

IASBriefing

This is a special issue of the *IASBriefing* that summarises the key points of the International Accounting Standards Board's recently published standard on *Share-based Payment* (IFRS 2).

Overview

The International Accounting Standards Board (IASB) issued IFRS 2 *Share-based Payment* on 19 February 2004. This standard introduces specific accounting requirements for an area where only disclosure requirements currently exist. IFRS 2 sets out how entities must recognise and measure share-based payment transactions with both employees and non-employees. It will require recognition at fair value for all goods and services received, including employee services, where payment is made in shares or options as well as cash-settled share-based payments. IFRS 2 also includes new disclosure requirements.

The standard is effective for annual periods beginning on or after **1 January 2005**. Earlier application is encouraged.

IFRS 2 is substantially different from the Exposure Draft issued in November 2002.

Objective and scope

The objective of IFRS 2 is to ensure that all share-based payment transactions are recognised in the financial statements and are measured at fair value. The standard covers all share-based payment transactions with employees as well as with others (e.g., suppliers).

The only share-based payment transactions outside the scope of the standard are (a) share-based consideration for the net assets acquired in a business combination; and (b) certain transactions that are within the scope of IAS 32 *Financial Instruments: Disclosure and Presentation* or IAS 39 *Financial Instruments: Recognition and Measurement* (e.g., certain derivatives on an entity's own shares).

IFRS 2 does not have any exemptions for employee share purchase plans, even when the discount is small. However, the general *materiality* criteria in IFRSs apply, and the standard need not be applied where its effect is immaterial.

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IFRS 2 captures share-based payment transactions within a group of entities (e.g., a subsidiary issuing options in its parent's shares). It also covers share-based payments made directly by shareholders on behalf of a reporting entity.

Basic recognition principles

The basic recognition principles in IFRS 2 are:

- an entity shall recognise the goods or services received or acquired in a share-based payment transaction when it *obtains the goods* or *as the services are received*;
- when the goods or services acquired in a share-based payment transaction do not qualify for recognition as an asset, an expense is recognised for the transaction; and
- the entity recognises a corresponding increase in equity if the goods or services were acquired in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.

Detailed guidance on recognition and measurement requirements is provided for each of the following categories of share-based payment transactions:

- equity-settled share-based payment transactions (including shares or share options);
- cash-settled share-based payment transactions (including share appreciation rights); and
- transactions where there is a choice of cash or equity settlement for either the reporting entity or the counterparty.

The requirements for each of the above categories are summarised in the following sections as they apply to share-based payment transactions with employees. The employee requirements also apply to those providing services similar to those provided by employees. According to the definition in IFRS 2, this includes *non-executive directors*, as well as those 'who work for the entity under its direction in the same way as those who are regarded as employees for legal and tax reasons'.

However, application of the measurement requirements, principally the measurement date, may differ for non-employee transactions.

Equity-settled share-based payment transactions

Measurement

Share-based payment transactions with employees are measured by reference to the fair value of equity instruments granted. In *very rare* cases when the fair value of the equity instruments cannot be estimated reliably an intrinsic value method approach is applied, with the intrinsic value remeasured at each balance sheet date until the instrument is settled.

Measuring and recognising the fair value of equity instruments to employees requires estimating:

- the fair value of the instrument at grant date; and
- the number of instruments expected to vest.

Determining the fair value of the equity instruments

IFRS 2 requires the fair value of the equity instruments granted to be determined as described below.

- If market prices exist for the equity instruments granted, the estimate of fair value should be based on these market prices.
- If no market prices exist for the equity instruments granted, the fair value of equity instruments granted is estimated using a *valuation technique*. IFRS 2 requires the valuation technique used to be consistent with generally accepted valuation methodologies for pricing financial instruments, but does not require use of a specific valuation model. It encourages use of the binomial model but describes transactions where the Black-Scholes model also may be appropriate.

Typically, a market price will not exist for equity instruments granted to employees due to the conditions attached to their grant. Accordingly, the use of a valuation technique generally is necessary.

Estimating the number of instruments expected to vest

In finalising IFRS 2, the IASB moved away from the 'units of service' approach it proposed in ED 2 *Share-based Payment*.

Instead it adopted an approach described as a *modified grant date approach*. Under this new approach, measurement of a share-based payment transaction with an employee is based on the fair value of the equity instruments measured at grant date, with some 'true up' for instruments that do not vest (commonly known as 'forfeiture').

In many cases there are conditions related to the vesting or exercisability of the equity instruments granted to employees.

IFRS 2 distinguishes between the following conditions:

- *service conditions*, which require employees to complete a specified period of service; and
- *performance conditions*; either:
 - market conditions, where vesting or exercisability of an equity instrument is related to the market price of the entity's equity instruments (e.g., a specific share price); or
 - non-market conditions, where vesting or exercisability of an equity instrument is related to specific performance targets (e.g., a specified increase in profit).

Market conditions are reflected only in the initial estimate of fair value at grant date. Service conditions and non-market conditions are estimated and 'trued up' for differences between the number of instruments expected to vest and the actual number of instruments vested.

