A practical guide to share-based payments

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Introduction

This publication has been updated (in February 2011) since it was originally released in November 2008 to reflect amendments to IFRS 2 – in particular, guidance under Q&A 5.2 and Section 6 'Group share-based payment arrangements'.

IFRS 2, 'Share-based payment' is a complex and challenging standard to apply specifically, as almost no two share-based payment arrangements are alike.

A substantial amount of new guidance has been issued since IFRS 2 was published. Specifically:

- The standard was amended in 2008 by 'Amendments to IFRS 2 – Vesting conditions and cancellations' (applicable to annual reporting periods beginning on or after 1 January 2009); and
- The standard was amended in 2009 by 'Amendments to IFRS 2 – Group cash-settled share-based payment transactions' (applicable to annual reporting periods beginning on or after 1 January 2010). The amendments incorporate IFRIC 8, 'Scope of IFRS 2', and IFRIC 11, 'IFRS 2 – Group and treasury share transactions', into IFRS 2.

This publication contains practical examples to help management draw similarities between the requirements in the standard and their own share-based payment arrangements. It also shares PwC insight and experience from dealing with countless share-based payment arrangements from around the world.

The publication aims to help manage many of the challenges in applying IFRS 2, such as:

- Deciding whether an arrangement is a share-based payment under IFRS 2;
- Classifying the share-based payment correctly (equity-settled or cash-settled);
- Determining whether a share-based payment has been modified, cancelled or forfeited;
- Accounting in individual group entities for group share-based payments and recharge arrangements; and
- Determining the accounting when a share-based payment occurs in a business combination or a joint venture.

It also covers:

- When to recognise a share-based payment expense in the income statement;
- How to measure a share-based payment;
- How to account for a trust that is set up to administer a share-based payment arrangement; and
- How to account for the tax effects of a share-based payment.

The publication takes into account all share-based payment guidance released up to December 2010.

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Section 1 Scope of IFRS 2

IFRS 2 should be applied to every share-based payment. The standard encompasses all arrangements where an entity purchases goods or services in exchange for the issue of an entity's equity instruments, or cash payments based on the fair value of the entity's equity instruments. In practice, the identification of arrangements that fall within the scope of IFRS 2 is not always straightforward.

1.1 Does a share-based payment arrangement always involve an employer and an employee?

No. Entities typically use share option plans for the purpose of employee remuneration, but the scope of the standard is much broader than this. A share-based payment arrangement only requires the exchange of equity instruments, or cash amounts based on the value of these equity instruments, with another party in return for goods or services.

Insight

Common share-based payment arrangements between employers and employees

- Call options that give employees the right to purchase an entity's shares in exchange for their services
- Share appreciation rights that entitle employees to cash payments calculated by reference to increases in the market price of an entity's shares
- Share ownership plans where employees receive an entity's shares in exchange for their services

Common share-based payment arrangements that are not between employers and employees

- An external consultant (not an employee) may provide services in return for shares in the entity
- A supplier may provide goods in return for shares in the entity (refer to Q&A 1.6)
- A shareholder (rather than an employer) may grant shares to an employee (see example below)

Example

An individual with a 40% shareholding in entity A has awarded 2% of his shareholding to a director of entity A. The shareholder of entity A has transferred equity instruments of entity A to a party that has supplied services to the entity (the director). Unless it is clear that the transaction is a result of some other relationship between the shareholder and the director that is unrelated to his employment, the award will be reflected as a share-based payment in entity A's financial statements.

An award is within the scope of IFRS 2 where either the entity or its shareholder issues equity instruments in any group entity in return for goods or services provided to the entity.

1.2 What types of transactions with employees are not within the scope of IFRS 2?

A transaction with an employee is not within the scope of IFRS 2 if:

- It is not related to the receipt of goods or services; or
- The amount paid to the employee is not based on the market price of that entity's equity instruments.

Examples

Share-based payments that are not related to employee services

An entity makes a rights issue of shares to all shareholders, including employees who are shareholders. The transaction is an arrangement with employees in their capacity as owners of equity instruments, not in their capacity as employees. Therefore, the transaction is not within the scope of IFRS 2.

Note: If the entity issued shares to the shareholders who are employees at a discounted price, the arrangement would be within the scope of IFRS 2. The favourable terms indicate that the entity is dealing with these shareholders as employees, rather than in their capacity as equity holders.

Cash payments that are not based on the market price of equity instruments

An entity makes a cash payment to an employee that is based on a fixed multiple of the entity's earnings, such as earnings before interest, tax, depreciation and amortisation (EBITDA).

The cash payment is not based on the entity's share price, so it is not within the scope of IFRS 2. The cash payment is an employee benefit, which is accounted for under IAS 19, 'Employee benefits'.

1.3 What common features identify a transaction as being a share-based payment arrangement with employees?

The following are examples of features frequently found in a share-based payment arrangement with employees.

1. Employees that are shareholders are granted additional benefits.
2. The arrangement incorporates 'leaver conditions'.
3. The arrangement involves a trust.

Each of these features is described below.

1. Employees that are shareholders are granted additional benefits

Additional benefits indicate the entity is dealing with the individuals as employees or providers of services rather than as investors or equity holders.

Examples of additional benefits include:

- Employees have the right to additional shares if the business performs well (often referred to as a ratchet mechanism).
- Employees' rights depend on whether the entity floats or is sold through a trade sale (ie, in the event of a trade sale an employee may automatically get a cash payment or a number of shares).

2. The arrangement incorporates 'leaver conditions'

Such conditions indicate the entity is dealing with the individuals as employees or providers of services rather than as investors or equity holders. For example, the employee only receives the shares if they remain an employee or if they are required to sell their shares back to the entity when they resign.

3. The arrangement involves a trust

The existence of an employee benefit trust that buys back shares from employees suggests that the shares are being used to obtain employee services.

Insight

Employees who have paid for shares or share rights may have a right to a refund in certain circumstances. For example, if they resign before a certain minimum time period, they can (or must) surrender their shares or share rights and receive their cash back. In this case, the entity recognises the liability for the refund under IFRS 2.

1.4 Can employee bonuses be considered share-based payments?

It depends. If the bonus is calculated by reference to an entity's share price (also known as share appreciation rights), it is accounted for as a cash-settled share-based payment under IFRS 2. This applies even if the payment is made under a bonus or profit-sharing plan.

If the bonus is:

- not calculated by reference to an entity's share price (such as those based on the revenue or profits of the employer entity), or
- not settled using equity instruments of the group,

then it is accounted for as an employee benefit under IAS 19, 'Employee benefits'.

Example

A non-quoted or unlisted entity issues share appreciation rights to employees. Employees can use 50% of their bonus payment to purchase these rights. The share appreciation rights entitle the employees to a cash payment from the entity. The arrangement's terms and conditions define the share price to calculate the payments to employees as five times EBITDA divided by the number of shares.

IFRS 2 does not apply to the arrangement because a fixed multiple of EBITDA is not likely to reflect the fair value of the entity's share price. Therefore, management should apply IAS 19, 'Employee benefits' to account for the arrangement.

Note: For some entities, an earnings multiple could reflect the fair value of the entity. The entity will therefore need to determine whether the cash payments are linked to the underlying value of the business. In which case, the arrangement would be within the scope of IFRS 2.

1.5 Can a share-based payment involve shares in a group entity other than the employer entity?

Yes, because it involves equity of another entity within the same group.

Note: For more guidance, refer to Section 6, 'Group share-based payment arrangements'.

1.6 Can a share-based payment involve the purchase of goods?

Yes. Share-based payments are used to procure goods in addition to being used with employees and other parties to purchase services.

Example

Entity B is developing a new product and purchases a patent from entity C. The parties agree a purchase price of 1,000 of entity B's shares. These shares will be issued to entity C within 60 days of finalising the legal documentation that transfers the patent from entity C to entity B.

This is an equity-settled share-based payment under IFRS 2. The goods to which IFRS 2 applies include inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets.

Note: Measurement of the transaction is discussed in Q&A 4.6.

1.7 Are all share-based payments that involve the purchase of goods within the scope of IFRS 2?

No. Contracts for the purchase of goods that are within the scope of IAS 39, 'Financial instruments: Recognition and measurement' (paragraphs 5-7) (or IFRS 9, 'Financial instruments') are outside the scope of IFRS 2. For example, a commodity contract that is entered into for speculative purposes (other than to satisfy the entity's expected purchase or usage requirements) is not within the scope of IFRS 2. In addition, contracts for the purchase of goods as part of a business combination in accordance with IFRS 3, 'Business combinations', are outside the scope of IFRS 2.

Example

Entity D enters into a contract with a producer to purchase 100 tonnes of cocoa beans. The purchase price will be settled in cash at an amount equal to the value of 1,000 of entity D's shares.

Entity D may settle the contract at any time by paying the producer an amount equal to the current market value of 1,000 of its shares, less the market value of 100 tonnes of cocoa beans. Entity D has entered into the contract as part of its hedging strategy and has no intention of taking physical delivery of the cocoa beans.

The arrangement is not within the scope of IFRS 2 because the contract may be settled net and has not been entered into in order to satisfy entity D's expected purchase, sale or usage requirements. Entity D has not purchased the cocoa beans; rather, it has entered into a financial contract to pay or receive a cash amount.

The arrangement should be dealt with in accordance with financial instruments standards IAS 32 and IAS 39 (or IFRS 9).

