

Technical Accounting Alert

Accounting for changes to share based payment agreements

Introduction

The purpose of this alert is to provide guidance on the treatment of modifications, cancellations and forfeitures of share-based payment agreements under AASB 2 *Share Based Payments*. This area is increasingly relevant in the current economic conditions where we have seen significant decline in company share prices and financial performance, reduction of workforce via redundancies and a weaker employment market.

A number of companies use share-based payment arrangements as an incentive for their employees; however in recent times we have seen a number of changes being made to these arrangements to ensure that they remain motivating, given that options may be heavily out of the money or earnings targets not achievable.

This alert has been written in the context of share based payment agreements with employees, however it applies equally to agreements with other parties, such as suppliers.

Methods of amending share-based payments and overview of treatment

A share based payment agreement between a company and an employee entitles the employee to receive equity instruments of the company provided the specified vesting conditions, if any, are met.

Once these agreements are in place, they are able to be amended; however the method of amendment affects the consequential accounting treatment.

There are two main methods for amending a share based payment agreement by the employer, being:

- Cancellation or
- Modification of an existing agreement.

In addition, a forfeiture may occur if non-market vesting conditions are not met.

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Each of these situations is described below:

Overriding accounting principle

The company should recognise, at a minimum, the value of the services received, which were measured at the grant date fair value of the equity instruments granted. In addition to this if the amendment to the agreement results in increased fair value to the employee, then an additional expense is recognised. This means that an amendment to the agreement will not reduce the initial expense identified at grant date but may increase it.

The only exception to this principle is where equity instruments do not vest due to a failure to satisfy a vesting condition (other than a market condition) that was specified at grant date.

Modification

What is a modification?

A modification occurs when one of the terms in an existing arrangement is amended; this may be, for example: to change the exercise price, the number of instruments to be received or a performance condition and in the current economic climate is likely to be beneficial to the employee.

AASB 2 accounting treatment

AASB 2 requires a company to measure the increase in fair value by comparing the fair value of the instrument immediately before and after the modification. The incremental fair value is then recorded over the remaining vesting period as an expense and increase in equity as well as the initial grant date fair value.

Measuring the fair value

Measuring the fair value of the instrument immediately before and after the modification date is likely to involve updating the valuation model used at grant date and therefore may need the engagement of a specialist.

If the instrument has already vested when the modification is applied, then the increase in fair value is recognised immediately, unless there is an additional service period which applies.

Decrease in fair value

If the modification causes a reduction in the fair value to the employee then the expense is the same as per the original grant agreement, i.e. there is no reduction in expense.

See scenarios 1 and 2 for illustrations of the accounting treatment for modifications.

Cancellation

What is a cancellation?

A cancellation is when an existing share based payment arrangement is terminated. It may be replaced by an alternative agreement and the appropriate accounting treatment for the

cancellation depends on whether a replacement scheme is identified and other factors such as payouts.

AASB 2 accounting treatment

No replacement agreement issued

Cancellation of a share based payment agreement is accounted for as an acceleration of any unvested portion of the share-based payment on cancellation date, i.e. any remaining portion of the share based payment expense not yet charged to the income statement is charged in full immediately.

See scenario 3 for an illustration of the accounting treatment.

Replacement agreement issued

If an existing scheme is cancelled and a replacement scheme is identified at the issue date of the new agreement; then the new agreement can be treated as a modification of the existing agreement.

This means that the company would continue to expense the existing agreement and expense any incremental fair value inherent in the new instruments over the remaining vesting period.

This is illustrated in scenario 4.

Compensation payment made to employee

On cancellation of a share based payment arrangement; the company may decide to compensate employees by a payment. This payment is treated as a repurchase of an equity interest.

Note, however, any portion of the payment which exceeds the fair value of the equity instrument at repurchase date is taken to the income statement.

Scenario 5 shows the accounting treatment for a cancellation with compensation payment.

Forfeiture

What is forfeiture?

A forfeiture occurs when a vesting condition, other than market conditions, are not met (e.g. 3 year service condition but employee resigned after 2 years).

Failure to meet market conditions is not forfeiture since this has already been factored in when determining the grant date fair value.