Since market conditions are reflected in the initial estimate of fair value, there is no true up for differences between estimated and actual vesting due to market conditions. Further, the estimated fair value of equity instruments is *not* revised for subsequent changes in value.

Grant date

Identification of grant date is important since the grant date, for grants to employees, is the date at which the fair value of equity instruments should be estimated. Generally, the grant date also is the date when recognition begins of the fair value of services received.

Grant date is defined as the date when the entity and the employee have a *shared understanding of the terms and conditions of the arrangement*. However, if the grant is conditional upon an approval process (e.g., from the shareholders of the entity), then the grant date cannot be earlier than the date when this approval is obtained.

Recognition

The cost of services received is recognised over the service period.

If conditions apply before the holders (employees) are entitled unconditionally to the equity instruments, the entity presumes that the services to be rendered will be received in the future. The entity accounts for the services as they are rendered from the date of the grant until the *vesting date*. The vesting date is the date when any specified vesting conditions are satisfied and the employees are entitled to the equity instrument.

The principles for recognition of share-based payment transactions with vesting conditions are as follows:

- the value of each equity instrument is measured once at grant date incorporating any uncertainties due to *market-based conditions* (as described above);
- at grant date, the best estimate is made of the number of equity instruments expected to vest;
- a portion of the total instruments expected to vest is allocated to each accounting period. The cost of the services received is measured as the allocated number of instruments multiplied by the grant date fair value per instrument. For example, if 300 instruments granted are expected to vest over a three-year service period, 100 instruments are allocated to each year of service at the fair value estimated at grant date of currency unit (CU) 10 per instrument. The cost of the services received is recognised as an expense in profit or loss unless the service cost is a qualifying cost of a recognised asset (e.g., inventory); and
- at each balance sheet date, the best estimate of the number of equity instruments expected to vest is revised, if necessary, so that on the vesting date, the entity has accounted for a number of equity instruments equal to the number actually vested. The effect related to past services of any changes in the estimated number of equity

instruments expected to vest is reflected immediately in profit or loss and is not spread prospectively.

If the employee is *not* required to complete a specified period of service before becoming unconditionally entitled to the equity instruments granted, then the equity instruments vest immediately. Therefore, there is a presumption that the services rendered as consideration for the equity instruments granted have been received and the fair value of the equity instruments is recognised immediately with a corresponding increase in equity.

The cost of grants subject to service conditions is recognised ratably over the vesting period, even if the grant does not vest *pro rata*. For example, if options are granted subject to a three-year service condition, and all options are forfeited if service is less than three years, recognition of the service cost cannot be deferred until service is complete, if the service condition is expected to be satisfied.

Other issues

IFRS 2 also includes specific requirements regarding modifications to terms and conditions of share-based payment plans, cancellations and reload features.

It also addresses repurchases of share-based payments and requires that, if the equity instruments granted subsequently are repurchased for an amount in excess of their then-current fair value, the amount exceeding fair value must be recognised immediately as an expense.

Cash-settled share-based payment transactions

Cash-settled share-based payment transactions result in a cash payment based on the price of the equity instrument (e.g., share price). For cash-settled share-based payment transactions the entity measures the services received and the liability incurred at the *fair value* of the liability. The initial measurement of the liability is recognised over the period where services are rendered.

IFRS 2 emphasises that the liability for cash-settled share-based payment transactions should be measured at its fair value rather than its intrinsic value. The fair value is expected to be higher because the instrument's value is not only its current settlement value, but also the potential future increase in value.

The entity must *remeasure* the fair value of the liability at each balance sheet date until the liability is settled and then again upon final settlement. Any changes in the fair value of the liability are recognised *immediately* in profit or loss. Therefore, the change due to the remeasurement of the liability does not qualify for capitalisation (e.g., as costs of inventory).

Choice to settle in cash or equity

Complex requirements apply for share-based payment transactions where either the entity or the employee may choose whether the transaction is settled in cash or equity instruments. This may involve a compound financial instrument where the entity has to

identify and account separately for the liability and equity components of the transaction.

Transitional provisions for existing IFRS reporters

The transitional provisions for an entity already reporting under IFRSs for equity-settled share-based payment transactions are described below.

- An entity shall apply IFRS 2 for shares, share options or other equity instruments that were granted after **7 November 2002** that have not yet vested at the effective date of the standard, 1 January 2005 (or date of adoption of IFRS 2, if early adopted).
- Entities are encouraged, but not required, to apply IFRS 2 to grants of equity instruments that have vested before 1 January 2005 (or the date of adoption of IFRS 2, if early adopted). However, a condition for doing this is that the fair value of those equity instruments has been disclosed publicly.
- IFRS 2 is adopted retrospectively with respect to all instruments to which it is applied.
- The disclosure requirements of IFRS 2 apply to all outstanding share-based payments, regardless of their grant date.
- If, after the IFRS becomes effective, an entity modifies the terms or conditions of equity instruments granted on or before 7 November 2002, the modifications must be accounted for under IFRS 2, even if the original grant is not. Application of IFRS 2 is not required for modifications made before the effective date unless the original grant is accounted for under IFRS 2.