1.8 Is it a share-based payment if the entity is unclear what goods or services it is receiving?

Yes. IFRS 2 applies where:

- Entities cannot specifically determine what consideration (goods or services) they are receiving in return for their shares; or
- The value of the identifiable consideration (goods or services) to be received by the entity is less than the fair value of the equity instruments granted or the liability incurred.

Insight

Sometimes entities grant shares or share rights to a not-for-profit entity or charity. Typically the entity receives intangible benefits that can be difficult to identify, such as improved corporate image or likely favourable publicity. Despite this, these benefits count as consideration and are measured and recognised using the guidance in IFRS 2.

1.9 Does IFRS 2 apply if the entity can choose to deliver a fixed amount in either shares or cash?

Yes.

Insight

At its May 2006 meeting, the IFRIC confirmed that the above scenario is within the scope of IFRS 2. It based its decision on the following:

- IFRS 2 contemplates a share-based payment where the terms of the arrangement provide the entity with a choice of settlement; and
- The definition of 'share-based' in the context of a share-based payment does not require the exposure of the entity to be linked to movements in the share price of the entity.

Example

An entity grants its employees an award. The terms of the award require the employees to remain as employees of the entity until the end of the year. At this time, the entity will either pay the employees C100 cash, or shares in the entity equivalent to the value of C100.

This is an award in the scope of IFRS 2 where the entity has choice of settlement (see Q&A 3.2).

Section 2 Identifying share-based payments in a business combination or joint venture

There is additional guidance on accounting for share-based payments in the business combinations standard. IFRS 3, 'Business combinations', provides guidance to determine whether replacement share awards are part of the consideration for the business combination or post-combination services.

2.1 Is it a share-based payment if an acquirer makes a grant in connection with a business combination?

It depends on what the acquirer receives in return for the shares:

- If the acquirer receives control of the acquired entity, the arrangement is excluded from the scope of IFRS 2. Instead, the shares form part of the purchase consideration for the acquired entity and are accounted for under IFRS 3. IFRS 3 requires the acquirer to measure the shares at their fair value at the date of exchange. The best evidence of their fair value is usually the published price.
- If the acquirer issues shares to employees in return for post-combination employee services, IFRS 2 applies.

Insight

It may be difficult to determine in practice whether shares have been issued in return for control of the acquired entity (IFRS 3) or for future employee service (IFRS 2).

The terms and conditions of the business combination grant might suggest that the grant is a mixture of both, which means that IFRS 3 and IFRS 2 will apply to portions of the grant. The examples below illustrate this.

2.2 An acquirer entity grants its shares to employees who are shareholders of the target entity. Does IFRS 2 apply to the grant?

It depends. If the grant is made to employees in their capacity as equity holders, it forms part of the cost of the business combination and is outside the scope of IFRS 2. Where the grant requires the provision of post-combination services, IFRS 2 applies.

2.3 An acquirer is obliged to replace a grant that has vested in the acquiree entity. Does IFRS 2 apply to the grant?

Usually a combination of IFRS 2 and IFRS 3 applies. The answer is explained in the example below.

Example

Entity E acquires 100% of the share capital of entity F in a business combination. Entity F had previously granted a share-based payment to its employees with a four-year vesting period. Its employees have rendered the required service for the award at the acquisition date but have not yet exercised their options. The fair value of the award at acquisition date is C100.

No post-combination services are required

Entity E issues a replacement award that does not require post-combination services. The fair value of the replacement award at the acquisition date is C120.

A portion of the fair value of the award granted by entity E is accounted for under IFRS 3 and a portion under IFRS 2, even though no post-combination services are required. The amount included in the cost of the business combination is the fair value of F's award at the acquisition date (C100). Any additional amount, which in this case is C20, is accounted for as a post-combination expense under IFRS 2. This amount is recognised immediately as a post-combination expense because no additional post-combination services are required.

Post-combination services are required

Now assume that one year of additional employee services is required after the acquisition date and that the fair value of entity E's replacement award is C150.

A portion of the fair value of the acquiree's award is accounted for under IFRS 3 and a portion under IFRS 2. The portion of the acquisition date fair value of F's award attributed to the cost of the combination (under IFRS 3) and the portion attributed to post-combination services is determined by the ratio of the pre-combination vesting period (four years) to the total vesting period (five years). C80 is therefore recorded under IFRS 3, and C20 under IFRS 2. The excess of C50 (C150-C100) of the fair value of the acquirer's award over the acquiree's award is accounted for under IFRS 2 and so C70 in total is recognised over the one-year vesting period post-combination.

Note: The above example is based on the application of IFRS 3 in E's group consolidated financial statements and not F's stand-alone financial statements.

2.4 An acquirer entity is obliged to replace a grant that has not vested in the target entity. Does IFRS 2 apply to the grant?

Usually a combination of IFRS 2 and IFRS 3 applies. The answer is explained in the example below.

Example

Entity G acquires 100% of the share capital of entity H in a business combination. Entity G issues a replacement award (to replace H's award) that requires one year of post-combination service. Entity H had an outstanding grant that required four years' service. H's employees had rendered two years' service at the acquisition date. The IFRS 2 fair value of both awards is C100 at acquisition date.

A portion of the fair value of the award granted by entity G will be accounted for under IFRS 3 and a portion under IFRS 2. The amount included in the cost of the business combination is the ratio of the pre-combination service (two years) to the higher of the original (four years) and the revised (three years) vesting period (2/4), ie, C50. The remaining amount is accounted for as post-combination expense under IFRS 2 over the remaining one-year vesting period.

2.5 Can a share-based payment arise from the formation of a joint venture?

It depends. When a joint venture entity issues shares in return for a business, it is excluded from the scope of IFRS 2. This is best explained in the example below.

Example

Entity J and entity K are brought together to form a joint venture.

Joint ventures are outside the scope of IFRS 3. This transaction does not meet the definition of a business combination because two separate entities are being brought together into one reporting entity without either entity gaining control; the scope exclusion in IFRS 2 therefore applies.

The combination of separate businesses to form a joint venture involves the issue of shares for the purpose of forming a joint venture, not the acquisition of goods or services. The transaction is therefore outside IFRS 2's scope.

2.6 Can a share-based payment arise in an existing joint venture?

Yes. The answer is explained in the example below.

Example

Entity J is a 50:50 joint venture between entity K and entity L. Entity K grants the senior employees of entity J options over its own shares and does not make any charge to entity J. Entity L does not provide any contribution to the joint venture to compensate K. K applies the equity method to investments in joint ventures in its consolidated financial statements and the cost method in its separate financial statements.

Entity J's financial statements

IFRS 2 includes within its scope transfers of equity instruments of an entity's parent or of an entity in the same group in return for goods or services. However, entity K is a joint venture investor and is not entity J's parent, nor is it in the same group (defined in IAS 27 as being 'a parent and all its subsidiaries') as entity J. Therefore, on initial consideration, from entity J's perspective, the award in entity J of share options in entity K is not within IFRS 2's scope.

The arrangement also falls outside the scope of IAS 19, 'Employee benefits'; the arrangement does not meet the IAS 19 definition of an employee benefit because no consideration is given by entity J.

IAS 8, 'Accounting policies, changes in accounting estimates and errors', requires entities to apply a hierarchy when determining their accounting polices. Where there is no IFRS that governs a particular transaction, IAS 8 requires management to look for guidance to another pronouncement that deals with similar or related issues.

We believe the most appropriate accounting is for entity J to apply the principles of IFRS 2 to the equity-settled share-based payment. This is further supported by the treatment where a parent entity grants options over its own shares to those of its subsidiary. Entity K does not meet the definition of a parent entity, but in the absence of any other guidance, this is an acceptable approach (see Section 6, 'Group share-based payment arrangements'). The disclosure requirements of IAS 24, 'Related party disclosures', should be applied if any of the employees are key management personnel.

Note: The transaction would be within the scope of IAS 19 if compensation was given by entity J for the share-based payment, perhaps in the form of a recharge payment to entity K.

Entity K (the investor)'s financial statements

Entity K has an equity-settled share-based payment arrangement and should measure the goods and services received in accordance with IFRS 2. In its separate financial statements, K would capitalise the IFRS 2 grant date fair value of the award to the cost of its investment in the joint venture and consider whether there were any impairment indicators.

Entity K's consolidated financial statements should apply the principles of IAS 31, 'Interests in joint ventures'. To the extent that J has accounted for the share-based payment, 50% of this would be recorded by K when the equity method is applied. In addition, as entity L did not provide an equivalent contribution into the joint venture, entity K would record an additional cost resulting in 100% of the share-based payment charge recorded in K. If the equity method for J did not account for the share-based payment, K would need to record an additional cost of 100%.

Entity L (the investor)'s financial statements

The share-based payment has no impact on entity L's separate financial statements. To the extent that entity J has accounted for the share-based payment, the proportional share (that is, 50%) of the charge that is recorded by entity L on consolidation would be eliminated against the gain recorded on application of IAS 31 paragraph 48; there is therefore no impact on consolidation.

Section 3 Classification of share-based payment arrangements

The classification of a share-based payment will determine its recognition and measurement. The measurement of a share-based payment expense depends on how the arrangement is classified. Correct classification is critical to determining the appropriate accounting and understanding the impact of share-based payments on an entity's financial statements. Determining the classification of some share-based payment arrangements is not always straightforward.

