IFRS 2

share-based payment

IFRS 2, *Share-based Payment*, applies when a company acquires or receives goods and services for equity-based payment. These goods can include inventories, property, plant and equipment, intangible assets, and other non-financial assets. There are two notable exceptions: shares issued in a business combination, which are dealt with under IFRS 3, *Business Combinations*; and contracts for the purchase of goods that are within the scope of IAS 32 and IAS 39. In addition, a purchase of treasury shares would not fall within the scope of IFRS 2, nor would a rights issue where some of the employees are shareholders.

Examples of some of the arrangements that would be accounted for under IFRS 2 include call options, share appreciation rights, share ownership schemes, and payments for services made to external consultants based on the company's equity capital.

RECOGNITION OF SHARE-BASED PAYMENT

IFRS 2 requires an expense to be recognised for the goods or services received by a company. The corresponding entry in the accounting records will either be a liability or an increase in the equity of the company, depending on whether the transaction is to be settled in cash or in equity shares. Goods or services acquired in a share-based payment transaction should be recognised when they are received. In the case of goods, this is obviously the date when this occurs. However, it is often more difficult to determine when services are received. If shares are issued that vest immediately, then it can be assumed that these are in consideration of past services. As a result, the expense should be recognised immediately.

Alternatively, if the share options vest in the future, then it is assumed that the equity instruments relate to future services and recognition is therefore spread over that period.

EQUITY-SETTLED TRANSACTIONS

Equity-settled transactions with employees and directors would normally be expensed and would be based on their fair value at the grant date. Fair value should be based on market price wherever this is possible. Many shares and share options will not be traded on an active market. If this is the case then valuation techniques, such as the option pricing model, would be used. IFRS 2 does not set out which pricing model should be used, but describes the factors that should be taken into account. It says that 'intrinsic value' should only be used where the fair value cannot be reliably estimated. Intrinsic value is the difference between the fair value of the shares and the price that is to be paid for the shares by the counterparty.

The objective of IFRS 2 is to determine and recognise the compensation costs over the period in which the services are rendered. For example, if a company grants share options to employees that vest in the future only if they are still employed, then the accounting process is as follows:

- The fair value of the options will be calculated at the date the options are granted.
- This fair value will be charged to the income statement equally over the vesting period, with adjustments made at each accounting date to reflect the best estimate of the number of options that will eventually vest.
- Shareholders' equity will be increased by an amount equal to the income statement charge. The charge in the income statement reflects the number of options vested. If employees decide not to exercise their options, because the share price is lower than the exercise price, then no adjustment is made to the income statement. On early settlement of an award without replacement, a company should charge the balance that would have been charged over the remaining period.

EXAMPLE 1

A company issued share options on 1 June 20X6 to pay for the purchase of inventory. The inventory is eventually sold on 31 December 20X8. The value of the inventory on 1 June

20X6 was $6m and this value was unchanged up to the date of sale. The sale proceeds were $8m. The shares issued have a market value of $6.3m.

How will this transaction be dealt with in the financial statements?

Answer
IFRS 2 states that the fair value of the goods and services received should be used to value the share options unless the fair value of the goods cannot be measured reliably. Thus equity would be increased by $6m and inventory increased by $6m. The inventory value will be expensed on sale.

PERFORMANCE CONDITIONS

Schemes often contain conditions which must be met before there is entitlement to the shares. These are called vesting conditions. If the conditions are specifically related to the market price of the company's shares then such conditions are ignored for the purposes of estimating the number of equity shares that will vest. The thinking behind this is that these conditions have already been taken into account when fair valuing the shares. If the vesting or performance conditions are based on, for example, the growth in profit or earnings per share, then it will have to be taken into account in estimating the fair value of the option at the grant date.

EXAMPLE 2

A company grants 2,000 share options to each of its three directors on 1 January 20X6, subject to the directors being employed on 31 December 20X8. The options vest on 31 December 20X8. The fair value of each option on 1 January 20X6 is $10, and it is anticipated that on 1 January 20X6 all of the share options will vest on 30 December 20X8. The options will only vest if the company's share price reaches $14 per share.

The share price at 31 December 20X6 is $8 and it is not anticipated that it will rise over the next two years. It is anticipated that on 31 December 20X6 only two directors will be employed on 31 December 20X8.

How will the share options be treated in the financial statements for the year ended 31 December 20X6?

Answer
The market-based condition (ie the increase in the share price) can be ignored for the purpose of the calculation. However the employment condition must be taken into account. The options will be treated as follows:

2,000 options x 2 directors x $10 x 1 year / 3 years = $13,333

Equity will be increased by this amount and an expense shown in the income statement for the year ended 31 December 20X6.

CASH SETTLED TRANSACTIONS

Cash settled share-based payment transactions occur where goods or services are paid for at amounts that are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company.

