IFRS 2 Share Based Payment (Final Revision checklist)

SHARE BASED PAYMENT

Definition

1. In a **share based payment** transaction the entity pays for goods and services it receives by issuing equity instruments (settled in equity), or incurs a liability (settled in cash) for those goods and services measured in the fair value of the entity's shares.

Example

An entity bought property, plant and equipment for €20 million. The supplier of the PPE can choose how the entity can settle the obligation. The choices are i) the entity can issue one million of its own shares in a years time estimated at €21 million and ii) the entity can settle in cash in six months time equivalent to the market value of 750,000 of the entity's shares worth €19 million.

Analysis

- the example illustrates the **options** typically available in **share-based** payment transactions (the **obligation** can be settled in cash or in equity)
- **if it is settled in cash** then on the date of the transaction the entity incurs a liability for the goods and services just as in any other transaction. The only difference from other transactions is that the amount of the obligation is measured at the fair value of the shares of the entity at the date of the transaction (and re-measured at fair value at each subsequent reporting date.) See example below under cash settled transactions
- if it **is settled in equity** then the entity measures the value of the equity on the due date and records an equivalent amount representing an increase in equity
- The question then is which option is operative? IFRS 2 states that where the supplier has the right to choose the payment method the entity is deemed to have issued a **compound instrument** consisting of a **debt component** (the cash element) and an **equity component**.

Accordingly, the entity will record a liability and the difference (between the fair value of the consideration for the goods and services and the fair value of the liability) will be recorded as equity. This is further discussed below (see TRANSACTIONS THAT CAN BE SETTLED FOR SHARES OR CASH 29-33).

- As you may have noticed in the case details the *time value of money* is very much relevant here explaining the disparity in the value of the **equity-settled** and the **cash-settled** amounts.

2. As can be seen the accounting for the settlement is dependent on how the transaction is settled.

RECOGNITION OF SHARE BASED PAYMENTS

3. IFRS 2 requires the goods and services received by the entity to be recognised as expenses or assets as normal. It is based on the matching principle. The following are examples of how IFRS 2 reflects the *matching principle*:

- expenses (settled in equity or settled in cash but based on equity values) are charged to **profit or loss** unless they are classified as assets in accordance with the relevant standards e.g. IAS 2 Inventory, IAS 16 PPE, etc
- share based transactions with employees e.g. **compensation costs** are recognised over the period in which services are rendered (the **vesting period**).

EQUITY SETTLED TRANSACTIONS

Explain the background to the ESOS scheme so that it is clear how the scheme works. Once we gain a clear outline about how the scheme actually works it would be so much easier to understand how the principles apply to the scheme. The study texts, revision guides and workbooks do not provide such a background. That is why understanding is impaired. Abstract concepts need concrete experience to make them real and to help the learner gain insight which is necessary for applying principles and exercising judgement.

Granting and vesting

4. Vesting date under IFRS 2 is the date on which the entity becomes obligated under the contract. (We have seen that under financial instruments this is the commitment date and other IFRS this is the delivery date or shipment date depending on the terms agreed under the contract.)

5. For goods and services the **vesting date** is not really an issue because it is the date on which goods are received by the entity.

Immediate vesting

6. For services there may be **immediate vesting** where equity instruments are granted (shares are issued) that vest immediately such that it can be presumed that the services for which the equity instruments have been issued have already been received by the entity in the past. In that case the fair value of the services received is equivalent to the fair value of the equity instruments on the vesting date (which coincides with the issue date). In that case the employee services must be recognised in profit or loss immediately and the equity of the entity must be increased by the same amount.

Vesting period

7. Alternatively where the share options do not vest until a period of time has elapsed this period is the vesting period. During this period the entity receives services under the contract at the end of which the share options are said to vest meaning the entity becomes obligated. What are the implications for recognition?

8. For example, if share options that vest in three years are granted to employees on condition that the employees remain in the entity's employment during that period then

- the fair value of the options will be measured at the date on which they were granted
- the fair value so determined will be charged to the SOI equally over the three year period adjusted annually for the best estimate of the options that will eventually vest
- equity (SOFP) will be increased annually by an equivalent amount to the charge to SOI

- the annual charge reflects the options that are (theoretically) vested in each year (not the options that are granted or exercised)
- if employees decide not to exercise their options (e.g. because the share price is below the exercise price) then no adjustment is made to SOI.