3.1 What are the different types of share-based payment?

There are three types of share-based payment arrangements:

- **Equity-settled share-based payments –** transactions in which the entity (a) receives goods or services as consideration for its own equity instruments (including shares or share options); or (b) receives goods or services but has no obligation to settle the transaction with the supplier.
- **Cash-settled share-based payments –** transactions in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.
- **Choice of settlement –** transactions in which the entity receives or acquires goods or services, and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

Example

Equity-settled share-based payment

The issue to employees of options that give them the right to purchase the entity's shares at a discounted price in exchange for their services.

A cash-settled share-based payment

Share appreciation rights that entitle employees to cash payments based on the increase in the employer entity's share price.

3.2 How should an entity classify a share-based payment that has a choice of settlement?

The table below summarises the appropriate accounting treatment.

<table>
<tr><th>Choice of settlement</th><th>Type of share-based payment and appropriate accounting treatment</th></tr>
<tr><td>At the option of the entity</td><td>The terms of a share-based payment may provide an entity with the choice to settle in cash or by the issue of equity instruments. The share-based payment is cash-settled if the entity has a present obligation (legal or constructive) to settle in cash. The entity has a present obligation if the choice of settlement has no commercial substance or if the entity has a past practice or stated policy of settling in cash.</td></tr>
<tr><td>At the option of the employee</td><td>This is a compound instrument that is similar to convertible debt because it has both a debt and equity component. An example of a compound instrument is where an employee has the choice of receiving share options or cash-settled share appreciation rights.

In accounting for this type of share-based payment, management should:

• Measure the fair value of the debt component (accounted for as a cash-settled liability); and
• Measure the fair value of the equity component, taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument.

For example, an employee may have the right to choose whether he or she receives C100 in cash or C100 worth of shares. In this case the fair value of the equity component is zero because the employee will have to forego the C100 of cash to receive C100 worth of shares.

Many share-based payment arrangements are structured so that the fair value of the settlement options is the same. If the fair values of the settlement alternatives differ, the fair value of the equity component will usually be greater than zero.</td></tr>
</table>

3.3 Does an entity's settlement practice affect the classification of its share-based payments?

Yes. If an entity has a past practice of settling its share-based payment arrangements in cash, it is assumed it will settle future share-based payment arrangements in cash.

Management should review its share-based payment arrangements at each balance sheet date (including previous grants that are outstanding) to ensure the classification remains correct. The determination of past practice should be fact-specific, and judgement should be used. If the classification has a material impact on the financial statements, it should be disclosed as a critical judgement.

Example

Entity M in year 1 grants its employees options that can be settled in cash or shares. At the grant date, the entity stated in its financial statements that it expected to settle the options by issuing shares. As explained in Q&A 3.2, M treats these awards as equity-settled. After three years, the options vest, and M decides to settle the options in cash.

As M chose to settle in cash, in the absence of any other evidence, this may act as a precedent for other arrangements that give the entity a choice of settlement. If it is determined that M has created a past practice of settling in cash, all arrangements that give the entity a choice of settlement are treated as cash-settled. M will need to revisit the classification of any similar grants it has made in the past and re-classify them to cash-settled, as discussed in Q&A 3.5.

Insight

A key difference between IFRS 2 and IAS 32 is that, where an entity intends to pay out cash but has no contractual obligation to do so, IFRS 2 requires a liability to be recorded; IAS 32 does not.

3.4 An entity buys equity instruments from a third party to give to an employee. Does this make the share-based payment cash-settled?

No. It would be an equity-settled share-based payment even though the entity will pay cash to acquire the shares on the market. The entity is still providing equity to the employee, and the employee will always receive shares if he or she meets the vesting conditions. How the entity acquires the shares that will be used to settle the award is a separate transaction, even if the entity will be forced to purchase shares because it cannot issue new shares.

Example

An entity grants employees rights to its shares subject to certain performance conditions. The entity purchases the shares on the market at the date that its employees satisfy those performance conditions.

When the entity purchases the shares on the market, the transaction is recognised in equity as a treasury share transaction to reflect the purchase of the entity's own shares. This does not affect the share-based payment accounting.

3.5 How does an entity account for a change in the classification of a share-based payment?

It depends.

On reclassification from cash-settled to equity-settled

The entity immediately reclassifies the amount recognised as a liability, up to the modification date, to equity. The expense for the remainder of the vesting period is based on the fair value of the award, measured at the modification date and not the original grant date.

On reclassification from equity-settled to cash-settled

The entity measures the liability initially using the reclassification date fair value of the equity award based on the elapsed portion of the vesting period. This amount is recognised as a credit to the liability and a debit to equity. The entity then re-measures the liability at each subsequent reporting date and recognises any additional expense from increases in the liability. The example below illustrates this.

The accounting for modifications from an equity award to a cash-settled award becomes more complicated if the fair value of the award on the modification date is less than the grant date fair value.

Example

Entity N has an equity-settled share-based payment that will vest when employees provide four years of continuous service. The grant date fair value is C10; the vesting period is four years. At the end of year 2, a cumulative charge of C5 has been recognised in the income statement with a corresponding increase in equity.

N decides to change the share-based payment award from equity-settled to cash-settled. The employees will now receive a cash payment based on the fair value of the shares at the end of year 4.

The accounting is illustrated by two scenarios, in which immediately before the change in classification, the fair value of the grant:

(a) Has increased:

Assume the fair value immediately before modification is C20. At the start of year 3, a liability of C10 (20/2) is recognised with a corresponding debit to equity of C10. The subsequent measurement of the liability would follow the requirements for cash-settled share-based payments.

(b) Has decreased:

IFRS 2 requires an entity to recognise a charge in the income statement for the services received of at least the grant date fair value, regardless of any modifications or cancellations of the grant. The only exception to this is where a non-market vesting condition is not satisfied.

Assume that the fair value immediately before the modification has decreased to C5 and there are no further movements in the fair value in years 3 and 4. The accounting would be:

- Years 1 and 2: a total expense and increase in equity of C5, is recognised.
- At the start of year 3: a liability of C2.5 is recognised with a corresponding decrease to equity. The fair value of the grant has decreased to C5.

- Years 3 and 4: an expense of C2.5 is recognised each year with a corresponding increase in the liability of C1.25 and equity of C1.25. The C1.25 expense and increase in equity recognised each year ensures that the income statement expense is at least equal to the grant date fair value.

At the end of the vesting period the total expense is C10 (of which C5 was a credit to equity and C5 a credit to liability). The total expense is equal to the grant date fair value of C10.

If the fair value was to change in years 3 and 4, the entity would need to recalculate the amounts to expense in these years as follows:

- Record the expense based on the grant date fair value and allocate this expense between debt and equity based on the ratio of debt to equity on the date of modification; and then
- Re-measure the value of the liability based on movements in the share price.

To illustrate, assume that at the end of year 3, the fair value of the award has decreased to C4. The entity:

- Records an expense, based on the grant date fair value, of C2.5 with a corresponding increase in the liability and equity of C1.25 (based on the ratio of equity to cash on the date of modification); and then
- Re-measures the value of the liability through the income statement from C3.75 to C3 (representing three-quarters of the fair value of the liability of C4 as we are three years through the four-year vesting period).

Insight

Re-classification of a share-based payment award may occur because:

- An entity is de-listing. To provide greater liquidity to employees the entity might change the share-based payment from equity-settled to cash-settled.
- The entity has changed its settlement practice (refer to Q&A 3.3).

3.6 Do post-vesting conditions affect the classification of a share-based payment?

Yes. IFRS 2 requires entities to consider the post-vesting terms and conditions of a share-based payment.

Example

A post-vesting restriction might be a pre-emption right. For example, an employee receives shares in the entity upon vesting, but he or she must offer them for sale to the entity if they resign or otherwise terminate their employment. Where the entity has an intention or established practice of exercising the pre-emption right, it would indicate that the award is in fact cash-settled.

Section 4 Recognition and measurement of share-based payments

IFRS 2 provides detailed guidance for the recognition and measurement of share-based payments. Management must determine the fair value of a share-based payment at the grant date, the period over which this fair value should be recognised (the vesting period), and the charge that should be recognised in each reporting period.

Management needs to understand the conditions of the share-based payments with employees and other parties to properly apply this guidance. This may prove challenging in practice because almost no two share-based payment arrangements are the same.

The goods or services received or acquired in a share-based payment are recognised when the goods are obtained or as the services are received. A corresponding increase in equity is recognised if the goods or services are received in an equity-settled transaction. A liability is recognised if the goods or services are acquired in a cash-settled transaction.

4.1 Does an entity recognise a share-based payment from its grant date?

Not necessarily. IFRS 2 requires the expense to be recognised on the date that services are provided.

Example

The terms of the award are not finalised

An employee may have commenced employment before the employer has finalised the terms of a share-based payment.

The award is subject to shareholder approval

If the issue of the equity instruments is subject to shareholder approval, the grant date might occur some months after the employees have begun rendering the services given in exchange for that grant.

In both cases, the entity estimates the grant date fair value of the equity instruments for the purpose of recording an income statement charge for the services received prior to the grant date. Once the date of grant has been established, the entity 'trues up' the expense so that it is based on the grant date fair value of the awards.

Insight

The grant date is the date that the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement and all required approvals have been obtained. The initial measurement of the share-based payment is at the grant date. In some cases, the grant date might occur after the employees have begun rendering services.