As an example, share appreciation rights entitle employees to cash payments equal to the increase in the share price of a given number of the company's shares over a given period. This creates a liability, and the recognised cost is based on the fair value of the instrument at the reporting date. The fair value of the liability is re-measured at each reporting date until settlement.

EXAMPLE 3

Jay, a public limited company, has granted 300 share appreciation rights to each of its 500 employees on 1 July 20X5. The management feel that as at 31 July 20X6, the year end of Jay, 80% of the awards will vest on 31 July 20X7. The fair value of each share appreciation right on 31 July 20X6 is $15.

What is the fair value of the liability to be recorded in the financial statements for the year ended 31 July 20X6?

Answer
300 rights x 500 employees x 80% x $15 x 1 year / 2 years = $900,000

DEFERRED TAX IMPLICATIONS

In some jurisdictions, a tax allowance is often available for share-based transactions. It is unlikely that the amount of tax deducted will equal the amount charged to the income statement under the standard. Often, the tax deduction is based on the option's intrinsic value, which is the difference between the fair value and exercise price of the share. A deferred tax asset will therefore arise which represents the difference between a tax base of the employee's services received to date and the carrying amount, which will effectively normally be zero. A deferred tax asset will be recognised if the company has sufficient future taxable profits against which it can be offset.

For cash settled share-based payment transactions, the standard requires the estimated tax deduction to be based on the current share price. As a result, all tax benefits received (or expected to be received) are recognised in the income statement.

EXAMPLE 4

A company operates in a country where it receives a tax deduction equal to the intrinsic value of the share options at the exercise date. The company grants share options to its employees with a fair value of $4.8m at the grant date. The company receives a tax allowance based on the intrinsic value of the options which is $4.2m. The tax rate applicable to the company is 30% and the share options vest in three-years' time.

Answer

A deferred tax asset would be recognised of:

$4.2m @ 30% tax rate x 1 year / 3 years = $420,000

The deferred tax will only be recognised if there are sufficient future taxable profits available.

DISCLOSURE

IFRS 2 requires extensive disclosures under three main headings:

- Information that enables users of financial statements to understand the nature and extent of the share-based payment transactions that existed during the period.
- Information that allows users of financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments which have been granted during the period, was determined.
- Information that allows users of financial statements to understand the effect of expenses, which have arisen from share-based payment transactions, on the entity's income statement in the period.

The standard is applicable to equity instruments granted after 7 November 2002 but not yet vested on the effective date of the standard, which is 1 January 2005. IFRS 2 applies to liabilities arising from cash-settled transactions that existed at 1 January 2005.

MULTIPLE-CHOICE QUESTIONS

1 Which of the following do not come within the definition of a share-based payment under IFRS 2?
  a employee share purchase plans
  b employee share option plans
  c share appreciation rights
  d a rights issue that includes some shareholder employees

2 A company issues fully paid shares to 500 employees on 31 July 20X8. Shares issued to employees normally have vesting conditions attached to them and vest over a three-year period, at the end of which the employees have to be in the company's employment. These shares have been given to the employees because of the performance of the company during the year. The shares have a market value of $2m on 31 July 20X8 and an average fair value for the year of $3m. It is anticipated that in three-years' time there will be 400 employees at the company. What amount would be expensed to profit or loss for the above share issue?
  a $3m
  b $2m
  c $1m
  d $666,667

3 A company grants 750 share options to each of its six directors on 1 May 20X7. The options vest on 30 April 20X9. The fair value of each option on 1 May 20X7 is $15 and their intrinsic value is $10 per share. It is anticipated that all of the share options will vest on 30 April 20X9. What will be the accounting entry in the financial statements for the year ended 30 April 20X8?
  a Increase equity $33,750; increase in expense in income statement $33,750
  b Increase equity $22,500; increase in expense in income statement $22,500
  c Increase liability $67,500; increase in expense income statement $67,500
  d Increase liability $45,000; increase in current assets $45,000

4 A public limited company has granted 700 share appreciation rights (SARs) to each of its 400 employees on 1 January 20X6. The rights are due to vest on 31 December 20X8 with payment being made on 31 December 20X9. During 20X6, 50 employees leave, and it is anticipated that a further 50 employees will leave during the vesting period. Fair values of the SARs are as follows:

	$
1 January 20X6	15
31 December 20X6	18
31 December 20X7	20

What liability will be recorded on 31 December 20X6 for the share appreciation rights?
  a $1,260,000
  b $1,680,000
  c $2,520,000
  d $3,780,000

ANSWERS

Answer 1: (d)
Answer 2: (b) $2m. The issue of fully paid shares is deemed to relate to past service and should be expensed to profit or loss at 31 July 20X8.
Answer 3: (a) 750 x 6 (directors) x $15 / 2 years = $33,750
Answer 4: (a) 700 x (400 - 100) x $18 x 1/3 = $1,260,000 ■

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