The transitional provisions for cash-settled share-based payment transactions outstanding at the date of application are described below.

- IFRS 2 is applied retrospectively with restatement of comparative information. However, an entity is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.
- Entities are encouraged, but not required, to apply IFRS 2 retrospectively to other liabilities arising from share-based payment transactions (e.g., liabilities settled in 2004).

Transitional provisions for first-time adopters

The requirements for first-time adopters are affected by the concern that entities might have to use hindsight in order to measure the fair value of share-based payment transactions for an earlier period. Therefore, special transitional requirements apply for first-time adopters. These requirements are summarised below.

- A first-time adopter is required to apply IFRS 2 to equity instruments that were granted after 7 November 2002, that have not yet vested at the *later* of (a) the date of transition to IFRSs, and (b) 1 January 2005. Date of transition to IFRSs is the beginning of the earliest comparative period presented on the basis of IFRSs.
- Modifications made *after* the date of transition to IFRSs (or 1 January 2005, if later), must be accounted for under IFRS 2, even if the original grant is not.
- Modifications made *before* the date of transition to IFRSs (or 1 January 2005, if later) must be accounted for under IFRS 2 only if the original grant is accounted for under the IFRS.
- Retrospective application of IFRS 2 is required with respect to all instruments to which it is applied.
- The disclosure requirements of IFRS 2 apply to all outstanding share-based payments, regardless of their grant date.
- IFRS 2 must be applied to liabilities arising from share-based payment transactions that are not settled at the date of transition to IFRSs (or 1 January 2005, if later). Limited retrospective application is required, since restatement of comparative information is not required in respect of periods prior to 7 November 2002.
- Application of IFRS 2 to other share-based payments is encouraged, but only when the fair value of those instruments previously was disclosed.

The transitional requirements in respect of equity-settled share-based payment transactions for first-time adopters are summarised below:

IFRS 2 applies to:		Modifications <i>before</i> the transition date (or 1 January 2005, if later)	Modifications <i>after</i> the transition date (or 1 January 2005, if later)
Equity-settled grants on:	Original grant		
On or before 7 November 2002	Optional*	Optional ^o	Mandatory
After 7 November 2002, but vesting before the transition date (or 1 January 2005, if later)	Optional*	Optional ^o	Mandatory
After 7 November 2002 and vesting after the transition date (or 1 January 2005, if later)	Mandatory	Mandatory	Mandatory

* Entities are permitted to apply IFRS 2 only if the fair value of the equity instruments has been disclosed publicly.

^o Entities are required to account for the modifications of the grant under IFRS 2, if the recognition and measurement principles of IFRS 2 were applied to the original grant.

Note – replace ‘transition date’ with ‘1 January 2005 (or date of actual adoption, if earlier)’ to illustrate the transition rules for existing IFRS users.

Convergence with US GAAP

Statement 123 *Accounting for Stock-Based Compensation* addresses accounting for share-based payments to employees and non-employees. For grants to employees it permits, but does not require, use of a modified grant date fair value approach. The ‘units of service’ method proposed by the IASB in ED 2 differed significantly from SFAS 123. In finalising IFRS 2, the changes made by the IASB have moved much closer to the fair value measurement methods in SFAS 123.

Currently the US Financial Accounting Standards Board (FASB) has an active project to revise SFAS 123. Based on the FASB’s public deliberations to date, it is expected to issue an exposure draft in March 2004 that will propose requiring fair value accounting, using a modified grant date approach, for share-based payments to employees.

The IASB and FASB have worked together closely and the recognition and measurement requirements of the FASB’s Exposure Draft are expected to be largely consistent with IFRS 2. However, some differences are expected to remain. These are mainly in relation to the:

- scope of the amendments in FASB’s Exposure Draft, which is expected to be limited to equity-settled instruments issued to employees. Currently, the fair value recognition and measurement provisions in SFAS 123 apply to share-based payments to non-employees; and
- treatment of the tax benefit (or expense). While there is convergence on the main principle (i.e., that there should be an allocation of tax benefit (or expense) between profit or loss and equity), the mechanics of the allocation in relation to equity-settled instruments is expected to be somewhat different.

Significant changes from the Exposure Draft

In its redeliberations, the IASB has made a number of changes, in part to achieve convergence with the FASB’s conclusions. The main changes from the Exposure Draft are highlighted below.

- The IASB has abandoned the *unit of service method* in favour of the FASB’s *modified grant date measurement method*. This change has a number of consequences (e.g., to the recognition of employee services received, accounting for cancellations and accounting for modifications).
- ED 2 proposed recognising all tax effects of share-based payment transactions in profit or loss. The IASB decided to require splitting the tax effects of share-based payment transactions between profit or loss and equity if the tax deduction to be received exceeds the expense recognised for accounting purposes.
- ED 2 proposed including reload features in the fair value measurement at grant date. IFRS 2 requires reload features to be accounted for as a new option grant, only when such a reload feature is granted.

If you would like further information on any of the matters discussed in this *IASBriefing*, please talk to your usual contact at KPMG or call any of our offices.

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