4.2 What are vesting conditions and the vesting period in a share-based payment?

Vesting conditions affect the measurement and recognition of a share-based payment.

IFRS 2 defines vesting conditions as the criteria that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement.

Vesting conditions include:

- **Service conditions**, which require the other party (such as an employee) to complete a specified period of service; and
- **Performance conditions**, which require that specified performance conditions are met before the counterparty becomes entitled to the grant. Performance conditions can be market-based (such as those that relate to the market price of the entity's equity) or non-market-based (such as those that relate to the entity's profit).

Other conditions attached to the award are referred to as non-vesting conditions, which are discussed in Q&A 4.13.

The vesting period is the period during which all the specified vesting conditions of a share-based payment are satisfied. The vesting period is generally specified in the terms and conditions of an arrangement. However, the vesting period should be estimated when an employee must stay in service until a particular event occurs (such as an initial public offering). The services are accounted for as they are rendered by the counterparty during the vesting period. The expense is recognised over the vesting period with a corresponding increase in either equity or a liability.

4.3 If the actual vesting period is shorter than originally estimated, is the share-based payment expense recognised over the shortened period?

Yes. When the actual vesting period is shorter than originally estimated, the grant date fair value should be accelerated and recognised as an expense over the shorter period.

Where the vesting period is linked to a non-market performance condition, an entity should recognise the goods and services it has acquired during the vesting period based on the best available estimate of the number of equity instruments expected to vest. The estimate should be reconsidered at each reporting date based on factors such as a shortened vesting period, and the cumulative expense should be 'trued up' for both the change in the number expected to vest and any change in the expected vesting period.

In our view, where the vesting period is linked to a market performance condition, an entity should estimate the expected vesting period. If the actual vesting period is shorter than estimated, the charge should be accelerated in the period that the entity delivers the cash or equity instruments to the counterparty. When the vesting period is longer, the expense is recognised over the originally estimated vesting period.

Example

Vesting period is linked to market performance condition

An entity grants 100 options to an employee at a fair value of C1 each. The options vest upon meeting a particular market condition (such as the entity's share price reaching C3), provided the employee has remained in the entity's service until that time. The terms and conditions of the options are that the market condition can be met in either year 3, 4 or 5 of the employee's service.

At grant date, the entity estimates the expected vesting period (consistent with the assumptions used in estimating the fair value of the options granted). The fair value cannot subsequently be revised.

The entity expects the market condition to be met in year 4, so the entity has the following expense profile: year 1: C25; year 2: C25; year 3: C25; year 4: C25.

If the market condition is met in year 3, the entity should accelerate the remaining expense in year 3. The expense profile would be year 1: C25; year 2: C25; year 3: C50. This occurs despite the vesting period being shorter than that originally estimated in the fair value calculation.

Note: If the market condition was actually met in year 5, the expense would still be recognised over the original vesting period of 4 years.

4.4 If shares vest in the event of an initial public offering (IPO), what is the vesting period?

It depends on when management assumes the IPO will occur. Management should determine at the grant date the probability of the IPO occurring and use the period until the assumed date of the IPO as the vesting period. Management should re-estimate the vesting period and probability of the IPO at each balance sheet date.

Insight

Usually entities do not have to estimate the vesting period because the vesting period is determined by the conditions included in the share-based payment. However, when a condition is based on an IPO or when an entity's shares are likely to float on the stock market, an estimate of the vesting period is required.

4.5 What is the appropriate accounting when a share-based payment has more than one vesting date?

It depends. Management should determine whether it has made one grant that has a number of possible vesting dates, or a series of grants that each have their own vesting date.

If there are a number of possible vesting dates associated with the same grant, the entity will need to make an estimate of the vesting period. The example in Q&A 4.4 involving an IPO is an example of this.

Insight

If an entity makes more than one grant, there will be more than one vesting period (refer to the example below). In all but exceptional cases, the vesting periods will begin in year 1, which will result in an expense for each tranche being recorded in that year (this is known as 'tranched vesting').

Example

Entity P makes a share-based payment to employees. The conditions of the award are that employees will receive 40 options per annum over a three-year period. The employees need to be employed by the entity at the end of each year.

The options vest in the following tranches:

- **Tranche 1:** year 1 if the share price reaches C1
- **Tranche 2:** year 2 if the share price reaches C2
- **Tranche 3:** year 3 if the share price reaches C3

This will result in three different grants (three tranches) and three vesting periods. The fair value of tranche 1 is recognised over the vesting period of year 1. The fair value of tranche 2 is recognised over the vesting period of years 1 and 2. The fair value of tranche 3 is recognised over the vesting period of years 1, 2 and 3. Note that, as there is a market condition, an expense is recognised provided the employee remains in service, regardless of the actual price of the shares.

This will result in the largest expense being recognised in year 1.

However, if the facts are different, the accounting will also be different. For example, assume the grant of 120 options is received at the end of year 3 if the share price reaches C3. There is one grant and one vesting period, which means that the one grant has a three-year vesting period.

Alternatively, if the employees receive the shares when the share price reaches C3, there is a variable vesting period that should be estimated and fixed at the grant date, as explained in Q&A 4.3.

4.6 How are share-based payments measured?

The fair value of goods or services received in exchange for a share-based payment is measured directly unless the fair value cannot be estimated reliably. In this case, the fair value is measured by reference to the fair value of the equity instruments granted as consideration. Services provided by employees are always measured by reference to the fair value of the equity instruments granted.

The measurement date for equity settled share-based payments depends on the other party to the transaction. For example, if the share-based payment is between the entity and:

- Employees or others providing similar services, the expense is measured at fair value at the grant date.
- Parties other than employees (and those providing similar services), the measurement date is the date that the entity obtains the goods or the counterparty renders the service.

For cash-settled share-based payments, the goods or services acquired and the liability incurred is measured at the fair value of the liability. Only cash-settled awards are subsequently re-measured.

4.7 What assumptions and valuation methods are used when calculating the fair value of a share-based payment?

It depends on the terms of the arrangement.

Calculating the fair value of shares of listed entities is straightforward, the quoted share price is used. If the shares are not quoted on an active market, the share price should be estimated by a valuations expert.

Options are often valued using the Black-Scholes model. However, many entities use a binomial methodology (also known as a lattice-based approach), or a Monte-Carlo simulation.

All of these models have their strengths and weaknesses, but management should remember that:

- If the same assumptions are input into these models, the same answer will be given.
- All models are based on the same underlying principles.
- The answers given by the models are only as good as the assumptions used

The models require six inputs as a minimum:

1. The share price;
2. The exercise price;
3. The risk free rate of return;
4. The expected dividends or dividend yield;
5. The life of the option; and
6. The volatility of the expected return.

The first three inputs are normally, but not always, straightforward. The last three involve greater judgement and have the greatest impact on the fair value.

The application guidance in IFRS 2 (Appendix B) provides guidance on the assumption-setting process.

Insight

When choosing an appropriate model, management should consider whether the award:

- **Includes a market condition or a non-vesting condition.** If it does, this is incorporated into the fair value of the award. The Black-Scholes model cannot accommodate this adjustment.
- **Has a long post-vesting exercise period and exercise behaviours that vary between employees.** If it does, it may be possible to incorporate a pattern of exercise behaviour into a binomial or Monte-Carlo model. The Black-Scholes model can only accommodate refinements that segment the employees and include a range of expected lives.

4.8 Are dividends included in the grant date fair value of share-based payments?

It depends on whether the employee (or other provider of goods or services) is entitled to dividends during the vesting period.

If the employee (or other provider of goods or services) is not entitled to receive dividends, the fair value of the award will be reduced by the dividends these parties have effectively 'lost'.

If the employee (or other provider of goods or services) is entitled to receive dividends, we believe that there are two acceptable treatments.

- Either no adjustment to the fair value is required for expected dividends. The share-based payment expense will include an expense relating to the dividend payments; or
- The grant is considered to be a compound instrument, as the employee will receive both cash over the vesting period and an equity instrument if the award vests. The entity would account for each element separately.

Insight

The difference between the two treatments, where dividends are received during the vesting period, can be summarised as follows:

- Where the expected dividends are included in the calculation of the grant date fair value, any dividends paid during the vesting period are recognised in equity and not the income statement. If the expected dividends included in the grant date fair value are not equal to the actual dividends paid, no adjustment is made for this – ie, the expected dividends are estimated only once.
- Where the expected dividends are treated as the debt portion of a compound instrument, any dividends paid during the vesting period are recognised in the income statement as an employee expense. The actual dividends paid therefore are recognised as an expense.

4.9 Does the fair value of a share-based payment equal its intrinsic value?

No. Intrinsic value is the difference between the share price and the exercise price. Fair value takes into account additional factors, such as the expected dividends, the life of any option, the volatility of the expected return and market performance conditions.

Only in rare circumstances does IFRS 2 allow intrinsic value to be used as a proxy for fair value when the fair value cannot be reliably obtained. However, in almost all cases, the fair value can be determined reliably.

Insight

The fair value of options over unlisted shares can almost always be reliably estimated. A price history has been established if the shares have been valued at any point in time and actual transactions provide some data points to establish volatility.

The guidance in IFRS 2 suggests looking at similar listed entities to obtain a share price estimate. The range of supportable volatility assumptions will be wider for an unlisted entity than for a listed one, but this does not mean that an estimate of the grant date fair value is unreliable.