AASB 2 accounting treatment

The cumulative expenses from prior periods will need to be reversed which means that no expense will remain in the financial records in relation to the forfeited agreements.

Accounting treatment for common scenarios

The scenarios in this alert cover some of the more common transactions we are currently observing rather than illustrating all possible situations.

Background

Company A grants 6,000 options to two employees with a 3 year service condition and market condition of a share price of \$1.50 to be achieved.

The fair value of the options at grant date was \$10.

The accounting treatment for the life of the option determined at grant date is:

Yr	Calculation	SBP Expense for the Yr	Balance of share option reserve
1	2 employees x 6,000 x \$10 x 1/3	\$40,000	\$40,000
2	(2 employees x 6,000 x \$10 x 2/3) - \$40,000	\$40,000	\$80,000
3	(2 employees x 6,000 x \$10) - \$80,000	\$40,000	\$120,000

Scenario 1 Modification: Market conditions

Determine if the fair value of the instrument has increased by comparing the fair value immediately before and after the modification. Any increase in fair value will be expensed over the remaining vesting period. Any decrease in fair value is ignored.

Using the information in the background above

Modification:

At the beginning of year 3; Company A changes the market condition to achieve a share price of \$1.20 rather than \$1.50.

The fair value of the instrument before modification is \$9 and the fair value immediately after the modification is \$12.

Accounting treatment

The original fair value at grant date continues to be expensed; therefore in year 3:

DR: Employee expense 40,000

CR: Share based option reserve 40,000

Additional charge in relation to the modification:

$$2 \text{ employees} \times 6,000 \times (12 - 9) = \$36,000$$

The additional charge of \$36,000 is expensed immediately since there is only one year until the vesting date.

Total expense for year 3 is \$76,000.

Note:

If this modification was performed in year 2, the expense would have been spread over the remaining two years until the vesting date.

Scenario 2 Modification: Service conditions

If the modification is beneficial to the employee, companies will need to re-estimate the number of the instruments that are expected to vest and reperform the initial calculation.

Background

In Company B, 100 employees are entitled to 1,000 options each with a fair value of \$15. Company B expects 30% of the original eligible employees to leave within the 3 year vesting period, being 10% attrition per annum. Therefore, they expect to issue 70,000 options (70 employees x 1,000)

Accounting treatment at grant date:

Yr	Calculation	SBP Expense for the Yr	Share option reserve
1	100 employees x 1,000 x \$15 x 1/3 x 70%	\$350,000	\$350,000
2	(100 employees x 1,000 x \$15 x 2/3 x 70%) - \$350,000	\$350,000	\$700,000
3	(100 employees x 1,000 x \$15 x 70%) - \$700,000	\$350,000	\$1,050,000

Modification:

In year 2 service conditions relating to performance terms were reduced from 3 years to 2 years.

The number of options expected to be issued is now 80,000.

The year 1 expense of \$350,000 has already been recognised.

The revised year 2 expense is:

$100 \times 1,000 \times 15 \times 80\% - \$350,000 = 1,200,000 - 350,000 = 850,000$. This accelerates the original expense over one year rather than 2 years and takes into account the additional 10,000 options expected to be issued.

The total expense charged over the vesting period is therefore $\$350,000 + \$850,000 = \$1,200,000$ compared to $\$1,050,000$ prior to the modification.

Scenario 3 Cancel the plan

Expense the remaining fair value of the agreement immediately.

Using the information in the background for Company A above

The share based payment agreement is cancelled during year 2.

Accounting treatment

Expense the remaining grant date fair value immediately.

At the end of year 2:

Dr Employee expense	\$80,000 (year 2 & year 3 expense)	
	Cr Share option reserve	\$80,000

Note:

The share option reserve may be cleared to nil via a transfer to another equity account.

Scenario 4 Cancel existing agreement and issue new agreement identified as a replacement

- a If the company identifies the new agreement as a “replacement award” at the grant date of the new agreement, the cancellation and reissue can be treated as a modification of the original agreement.
- Continue to expense original fair value over vesting period
 - Expense the incremental fair value over the remaining vesting period where the modification has resulted in an increase in fair value.

Using the information in the background for Company A above.

The existing agreement is cancelled at the beginning of year 3 and a new plan is issued which identified as a replacement plan. The fair value of the new instruments is \$12 with a one year vesting period. The fair value of the instrument immediately before the replacement plan is issued is \$9.