9.

Vesting conditions

10. The conditions that must be met before the employee becomes entitled to shares or options in an ESOS (employee share option scheme) are known as vesting conditions and they can be **market** or **performance conditions**.

11. **Market conditions** are not taken into account when determining the number of equity instruments that vest at the end of the vesting period because IFRS 2 assumes these are included in the fair value of the instruments on granting date.

Example

An entity grants the chief executive share options subject to him remaining in employment for three years at the end of which the share price exceeds €10.

Required

Explain how the share price condition will affect the accounting for the share based payment

Analysis

- According to IFRS 2 the share price condition is effectively reflected in the number of equity instruments granted and the grant price.
- As long as the employee remains employed at the end of the vesting period the options will vest regardless of the share price
- The employee may choose not to exercise the option because the **share price** on the vesting date is lower than the **exercise price** but this will not affect the amount recognised as a charge to SOI

12. **Performance conditions** such as earnings growth (indicated by EPS movements) are taken into account when determining the number of equity instruments to be issued to employees in an ESOS on vesting date. This is because performance conditions are not taken into account when the fair value of the options is determined on the grant date. Thus the **performance condition** is taken into account on each reporting date when assessing the number of share options or shares that will eventually vest.

Exam insight
- This could be examined under acquisitions (IFRS 3) where the employee is given share options to retain their services after the acquisition for the benefit of the entity (not the seller). - It could also be examined under performance analysis and appraisal where EPS is calculated. - Another possible area is the statement of comprehensive income where you may asked to calculate the amount to be charged to profit or loss

given the details of the ESOS involving complications such as cancellations, deferred tax, etc.

Example
An employee has been granted share options and as part of the vesting conditions the employee should continue to work for the entity for a further three years and the earnings per share during the vesting period should increase by at least 25%. The share options will vest only if both of those conditions are satisfied.

Required
Explain the accounting implications of this **performance condition**.

Analysis
- The allocation of the cost of the shares to the SOI is not affected by the performance condition as the expense will still be charged over the vesting period of three years. **Remember that the expense recognised in respect of the granting of the options is the estimated amount of the fair value of the equity instruments that will vest** (measured at the fair value at the grant date) not the fair value of the options that will be exercised, nor the fair value of the total amount granted.
- Therefore, even if the share options are not exercised the period charge will not be affected i.e. the SOI will not be adjusted by reducing the annual expense charge simply to reflect the fact that some of the options are not exercised by the employee due to the failure to meet performance conditions.

Extracts from published reports – insert here an example of SOI, SOCE, SOFP, notes to the accounts from a large plc. **Insightful enquiry**:
- trace the annual charge (in the SOI) for the expenses incurred in granting the options
- can you identify the equity account into which the credit is held pending issue of shares at the end of the vesting period? Remember that the shares are not issued until the vesting conditions are fulfilled.
- Can you trace the movement in the SOCE and explain the event that caused it?

13.

Modifications

14. The **original option contract** is said to be modified if

- it is cancelled
- withdrawn and re-issued on new terms

15. A **modification that does not alter the fair value or improve the benefit of the option to the employee is ignored** and does not alter the amounts recognised under IFRS 2 in respect of the share based payment. This means that the charge relating to the original option is still recognized in full.

16. A **modification that increases the total fair value of the share based payment** is recognised in full over the period since modification until the shares vest. Any additional benefit provided by the modification is reflected in the valuation of and number of equity instruments issued

17. If a **modification occurs after a vesting period** the increase in fair value should be recognised over the extended vesting period. If there is no period then the entire increase should be recognised immediately.

18. If the **option is cancelled or settled before the vesting date,** the vesting date is treated as brought forward and any balance of fair value (relating to the granting of the options) not yet charged is expensed immediately in SOI. **Compensation paid for the cancellation** is debited to equity up to the fair value of the options at the date of cancellation. Any excess over the fair value of the options is debited to profit or loss immediately.

19. An option may be withdrawn and re-issued on new terms. The **incremental fair value** of this transaction (the difference between fair values of the old and new option contracts) is treated as an expense recognised over the modified period or immediately, if no extended period.

20.

CASH SETTLED TRANSACTIONS

21. In a cash-settled share-based payment goods or services are paid for in cash determined by the value of shares on the vesting date or on the settlement date. The key issues that need to be determined are:

22. **The vesting date: delivery date** if goods; at the end of the period of service if employment services.