4.10 Does fair value equal zero where no identifiable goods or services are received in connection with the share-based payment?

No. IFRS 2 still applies to the share-based payment and its fair value should be determined.

> **Example**
>
> Entity Q is a mutual entity and its shares are held by members. However, Q plans to demutualise and list on the local exchange and it will convert the existing 'member' shares to ordinary equity capital in a listed entity. As part of the process, Q will issue free shares to its customers (those customers that are not members).
>
> The appropriate accounting for the share-based payment is determined by separately considering the shares issued to existing members and customers.
>
> **Existing members**
>
> This arrangement is not a share-based payment as it is with members in their capacity as existing equity holders. Refer to the guidance in Q&A 1.2.
>
> **Customers (that are not members)**
>
> The entity has issued shares for nil consideration, and it is not possible to identify the specific goods and services received in return for the shares. Q accounts for this arrangement under IFRS 2 para 13A.
>
> Q measures the unidentifiable goods and services that have been received in accordance with IFRS 2 by using the fair value of the equity instrument granted.

4.11 How do service conditions affect the recognition and measurement of a share-based payment?

Service conditions are not considered when estimating the fair value of a share-based payment. However, when the awards can be exercised only after the completion of the service condition, the entity should presume that services are to be rendered over that period. This is referred to as the vesting period.

> **Example**
>
> Entity R grants share options to employees with service conditions that need to be satisfied over a three-year period. The vesting period is therefore three years.
>
> R should recognise the services it has acquired during the vesting period based on the best estimate of the number of equity instruments expected to vest. R should subsequently revise that estimate if necessary. On the vesting date, R should revise the estimate to equal the number of equity instruments that ultimately vest.

4.12 How do performance conditions affect the recognition and measurement of a share-based payment?

It depends on whether the performance condition is a market condition or a non-market condition.

- **Market conditions**

  Market conditions are performance conditions that relate to the market price of the entity's equity instruments. Examples include where an entity's share price must outperform the market, achieve a minimum price in a specific period, or achieve a total shareholder return target. These conditions are included in the estimate of the fair value of a share-based payment. They should not be taken into account for the purpose of estimating the number of equity instruments that will vest.

- **Non-market conditions**

  Non-market conditions are performance conditions that are not related to the market price of the entity's equity instruments. An example of a non-market condition is an earnings per share or a profit target. They should not be considered when estimating the fair value of a share-based payment. They should be taken into account for the purpose of estimating the number of equity instruments that will vest.

4.13 How do non-vesting conditions affect the recognition and measurement of a share-based payment?

Non-vesting conditions are conditions other than service and performance conditions. Non-vesting conditions are often wholly within the control of the employee; they do not therefore determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments in a share-based payment arrangement.

Non-vesting conditions should only be taken into account when determining the fair value of the equity instruments granted. They are ignored for the purpose of estimating the number of equity instruments that will vest.

Example

An entity enters into a share-based payment with employees. Each employee is entitled to 1,000 free shares at the end of a three-year period, provided the employee:

- Completes the three-year service period with the entity from the date of the grant of the award; and
- Buys 1,000 shares at fair value on the date of the grant of the award and holds them for the three-year period ('restricted shares').

If the employee leaves the entity prior to the end of the three-year period, or sells his or her restricted shares within the three-year period, the employee will no longer be eligible to receive the matching shares.

The requirement to hold the restricted shares for three years is not a vesting condition. Although the requirement occurs during the service period, it is wholly within the control of the employee and does not determine whether the entity receives the services that are linked to the matching shares. Non-vesting conditions are part of the inputs needed when determining the fair value of the share-based payment.

The appropriate accounting treatment for vesting conditions (taken from guidance included in IFRS 2)

The following table, taken from the guidance in IFRS 2, summarises the implications of vesting and non-vesting conditions on accounting for share-based payments.

	Vesting conditions			Non-vesting conditions		
		Performance conditions				
	Service Conditions	Performance conditions that are market conditions	Other performance conditions	Neither the entity nor the counterparty can choose whether the condition is met	Counterparty can choose whether to meet the condition	Entity can choose whether to meet the condition
Example conditions	Requirement to remain in service for three years	Target based on the market price of the entity's equity instruments	Initial public offering with a specified service requirement	Employee will receive shares if a commodity index increases by a minimum percentage. (eg, 50%)	Paying contributions towards the exercise price of a share-based payment	Continuation of the plan by the entity
Include in grant date fair value?	No	Yes	No	Yes	Yes	Yes *
Accounting treatment if the condition is not met after the grant date and during the vesting period	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest (paragraph 19).	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period (paragraph 21).	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest (paragraph 19).	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period (paragraph 21A).	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period (paragraph 28A).	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period (paragraph 28A).

* In the calculation of the fair value of the share-based payment, the probability of continuation of the plan by the entity is assumed to be 100%.

4.14 How are conditions that use indices accounted for?

These are usually performance vesting conditions.

Example

An entity grants shares to an employee on the condition that:

- The employee remains in employment for three years; and
- Over that period the entity's earnings per share (EPS) increases by 5% per annum more than a share price index.

The award is based on a three-year service condition and a non-market-based performance condition (ie, the earnings per share condition).

Note: Where the condition is purely based on an index, with no link to service, it would be a non-vesting condition.

4.15 How is a condition that is linked to a change in control accounted for?

It depends on whether the change of control condition occurs within the vesting period or after the vesting period.

A post-vesting restriction might require an employee to sell their vested shares to an acquirer in the event of a change in control of the employer entity. This condition is taken into account in measuring the fair value of the grant.

If the change in control occurs during the vesting period, it is a **non-market performance condition** as it is not related to the market price of the entity's equity instruments. This condition is taken into account for the purpose of estimating the number of equity instruments that will vest (see example below).

Example

An entity enters into an equity-settled share-based payment with employees. Each employee is entitled to 1,000 free shares, provided:

- There is a change in control of the entity (for example, the majority of shareholders change). The condition is not within the control of either the entity or the employees.
- The employee is employed by the entity on the date that the change in control occurs.

The change in control is a non-market performance condition. This condition exists during the service period and is not wholly within the control of the counterparty or the entity. The entity therefore estimates – at the grant date and at each reporting period – the number of awards that are expected to vest based on the number of employees who are expected to achieve the service period. The entity also determines whether the change in control is probable.

If the assessment of the change in control condition changes from probable to improbable, the cumulative charge would be fully reversed through the income statement. In contrast, for a cash-settled share-based payment, the change would reduce the fair value of the liability, as the measurement of the liability would reflect all possible outcomes on a weighted-average basis.

Further information on the appropriate accounting treatment can be found in Q&A 5.6.

4.16 What is the appropriate accounting when an award specifies that the number of equity instruments that will vest is variable?

It depends on the type of condition that is included in the award.

A non-market performance condition will be taken into account at each balance sheet date in the estimation of the number of equity instruments that are expected to vest (refer to the example below).

A market performance condition will be taken into account in the calculation of the grant date fair value. For example, an employee may receive 50 shares at the end of year 1 if the share price reaches C1 or 75 shares if the share price reaches C1.50.

A non-vesting condition will be taken into account in the calculation of the grant date fair value. For example, an employee may receive 100 shares at the end of year 1 if a commodity index reaches C3 or 150 shares if the index reaches C4.

Example

A grant might specify that the number of equity instruments that will vest to employees at the end of year 5 will depend on a sales target. This is a non-market performance condition.

Therefore:

- If sales exceed C5 million, 100 shares will vest
- If sales exceed C10 million, 150 shares will vest
- If sales exceed C15 million, 200 shares will vest

At each balance sheet date, the entity estimates the number of equity instruments that are expected to vest.

4.17 Where in equity is the credit entry recorded for an equity-settled share-based payment?

IFRS 2 is not prescriptive on the accounting required for the credit to equity in respect of an equity-settled share-based payment. Practice varies depending on local regulatory requirements. One approach that is common in some countries is to put the credit to a share-based payment reserve until the award has been settled and then make a transfer to share capital (although this is not permitted in some countries), other reserves or retained earnings. In other countries, the credit entry may be directly to retained earnings. This is a complicated area; management may need to take legal advice to comply with local legislation.

4.18 Is there an expense to recognise if an employee pays fair value for equity instruments?

Management should first determine whether the right to own the share is linked to the employment and then whether the employee has paid fair value for the equity instruments under IFRS 2.

The following are indicators that the fair value hasn't been calculated in accordance with IFRS 2:

- The award price is its intrinsic value rather than its fair value;
- Market price is not available for the award, and the entity has not applied the option pricing valuation requirements in IFRS 2; and
- The entity has factored into the price of the award at grant date the applicable vesting conditions (other than market performance conditions).

If the employee has paid fair value for the equity instruments under IFRS 2 and does not have to surrender them if he or she leaves employment, the award would be fully vested on grant date. There would be no expense to recognise, but the disclosure requirements of IFRS 2 would need to be satisfied. For example, disclosure of how the fair value was determined and the assumptions for an option pricing model if one was used.

In contrast, if the employee has paid fair value for the equity instruments under IFRS 2 and has to surrender the shares if he or she leaves employment there will be a vesting period to consider.

Although there may be no initial IFRS 2 expense, there may be consequences if the employee leaves employment (for example, the employer must repurchase the shares at fair value when the employee resigns). If the shares must be bought back by the entity when the employee leaves, the entity has entered into a cash-settled share-based payment, which is measured at fair value at each reporting period.