Accounting treatment:

Original agreement

Amounts in years 1 and 2 previously expensed are: \$80,000.

Year 3 expense related to original agreement \$40,000

Revised agreement

Incremental fair value:

$2 \times 6,000 \times (12-9) = \$36,000$ to be expensed in year 3.

Total expense in year 3 = \$76,000.

- b If the company did not identify the new agreement as a “replacement award”, then the transaction is treated as a cancellation of the existing agreement and granting of a new agreement., i.e.
- Expense the remaining fair value of the existing agreement immediately
 - Expense the fair value of the new agreement over the period of the new plan at grant date of the new agreement.

Using the information in the background for Company A above._

The existing plan is cancelled at the beginning of year 3 and a new plan issued with a fair value of the new instruments of \$12. There would be one year vesting period for the new instruments.

Accounting treatment:

- i Cancel existing plan – expense the remaining amounts on the existing agreement:

Dr: Employee expense 40,000

Cr: Share option reserve 40,000

- ii Recognise the new agreement over the 1 year vesting period:

$2 \times 6,000 \times \$12 = \$144,000$

Dr: Employee expense 144,000

Cr: Share option reserve 144,000

Total expense in year 3 is \$184,000.

Scenario 5 Cancel the existing agreement with compensation pay out

Expense the remaining fair value of the plan immediately. Consider whether any portion of the compensation payment exceeds the fair value of the instrument at repurchase date.

Using the information in the background for Company A above

The share based payment agreement is cancelled during year 2 and compensation payment of \$2,000 to each employee was made. The fair value of the instruments at the repurchase date is \$8.

The \$2,000 payment equates to 33c per instrument ($\$2,000 / 6,000$ options) and therefore the payment is less than the fair value of the instruments which therefore means the payment is accounted for as a repurchase of equity.

Accounting treatment at year 2:

DR: Employee expense 80,000 (remaining expense from years 2 and 3)

CR: Share option reserve 76,000 (being 80,000 – 4,000)

CR: Cash 4,000 (compensation payout)

Note:

The net fair value of the cancelled instrument is the fair value immediately before the cancellation less any amount of payment to the employee.

Scenario 6 Downsizing via staff redundancy

In the current economic environment we are seeing a number of redundancies and a number of the personnel being made redundant were participating in share based payment arrangements.

There are two permitted treatments for agreements where the employee has been made redundant; either forfeiture or cancellation.

The rationale for the two treatments are:

- Cancellation – given that the company terminated the employment of the employee, they were cancelling the share based payment agreement.
- Forfeiture – the performance conditions within the agreement being terms of service were not met due to the employee no longer being in the employment of the company.

The accounting treatment of cancellation has been discussed in scenario 3.

In the forfeiture situation, companies should reverse all of the expense that was previously recognised in relation to the employee in the existing agreement as part of the revision of the estimate of the number of vesting instruments.

We would anticipate the forfeiture option to be the most commonly used and therefore a revision of the estimate of the number of instruments to be issued is made.

Using the information in the background for Company A above

One employee was made redundant at the end of year 2, Company A will treat this as forfeiture and therefore revise the anticipated number of instruments which will vest.

Revised expenditure:

Year 2:

$1 \times 6,000 \times 10 \times 2/3$ - amounts previously charged = 40,000 – 40,000 = \$Nil

Year 3:

$1 \times 6,000 \times 10$ - accumulated amount previously charged = 60,000 – 40,000 = 20,000

The total expense over the term of the agreement is \$60,000 which is 50% of the original grant date value and indicative of the number of instruments vesting being 50% of the initial number.

Note:

If the option had vested before the date of redundancy, then there would be no change in expense since no change to the number of vested shares.

Summary

In the current economic environment, a number of companies are looking for ideas to improve their financial performance and maintain staff morale.

When companies make changes to share-based payment arrangements, it is important to consider the potential profit and loss impact of these changes since some decisions may actually worsen results rather than improve them in the year of modification.

The tax implications of the amendments to the agreements have not explicitly been covered and therefore we recommend companies consult with their accounting and tax advisors prior to amending any share based payment agreements.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au