23. **The settlement date:** when payment is due; this can be later than the delivery or vesting date for goods. If so there are implications for the settlement amount quoted in shares.

24. **Measurement of the share price:** at each reporting date the shares on which the settlement is based are re-measured and the change in value is recognised immediately. The cumulative expense is the fair value at the reporting date multiplied by the period of vesting that has elapsed. See example below- check that this works. Use examples in Workbook for further practice.

25. **Share appreciation rights:** the employee is entitled to receive cash for the appreciation of a fixed number of equity instruments between the granting date and the settlement date. In equity settled transactions the employee will first buy the shares at the striking (exercise) price and sell

them at the market price to gain the share appreciation benefit.

26. **Modifications**: unlike equity settled transactions any reduction is immediately recognized (at the reporting date).

27. How does cash settled in relation to goods differ from cash settled in relation to services? The method of settlement is not different. However, the **vesting period** is different in that it is extended whereas the delivery of goods is completed at a point in time unless it is a long term contract.

28. Remember that at the end of the vesting period the employee receives cash (not shares as in the case of share options).

TRANSACTIONS THAT CAN BE SETTLED FOR SHARES OR CASH

29. Some share-based payment transactions allow the entity or the employee the choice as to whether to settle the transaction in cash or by the issue of equity instruments. An employee or a supplier of goods and services to the entity may have the right to choose between

- payment equal to the **market price** of shares (the shares are not issued but used only to measure the value of the goods and services received by the entity as consideration) or
- be given shares subject to conditions and restrictions (e.g. not to sell the shares or leave the entity until after a certain period has elapsed – the vesting period)

30. The key issue that has to be decided is how should be above arrangements be accounted for? The key determinant of how these types of transactions should be accounted for is **who has the right to choose the settlement method? As this type of transaction is a performance transaction such a right would logically fall to the party that has performed under the contract. Thus the entity that has supplied goods has the right to choose how the amount owed to it should be settled. And the entity has an obligation to fulfil that requirement.**

31. If the employee or supplier of goods and services has the right to choose a settlement method the instrument or contract is deemed to be a compound (or hybrid) consisting of

- a debt component (the cash element) and an
- equity component (where the supplier has the right to receive equity instruments)

32. The question then is how are the components measured? If the fair value of the consideration (goods and services) received by the entity can be measured **directly** and **easily** then the fair value of the equity is

FAIR VALUE OF EQUITY = FAIR VALUE OF GOODS AND SERVICES – FAIR VALUE OF DEBT ELEMENT (CASH)

Example

Plot a plc purchased inventory worth €150,000. The company has offered the supplier a choice of settlement options. The options are either to be issued 500 shares of Plot nine months after the purchase date (they are worth €160,000 on the purchase date) or to receive a cash payment on 30 June 2012 equal to the fair value of 400 shares valued at €130,000.

Required
Discuss how the above transaction should be accounted for.

Solution
Analysis
- The supplier has been offered a choice of settlement between **cash** and **equity**
- This choice is deemed to be a **hybrid** or **compound instrument** consisting of a **debt component** and an **equity component** as the supplier has been offered the optional right to receive shares.
- As the consideration received can be fair valued directly and easily the equity component is the difference between the fair value of the consideration received and the fair value of the debt component, the payment.
- Thus the accounting entries are:

	DR	CR
	€	€
Inventory	150,000	
Liability		130,000
Equity		20,000
	150,000	150,000

Note that the time value of money is at work here in that the value of the ***share settlement option*** *which is effectively a deferred payment is worth more than the fair value of the* ***cash settlement option****.*

33. Measurement of components: **if the fair value of the consideration is measured by the value of the equity instruments issued to the supplier then the whole of the equity instruments is measured at fair value and the equity components is then the difference between the fair value of the equity instruments granted and the debt component:**

FAIR VALUE OF EQUITY = FAIR VALUE OF EQUITY INSTRUMENTS – FAIR VALUE OF DEBT

Example
An entity grants an employee the right to choose to be remunerated for his bonus in shares or in cash. The share settled option involved the issue of 1

million shares at a price of €7 and the cash settled option involved the issue of 750,000 shares at a price of €5.5 per share.

Required
Discuss how this transaction is accounted for.