Insight

Entities often overlook the detailed guidance in IFRS 2 concerning the calculation of fair value for rights such as options. Where the options and shares are not listed in a public market, it is not sufficient for management to state that fair value is what they have estimated if that estimate was created without following the guidance on option pricing models contained in IFRS 2. In this case, management's estimate may be very different from the fair value calculated using IFRS 2.

4.19 How are limited-recourse loans provided to employees accounted for?

These loans are recognised under IFRS 2 as the grant of an option.

Limited-recourse loans give the borrower (usually an employee) the ability to walk away from the loan by surrendering shares in the entity that were acquired with the loan proceeds.

Insight

At its November 2005 meeting, the IFRIC explained that because the employee can give the shares back (or not exercise its options) if their value is less than the outstanding loan, there is no downside risk to the employee. In substance, the employer has issued an option (or shares) and not a loan and equity instruments. No loan receivable should be recognised by the entity; however, the share option should be accounted for under IFRS 2. The limited-recourse loan does not satisfy the definition of a financial instrument.

4.20 How does an entity account for a full-recourse loan given to employees?

The employee is unconditionally bound to repay a full-recourse loan. The entity records a receivable for the loan balance with a corresponding adjustment to equity.

However, if the terms of the loan with the entity were such that a preferential interest rate was given to employees, a fair value adjustment to the loan balance is recognised as an employee remuneration expense over the period of the related service (under IFRS 2 or IAS 19). This is because the fair value of the loan has been reduced through a preferential rate and a benefit has been provided to the employee. In all other cases, if the amount paid for the shares is not based on their fair value, there will be an IFRS 2 expense to record.

Insight

It is rare for entities to have a full-recourse loan based on 'arms length' conditions. Of those that do arise, the following is an example of a typical loan's terms:

- Shares are granted to employees at market price at the date of grant
- Employees have a contractual obligation to repay the loan even if the loan is greater than the value of the shares
- The loan is interest-free or bears an interest rate that is below the market rate
- Dividends are applied to reduce the loan balance
- The arrangements vest immediately

Section 5 Modifications, cancellations and forfeitures of share-based payments

Entities often make changes to their share-based payment arrangements. Common examples include:

- Where the share price falls, an entity might modify the terms and conditions on which equity instruments were granted to maintain an incentive to the employee.
- Where entities or employees cancel and settle a grant of equity instruments during a vesting period.
- Where employees leave their employment with an entity and forfeit their rights to share-based payments.

Entities may find the share-based payment requirements around modifications, cancellations and forfeitures to be counter-intuitive. Management have often been surprised by the accounting result.

5.1 How does an entity account for a situation where it cancels a grant in anticipation of an employee failing to meet a non-market performance condition?

If the award is forfeited because of failure to meet a non-market performance condition, the cumulative expense recorded is reversed because no equity instruments will have vested. Cumulatively, no expense will be recorded by the entity.

If the entity knows in advance that the employee will not meet the non-market performance condition, it should not pre-empt this by cancelling the award ahead of time because it will be treated as a cancellation under IFRS 2. The entity will have to immediately recognise the amount of the expense that would otherwise have been recognised over the remainder of the vesting period (refer to Q&A 5.2).

Insight

The IFRS 2 requirements relating to cancellations were implemented by the IASB as an anti-avoidance measure. These requirements aim to stop entities reducing a share-based payment expense by decreasing the number of equity instruments granted.

5.2 When cancelling an award, on what basis does management determine how many of its share-based payments are expected to vest?

This question is not clearly answered in the IFRS 2 guidance. However, IFRS 2 para 28(a) requires a cancellation of a share-based payment to be treated as an acceleration of vesting. It is recognised immediately at the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

Opinions are divided on the amount that should be recognised at the date of cancellation. We believe that the charge should reflect all awards that are outstanding at the date of cancellation, without adjusting for any estimate of the number of awards that are not expected to vest. This is because the cancellation results in early vesting (satisfaction of a non-market performance condition) and thus accelerated recognition of the grant date fair value.

There is an alternative interpretation that focuses on the words ' ... the amount that otherwise would have been recognised for services received over the remainder of the vesting period' and recognises a charge that reflects the number of awards that were expected to achieve the performance condition just prior to the award being cancelled.

Either interpretation could be applied, but we believe that the first more faithfully reflects the principles of IFRS 2.

Example

Entity S has an equity-settled share-based payment arrangement with 120 employees. It decides to cancel the arrangement during the reporting period. Immediately prior to the cancellation, entity S estimated there is a 90% chance of the employees meeting a non-market performance condition (a profit target) and that 80 of the employees will meet a service condition (to remain in employment for three years).

Should the expense that is recognised be calculated based on:

a) 120 employees and 100% of the award;

b) 120 employees and 90% of the award; or

c) 80 employees and 90% of the award?

We believe the cancellation charge should be based on (a) 120 employees and 100% of the award. This is because at the date of cancellation, management's expectations are no longer relevant.

However, the answer could also be (c) based on the alternative interpretation that the charge should reflect the number of awards that were expected to vest.

5.3 Can an employee cancel a share-based payment arrangement?

Yes. As a result of the 2008 amendment, IFRS 2 requires consistent treatment regardless of which party cancels the arrangement.

Cancellations can be made by the entity (such as the employer), the counterparty (such as the employee) or a third party (such as a shareholder). All cancellations receive the same accounting treatment, which is to accelerate the vesting period and the related expense (see also Q&A 5.2 above).

Example

Entity T enters into a save as you earn (SAYE) plan with its employees.

The employees contribute C250 per month to the SAYE plan over a five-year period. After this time, the employee has a choice: to receive either their cash back, plus accrued interest, or use the cash to acquire shares at a 20% discount to their market price at the grant date.

If an employee stops contributing to the share trust before the end of the five-year period, they receive a reimbursement of the amounts saved to date, plus interest. However, they must withdraw from the plan and forfeit their right to acquire shares.

Entity T should account for the employees' failure to save as a cancellation of the share-based payment. The savings requirement does not meet the definition of a service or performance condition and is therefore a non-vesting condition.

This results in the acceleration of any unvested portion of the share-based payment on the date that the employee elects to stop contributing to the plan and instead opts to receive their cash. The fair value of the award will take account of the probability of employees continuing to save and the correlation between any decision to stop saving and movements in the share price.

5.4 How does an entity account for a modification to a share-based payment?

When a share-based payment is modified, management should determine whether the modification:

- Affects the fair value of the instruments granted;
- Affects the number of equity instruments granted; or
- Is otherwise beneficial to the employee.

Each of these possible impacts is detailed below.

Does the modification affect the fair value of the equity instruments granted?

An entity might reduce the exercise price of options granted to employees. If it does, the entity should recognise the incremental change in fair value (along with the original fair value determined at grant date) over the remaining vesting period as an expense and an increase in equity. Decreases in the fair value are not considered. To determine if an increase has occurred, management should compare the fair value of the modified award with the fair value of the original award at the modification date.

Example

Entity U makes an award to employees on 1 January 20X7. Employees will receive 500 shares in U at the end of three years subject to a service condition (remain employed for three years) and a market condition (share price reaches C5). After grant date, there has been a decline in the market value of the shares of U.

To ensure the award continues to incentivise employees, during year 2 on 12 April 20X8, U modifies the market condition to a share price target of C3.

The fair values are as follows:

- 1 January 20X7 at grant date: C20
- 12 April 20X8 immediately before modification: C10
- 12 April 20X8 immediately after modification: C30

Under IFRS 2, the incremental fair value is C20, which is the difference in the fair value immediately before and after the modification. The C20 will be recognised as an expense over the remainder of the vesting period in addition to the grant date fair value.

Insight

In the example above, a common error is to account for the incremental fair value at C10. This is the difference in the fair value from the grant date to immediately after the modification (30-20). Incremental fair value arises from the effect of the change rather than the market movement since the grant date.

Does the modification affect the number of equity instruments granted?

Management should determine the fair value of the additional equity instruments granted, measured at the date of the modification, which is then included in the expense recognised for services received over the period from the modification date until the date when the additional equity instruments vest.

Note: Entities should consider whether the modification has decreased the number of equity instruments granted. If it has, the reduction is treated as a cancellation of that portion of the grant (that is, the remaining unrecognised grant date fair value is recognised as an expense for the instruments that the employee has 'lost').

Is the modification otherwise beneficial to the employee?

For example, the employee may benefit from the entity reducing the vesting period or modifying or eliminating a non-market performance condition so that 100% of the award vests rather than 50%. Any benefit to the employee should be taken into account in estimating the number of equity instruments that are expected to vest.

5.5 If a modification reduces the vesting period of a share-based payment, does the adjustment to the expense occur from the modification date (prospectively) or the grant date (retrospectively)?

There are two acceptable approaches. They are explained in the example below.

Example

On 1 July 20X7, entity V made an award of 100 share options to an employee. The only condition associated with the award is that the employee must remain in the employment of V for three years, hence the vesting period is three years. At 1 July 20X7, the fair value of each option is C6.

On 1 June 20X8, V decides to reduce the service requirement from three years to two years, thereby reducing the vesting period to two years.

Does the expense calculated for the year ended 30 June 20X8 take into account the reduced vesting period (and so increased pro-rata expense) from 1 July 20X7 or 1 June 20X8?

