicable laws or regulations.

Voluntary replacement of expired awards

When a business combination takes place, share-based payment awards may expire. For example, the award may contain a clause indicating that it expires upon a change in control of the entity, such that the employees are no longer entitled to the share-based payment. If the acquirer voluntarily replaces the awards, the fair value of the replacement award, as determined on the acquisition date using the measurement requirements in PFRS 2, is recognised as remuneration cost in the post-combination financial statements.

Obligatory replacement of acquiree awards

When the acquirer is obliged to replace the awards, the exchange is accounted for as a modification of a share-based award and a portion of the fair value of the replacement award is allocated to the consideration transferred in the business combination. As a first step, as of the date of acquisition, the acquirer measures both the fair value of the replacement awards and the fair value of the acquiree awards, in accordance with PFRS 2. The portion of the fair value of the replacement awards allocated to consideration consists of the amount of the acquiree award that is attributable to service provided by the employees prior to the business combination (ie "pre-combination service"). This is determined as follows:

$$\text{Consideration} = \text{Fair value of acquiree awards (under PFRS 2) at acquisition date} \times \frac{\text{Vesting period completed}}{\text{Greater of: Total vesting period OR Original vesting period}}$$

The 'total vesting period' represents the portion of the original vesting period prior to the acquisition date, plus the vesting period of the replacement awards. The original vesting period represents the vesting period of the original acquiree award.

Any excess amount of the fair value of replacement awards over the portion allocated to consideration (as calculated above) is allocated to post-combination service and is recognised as remuneration cost in the post-combination financial statements as the services are provided by the employees.

The accounting for replacement awards described above applies regardless of whether the award is classified as an equity-settled share-based payment transaction or cash-settled share-based payment transaction. All changes in the fair value of awards classified as liabilities after the acquisition date are recognised in the acquirer's post-combination financial statements in the period in which those changes occur.

Example 14: Accounting for replacement awards during business combinations

Company N grants 100 equity-settled share-based payment awards to each of its 10 employees on January 1 of year one. These awards have a four-year service condition and must be replaced in the event of a change of control according to their terms. On July 1 of year three (ie two and a half years into the original service period), Company N is acquired by Company O for CU1,000 in cash. Company O also issues replacement awards to the 10 employees with a vesting period of two years.

Analysis

On the acquisition date, the fair values of the awards are as follows:

Company N original acquiree awards:	CU500
Company O replacement awards:	CU600

All employees are expected to meet the service condition.

Amount allocated to consideration:

CU500 × 2.5 years / 4.5 years[1] = CU278
Consideration = CU1,000 + CU278 = CU1,278

[1] Greater of: (1) total vesting period = 4.5 years (2.5 years elapsed + 2 years for replacement awards)
(2) original vesting period = 4 years

Amount allocated to post-combination service:

CU600 – CU278 = CU322 allocated to remuneration cost, to be recognised over the two-year vesting period

Voluntary replacement of acquiree awards

When an acquirer voluntarily replaces awards that would not have expired as a result of a business combination, the accounting is similar to the approach described above for when the acquirer is obliged to replace awards (ie the acquisition date fair value of the replacement award, determined using the measurement requirements in PFRS 2, is determined and apportioned between pre-combination service and post-combination service).

How we can help

We hope you find the information in this article helpful in giving you insights into aspects of PFRS 2. If you would like to discuss any of the points raised, please contact and visit https://www.grantthornton.com.ph/Contact/.

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