Solution
Analysis
- In this case the thing to note is that the value of the equity instruments issued sets the fair value of the consideration (unlike the previous example in which the value of the goods and services sets the value of the consideration). The rest is the same:
- The employee has been offered a choice of settlement: cash or equity. This is a compound instrument (remember we are not talking about financial instruments) consisting of a **debt component** and an **equity component**.
- The debt component is the equivalent of the cash settled option and the equity component is the difference between the equity settled option and the cash settled option. Thus the accounting entries are:

	DR	CR	
	€m	€m	
Equity instruments	7.00		Consideration
Liability		4.50	
Equity		2.50	
	7.00	7.00	

34. Normally an entity would treat all such transactions as cash settled if:

i) there is a clear policy to that effect backed by past practice;
ii) there is no commercial substance to an equity settled option (e.g. incentives to either party to participate in equity e.g. because of the time value of money)
iii) if equity instruments are redeemable (puttable)

35. If the transaction is settled by the issue of equity instruments (equity-settled), the accounting depends on which option is more valuable.

ENTITIES WITHIN THE SAME GROUP

36. Share based payment transaction in which an entity receives services as consideration for **its own equity instruments** is treated as *equity-settled* regardless of how the equity instruments are provided to the supplier or employee. The entity may

- buy those equity instruments from another party to satisfy its obligations to its employees (suppliers)
- grant the instruments itself
- settle the instruments itself
- have the obligation settled by its shareholders

37. In case of **share based payment** arrangements involving **equity instruments** of the parents

Share based payment transaction	**How settled**	**Measurement procedure**
Entity receives services as consideration for its own equity instruments	Equity settled. *This will be the case regardless of how the equity instruments are acquired or delivered*.	Entity measures the fair value of the goods and services received (say $1,000) and issues equity instruments (say 100) based on the prevailing market price (equals $10).
Parent grants rights to its own equity instruments to employees of the subsidiary	Equity settled	Subsidiary measures consideration received at fair value and treats this as contribution to equity from the parent. *Remember that IFRS 2 requires the amount recognised in SOCI annually to be the best estimate of the striking price of options that will vest (not the cost of the options that was granted or that will be exercised by the employees).*
Subsidiary grants to its employees rights to parent's own equity instruments	Cash settled	Again this is treated as a contribution by the parent to the equity of the subsidiary unless there is a clear requirement for reimbursement to the parent by the subsidiary. ACCOUNTING Unless reimbursement required by parent Parent DR Investment in subsidiary CR Equity Subsidiary DR Profit or loss CR Equity

SEPARATE ENTITY		
Entity grants employees rights to own equity instruments. Equity instruments provided by another party (by choice or by obligation).	Cash settled	Fair value of the services recognised. Obligations set up to be settled by the entity upon issue of equity instrument to employees
Entity (or shareholders) grants employees rights to own equity instruments. Shareholders provide equity instruments.	Equity settled	Fair value of services recognise and equity increased by that amount.

38.

39. COMPARE CASH SETTLED WITH EQUITY SETTLED

	Equity settled	**Cash settled**
Instrument	Share options	Share appreciation rights
Price	Fixed exercise (striking) price; share appreciation only gained if shares are bought at the striking price and then sold at the market price by the employee.	Fair value, allowing for automatic share appreciation rights to be exercised which is the right to participate in future gains.
Recognition basis for SOI	Estimate (at the reporting date) of amounts that will vest (not amount granted or exercised). Number of instruments x striking price (unchanged).	Estimates of fair value of equity instruments granted in exchange for goods and services.
Settlement terms	Payment *deemed* to occur on vesting date	Payment can occur after the services are rendered. So the vesting date (services delivery date) and the settlement date can be different. The *changes in fair value* between these two dates are recognised immediately at the **reporting date**.
Currency	Functional currency	
Vesting conditions		
Vesting period		
Modifications	Reduction in the award not recognized; expense not reduced	Any reduction in the award is recognized immediately

40.

41. DEFEERD TAX

42. As it is unlikely that the amount of tax deductible (the tax base) in respect of employee share options will equal the amount charged in SOI, deferred tax should be assessed for each cash-settled or equity-settled transaction.