IFRS 2 does not specify whether the change in the vesting period is accounted for prospectively from the date of modification or retrospectively in the case where modification occurs in a reporting period earlier than the one in which the award vests. In our view, both approaches are acceptable.

5.6 How does an acquiree entity treat any unvested grants where there is a change in control that triggers changes to its unvested grants?

The entity should consider whether the terms relating to a change in control were included in the original grant.

Insight

We see many different conditions in practice that apply in the event of a change of control. For example, an award may specify that in the event of a change in control, part or all of the award will be withdrawn. Management should look closely at the terms in their share-based payment arrangements to determine the accounting treatment.

If the terms concerning a change in control were:

- **Set in the original terms of the grant**, the entity should consider whether there is any change in the number of equity instruments expected to vest. If there is a change, the accumulated expense for the number of shares that actually vested should be trued up.
- **Not set in the original terms of the grant**, any changes to unvested grants should be treated as a modification because the terms of the original grant have changed. This might occur where the terms have been subsequently determined by the remuneration committee (or other body responsible for setting and revising the terms of the grant). If the effect has been to waive a market performance condition, there will be additional fair value to be recognised as an expense. For more information refer to Q&A 5.4.

Example

Entity W acquires 90% of the share capital of entity X in a business combination. Entity W has previously granted share options to employees. These options will vest if a service condition of four years continuous employment is met. The date of the business combination occurs half-way through the vesting period (that is, two years after the grant date). The terms of the original award by entity X specify that in the event of a change in control all unvested awards immediately vest (accelerated vesting) because the service condition has been removed.

In this case, the terms concerning a change in control were included in the original terms of the award. Therefore, entity X should 'true up' the accumulated expense for the additional shares that will vest upon the change of control and the shortening of the vesting period. From W's perspective, the 'true up' occurs pre-acquisition. Further guidance on IFRS 2 and business combinations is provided in Section 2, 'Identifying share-based payment arrangements' in a business combination or joint venture.

5.7 How does an entity treat the cash-settlement of an equity-settled share-based payment arrangement?

Any cash payment made to an employee upon the cancellation or settlement of an award that has been classified as equity-settled should be accounted for as the repurchase of an equity interest (that is, a deduction from equity).

Management should remember that IFRS 2 requires any excess of the settlement over the grant date fair value to be treated as a deduction from equity – and not an expense – provided the settlement is not greater than the fair value of the equity instruments granted when measured at the settlement date. Any excess payment over the fair value of the award at the settlement date is recognised as an expense.

5.8 How does management account for the forfeiture of a share-based payment?

It depends what is meant by forfeiture. An award can fail to pay out for the following reasons:

- A service condition is not met;
- A non-market performance condition is not met;
- A market performance condition is not met;
- A non-vesting condition is not met; and
- It is cancelled.

A forfeiture occurs when either a service or a non-market performance condition is not met, as this affects the number of awards that vest; failing to meet a market or non-vesting condition are not forfeitures, as these are already taken into account when determining the grant date fair value. Cancellations result in an immediate acceleration of any remaining expense.

Forfeiture of a vested award has no accounting implications.

Where awards are forfeited, the expense is revised to reflect the best available estimate of the number of equity instruments expected to vest. Hence, on a cumulative basis, no expense is recognised for goods or services received if the equity instruments do not vest (for example, if the employee or counterparty fails to complete a specified service period).

Section 6 Group share-based payment arrangements

It is common for employees of an entity to receive shares or rights to shares in another entity within the consolidated group. Usually this is shares or rights to shares in the parent entity. For example, within a multinational group, shares in the listed parent entity may be granted to the employees of various subsidiary entities located around the world. IFRS 2 is clear that these transactions are share-based payments.

IFRS 2 now provides a clear basis to determine the classification of share-based payment transactions in both consolidated and separate financial statements with the issuance of 'Amendments to IFRS 2 – Group cash-settled share-based payment transactions'. The amendments apply to entities with annual reporting periods beginning on or after 1 January 2010.

6.1 What is a group share-based payment arrangement?

A group share-based payment arrangement is an arrangement that involves two or more entities within the same group. For example, employees of a subsidiary are granted rights to equity instruments of its parent entity for services provided to the subsidiary.

6.2 How does an entity account for a group share-based payment arrangement?

The standard provides a clear basis to determine the classification of awards in both consolidated and separate financial statements by setting out the circumstances in which group share-based payment transactions are treated as equity-settled and cash-settled. The entity receiving goods or services should assess its own rights and obligations, as well as the nature of awards granted, in order to determine the accounting treatment. The amount recognised by the subsidiary entity receiving the goods or services will not necessarily be consistent with the amount recognised in the consolidated financial statements.

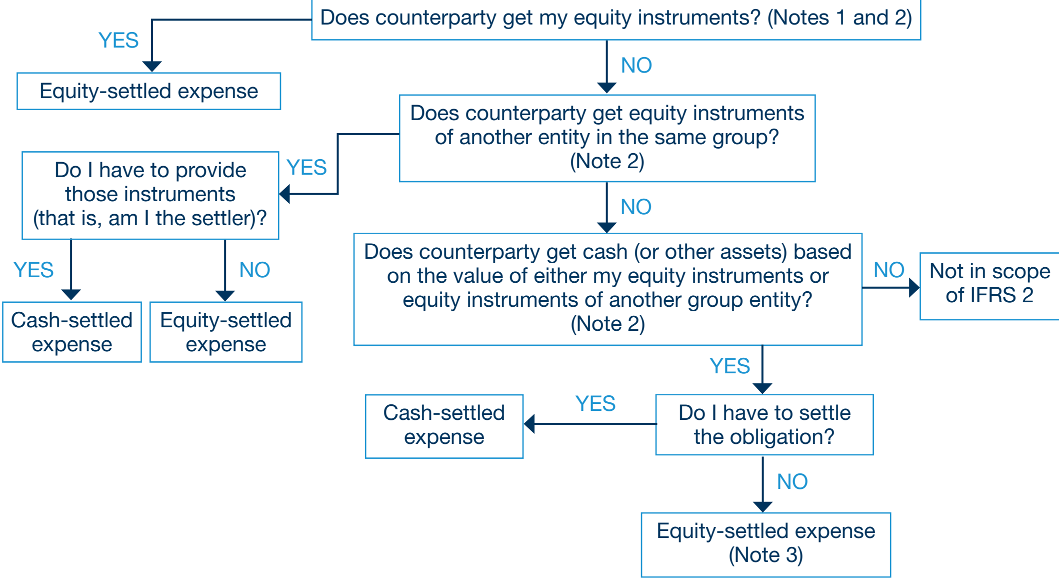
In group share-based payment transactions, the entity receiving the goods or services should account for awards as equity-settled when:

- the awards granted are the entity's own equity instruments; or
- the entity has no obligation to settle the share-based payment transaction.

In all other situations, the entity receiving the goods or services should account for the award as cash settled.

The following flowchart summarises the classification of both cash-settled and equity-settled share-based payment transactions in group situations.

Classification of share-based payment transactions in group arrangements



Notes:

1. 'My equity instruments' include equity instruments of my subsidiaries (non-controlling interests) in consolidated financial statements, but not when equity instruments are accounted for as an investment in individual financial statements.
2. 'Counterparty' includes employees and other suppliers of goods or services even where the goods or services are unidentifiable.
3. For the entity that settles the obligation, treatment will be as equity settled only if the transaction is settled in equity instruments of that entity (including equity instruments of a subsidiary of that entity). For the entity receiving the goods or services, treatment will be as equity settled unless there is an obligation to settle in cash or other assets.

Example 1

A group scheme awards shares in the parent entity to employees in a subsidiary. The share-based payment is equity-settled on consolidation and it is the parent entity that has the obligation to deliver the shares.

In the consolidated financial statements, the transaction is treated as an equity-settled share-based payment, as the group has received services in consideration for the group's equity instruments. An expense is recognised in the group income statement for the grant date fair value of the share-based payment over the vesting period, with a credit recognised in equity.

In the subsidiaries' financial statements, the award is treated as an equity-settled share-based payment, as the subsidiaries do not have an obligation to settle the award. An expense for the grant date fair value of the award is recognised over the vesting period, with a credit recognised in equity. The credit to equity is treated as a capital contribution, as the parent is compensating the subsidiaries' employees with no cost to the subsidiaries. In this example, the shares vest immediately; therefore, an expense is recognised in the subsidiaries' income statement in full based on the grant date fair value and a credit to equity.

In the parent's separate financial statements, there is no share-based payment charge, as no employees are providing services to the parent. The parent would therefore record a debit, recognising an increase in the investment in the subsidiaries as a capital contribution from the parent and a credit to equity.

The grant date fair value is C1,200. The journal entries recorded over the vesting period will be as follows:

Consolidated	Parent	Subsidiary
DR Expense 1,200	DR Investment in subsidiary 1,200	DR Expense 1,200
CR Equity 1,200	CR Equity 1,200	CR Equity* 1,200

* Contribution from parent entity

Example 2

In a group scheme, the parent entity awards share appreciation rights to employees in a subsidiary. At the end of two years, the parent will pay cash to the subsidiary's employees equivalent to the difference between the share price on vesting and the share price at grant date. The share-based payment is cash-settled on consolidation, as the parent entity has an obligation to pay cash.

In the consolidated financial statements, the transaction is treated as a cash-settled share-based payment, as the group has received services in consideration for cash payments based on the price of the group's equity instruments. An expense is recognised in the group income statement for the fair value of the share-based payment over the vesting period, with a liability being recorded as the other side of the entry. This liability is re-measured at each reporting date until settlement.

In the subsidiary's financial statements, IFRS 2 requires the award to be treated as equity-settled, because the subsidiary does not have an obligation to settle the award. An expense would be recognised in the subsidiary's income statement over the vesting period based on grant date fair value, with a credit recognised in equity. The credit to equity is treated as a capital contribution from the parent, as the parent is compensating the subsidiary's employees at no cost to the subsidiary.

In the parent's financial statements, there is no share-based payment expense recorded, as the employees are not providing services to the parent. Rather, the share-based payment transaction results in a debit to 'investment in subsidiary', with a corresponding liability recorded at fair value at each reporting period end.

To illustrate this example, the grant date fair value is C1,200, and the fair value at settlement is 1,500. The journal entries recorded over the vesting period will be as follows:

Consolidated		Subsidiary		Parent	
DR Expense	1,500	DR Expense	1,200	DR Investment in subsidiary	1,500
CR Liability	1,500	CR Equity*	1,200	CR Liability	1,500

* Contribution from parent entity

Note: Measurement could vary between the two sets of accounts because the fair value is subsequently re-measured in group consolidated financial statements but not in the subsidiary's financial statements.

6.3 How does an entity account for a recharge from a subsidiary to the parent entity?

Many group share-based payment arrangements include a recharge where the parent charges the subsidiary for the equity or cash it provides to the employees (or other providers of goods or services) of the subsidiary. This scenario is not addressed under IFRS 2 or any of the related guidance.

In our view, where there is a clear link between the recharge and the share-based payment, it is appropriate to offset the recharge against the capital contribution in the separate financial statements of the subsidiary and the parent entity. There would, for example, be a clear link where the recharge is based on the intrinsic value or market value of the shares when they vest. When the inter-company charge exceeds the capital contribution, the excess should be treated as a distribution from the subsidiary to its parent entity. This is consistent with the principles applied to other shareholder contributions.

When there is no clear link between the recharge and the share-based payment, we believe the payment between the subsidiary and its parent entity should be recognised as an expense in the same way as other management recharges. However, management should be aware that this will result in a 'double debit' to the income statement, as the subsidiary would have already recorded an expense for services received under IFRS 2.

Example

A parent entity recharges a subsidiary for an award. It is equity-settled on consolidation and it is the parent entity who has the obligation.

The subsidiary has charged the grant date fair value of C1,200 (Dr Expense Cr Capital contribution) in the income statement. The parent entity's recharge is based on the market value at exercise date, which is C1,500.

The journal entries recorded for the recharge will be as follows:

Parent	Subsidiary
DR Cash 1,500	DR Capital contribution 1,200
CR Investment in subsidiary 1,200	DR Distribution 300
CR Dividend 300	CR Cash 1,500

Note: Although there is no authoritative guidance that covers recharge arrangements, IFRIC considered this issue in its draft interpretation D17, 'IFRS 2, Group and treasury share transactions'. The example above reflects IFRIC's draft proposals, which were not included in the final interpretation.

6.4 When is a recharge recognised?

Typically a recharge is only due to be paid to the parent entity when the award vests or the employees exercise their options. The question that arises in practice is whether the obligation to the parent entity should be accrued before that date (ie, as the employees provide service), or not.

In our view, it is unlikely that the obligation arises with the provision of employee service. Therefore, the subsidiary should recognise the obligation on the earlier of the vesting date for a share award or the exercise date for an option and when the recharge is due to the parent entity.

Insight

In most cases, we believe that a subsidiary entity would account for a recharge when the payment is made to the parent. The recharge would be disclosed as a contingent liability during the time that the recharge payment is not recognised as a liability. It may be appropriate to recognise a liability for a recharge before the payment is made – for example, once an award has vested and the options to be exercised are deeply in the money. However, there is an alternative view that the subsidiary entity would spread the recharge over the vesting period, as the recharge payment arises from the share-based payment arrangement. This view may also be acceptable in practice, as there is no specific guidance on the recharge arrangement in IFRS.

6.5 What is the accounting by an intermediate entity between a parent and subsidiary, both of which are parties to a group share-based payment arrangement?

In our view, there is no need to 'cascade' journal entries through the intermediate entities. Only the ultimate parent entity and the subsidiary need to recognise the transaction.

6.6 What disclosures are required in an entity's financial statements in relation to a group share-based payment arrangement?

Where a subsidiary entity accounts for a share-based payment transaction in group situations as discussed above in Q&As 6.1 and 6.2, the disclosures prescribed by IFRS 2 are required in full. The subsidiary entity's financial statements should be stand-alone; it is not possible, for example, to cross-refer to share-based payment disclosures given in the parent's (or group's) financial statements.

Section 7 Share plan trusts

Share plan trusts are often created by a sponsoring entity for employees. They are designed to facilitate employee shareholding and are often used as a vehicle for distributing shares to employees under remuneration schemes.

Entities usually engage in one of two methods to fund share-based payments – either they will make a fresh issue of shares or buy their own shares on the market. The latter method is more common for commercial reasons, because it does not add to the share base or dilute the interests of existing shareholders. However, this method poses problems for some entities.

The legal requirements in some jurisdictions state that entities are not allowed to own their own shares. Therefore, many entities set up special purpose share plan trusts to hold entity shares on behalf of the plan participants.

7.1 Is a trust that is created by an entity to administer a share-based payment award consolidated?

Yes. In all but very rare circumstances, the trust should be consolidated into the financial statements of the group receiving the goods or services.

Insight

In 2004, IFRIC concluded that the scope of SIC-12, 'Special purpose entities', should be amended to remove the scope exclusion for equity compensation plans. Hence, the trust should be consolidated where the activities of the trust are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the trust's operations.

Where the trust is administering an award to employees of several entities within the same group, our view is that the trust should be consolidated into the group financial statements.

7.2 How are shares held by the trust accounted for by the consolidated group?

As the trust is consolidated, the shares are treated as treasury shares in the consolidated financial statements (that is, as a deduction from equity).

7.3 How is the entity's interest in the trust accounted for in its separate financial statements?

There is no guidance in IFRS 2 concerning the accounting for an entity's interest in a trust. In our view, the appropriate accounting depends on whether:

- **The entity has a beneficial interest in the trust's residual assets**. The entity could recognise an investment in the trust.
- **The employees own the beneficial interest in the residual assets**. If they do, and there is no formal loan agreement, the entity should record a debit in equity.
- **A formal loan arrangement exists between the entity and the trust**. The funding could be treated as a loan to the trust. Entities should be aware that this loan may become impaired.

Insight

If the transfer of cash to the trust is treated as a 'loan and receivable' asset under IAS 39 (or 'amortised cost' asset under IFRS 9), an impairment charge may often be required because the asset is not recoverable. The expectation is that the employees will ultimately receive the shares, at which time the trust would no longer have any assets to justify the receivable in the sponsoring entity's accounts and the asset would be impaired. If the transfer of cash to the trust is treated as a capital contribution, any 'investment in trust' balance generated would also be subject to impairment review.

An impairment may result in a 'double debit' because the entity recognises both the share-based payment charge and the impairment charge.

In our view, where it is clear that the sponsor retains the majority of the risks and rewards relating to the funding arrangement, the trust has, in substance, acted as an agent for the sponsor. We believe it would be acceptable in this case for the sponsor to account for the issue of the shares to the trust as the issue of treasury shares, thus eliminating the problem of the 'double debit' described above. Factors that may indicate that the trust has acted merely as an agent and the sponsor retains the risks relating to the funding include:

- The entity bears the ultimate risk of a fall in the price of the shares held by the trust;
- The trust has no other unencumbered assets on which the entity could claim should the shares be issued to employees; and
- The entity has guaranteed any portion of any third-party loan the trust has obtained.

Section 8 Tax and share-based payments

The impact of share-based payments on current and deferred tax is addressed in IAS 12, 'Income taxes'.

8.1 Does deferred tax arise from equity-settled share-based payment arrangements?

Yes. In some tax jurisdictions, a tax deduction is received for remuneration paid in shares, share options or other equity instruments of the entity.

Example

An entity may be entitled to an upfront tax deduction where shares are purchased on the market through a trust structure. As the IFRS 2 share-based payment expense has not yet been incurred, a deferred tax liability is recognised and will unwind over the vesting period.

The IFRS 2 expense may be charged to the income statement over the vesting period, but the tax deduction is only available when the shares are issued to the employees on exercise. The calculation of the deferred tax asset is complicated because the future tax deduction may be based on the share price at the date of exercise, which cannot be known until that date.

In this situation, the expected tax deduction is estimated on the basis of the information that is available at the end of the period. Therefore, the measurement of the deductible temporary difference is based on the entity's share price at the balance sheet date.

To the extent that the tax deduction is equal to, or is less than, the cumulative remuneration expense under IFRS 2, current and deferred tax is recognised through the income statement. However, when the tax deduction is greater than the cumulative expense, the incremental tax deduction is recognised in equity.

8.2 Does deferred tax arise from cash-settled share-based payment arrangements?

Typically yes, where a tax deduction is available when the payment is made. Cash-settled share-based payments, such as share appreciation rights issued to employees, would be treated in exactly the same way as other expenses where there is a timing difference between the accounting recognition and any tax deduction.