43. The reason the tax base (the maximum amount deductible) may be different from the charge in SOI is that

- the tax deductible is usually based on the **intrinsic value of the option** (the difference between the **market value** and the **exercise price**)
- the market value can be determined annually and compared with the striking or exercise price (which does not change) or for practical reasons
- the market price of the option at the exercise date can be estimated and one lump sum allowance determined on that basis. This can subsequently be adjusted annually to reflect fluctuations in market prices.

Example
Say the striking price of the options is $2,500 per share and the market price is estimated at $7,500 on exercise. The intrinsic value of the option is $5,000. If the tax rate is say 20% then the total tax allowance on the option is 20% x $5,000 equals $1,000 (over the vesting period) assuming the allowance is given on the **intrinsic value**.

If **the shares vest after two years** then the total annual charge to SOI is $2,500/2 ($1,250), assuming the options vest in full. (Remember that the amount charged to SOI is the best estimate at each reporting date of the options that are expected to vest, **not** the amounts granted or expected to be exercised).

IFRS 2 requirements
If the estimated or actual tax deduction ($1,000) is less than or equal to the cumulative recognized expense ($2,500) then, the associated tax benefits (20% x $2,500 equals $500) are recognized in SOI annually. And because the intrinsic value of the options ($5,000) are estimated to be higher than the amount charged to SOI ($2,500), the deferred tax asset that is not recognised in SOI is recognised in equity.

Applying the above:

Actual (or estimated) tax deduction less <= expense recognized		
	DR	CR
Deferred tax asset 20% x $5,000/2	500	
SOCI: 20% x $2,500/2		250
Equity: the difference		250
	500	500

Note that normally the benefit of the deferred tax asset (20% x $5,000 = $1,000 over the two years) would be recorded as a credit of an equal amount to the SOI. However, in this case because the amount charged to SOI is only $2,500 (over the two years) the benefit of the deferred tax is limited to it (20% x $2,500 = $500 over two years). The difference is recorded as equity ($1,000-$500 = $500) over the two years.

The amount recorded in equity will be reallocated to SOI if in future the **intrinsic value** of the options is less than the amount charged to SOI. This may be the case where the market prices fall below the exercise price.

44. If the total tax deduction exceeds the cumulative recognised compensation (or share option) expense the difference is recorded in a separate component of equity.

45.

46.

47.	

48. BACKGROUND INFORMATION

employee share scheme

Share-option schemes are typically used as an incentive for employees.

A share option is the right to buy a certain number of shares at a fixed price, some time in the future, within a company.

Employees can generally exercise their options - ie buy the shares - after a specified period, known as the **vesting period**. You can make the granting and exercising of options dependent on reaching certain targets, such as sales targets.

When an employee exercises their options, it's at the price fixed at the date of grant, ie when the options were given to the employee, regardless of the prevailing market price. They can then keep the shares or, if the market price is higher, sell them at a profit.

Share-award schemes involve giving employees actual shares rather than options, free or for less than their market value. The value of shares given to employees is treated as employment income - subject to tax and National Insurance contributions,

Share-purchase schemes allow employees to:

- buy shares
- save money to buy shares
- buy shares for a small deposit, paying the rest at a later date

There are **3 types of employee share schemes**: **share option schemes**, **share award schemes** and **share purchase schemes**. Share option schemes give employees the right to buy a certain number of shares in their company at a set price at some time in the future. The right to exercise the option can be dependent on achieving certain performance targets. Share award schemes involve giving employees shares rather than options, for free or for less than their market value. Share purchase schemes permit employees to buy shares or save money to buy shares.

Definition of 'Strike Price'

The price at which a specific derivative contract can be exercised. Strike prices is mostly used to describe stock and index options, in which strike prices are fixed in the contract. For call options, the strike price is where the security can be bought (up to the expiration date), while for put options the strike price is the price at which shares can be sold.

49.

50. Clarity and quality of discussion
Revise the glossary from … and test your knowledge rigorously using i) objective tests; ii) fill in the blanks; iii) match the concept

Key terms

Key words
- Cash settled
- Counterparty

- Equity settled - Fair value (valuation of equity instruments) - Grant date (- Intrinsic value (valuation if unable to measure FV reliably e.g. unlisted or newly listed entities) - Performance conditions (vesting) e.g. target margins - Service conditions (vesting) - - Vesting conditions (service, performance)	
Key phrases: it is worth memorizing these as **prepared phrases** could potentially save you time in the exams and make your answers read more professional.	
51. News digest & Developments	