Deloitte.

Share-based payments

A guide to IFRS 2

June 2007

An IAS Plus guide

Audit . Tax . Consulting . Financial Advisory .

Contacts

Global IFRS leadership team

IFRS global office

Global IFRS leader
Ken Wild
kwild@deloitte.co.uk

IFRS centres of excellence

Americas
D.J. Gannon
iasplusamericas@deloitte.com

Asia Pacific

Hong Kong
Stephen Taylor
iasplus@deloitte.com.hk

Melbourne
Bruce Porter
iasplus@deloitte.com.au

Europe-Africa

Copenhagen
Jan Peter Larsen
dk_iasplus@deloitte.dk

Johannesburg
Graeme Berry
iasplus@deloitte.co.za

London
Veronica Poole
iasplus@deloitte.co.uk

Paris
Laurence Rivat
iasplus@deloitte.fr

Deloitte's **www.iasplus.com** website provides comprehensive information about international financial reporting in general and IASB activities in particular. Unique features include:

- daily news about financial reporting globally.
- summaries of all Standards, Interpretations and proposals.
- many IFRS-related publications available for download.
- model IFRS financial statements and checklists.
- an electronic library of several hundred IFRS resources.
- all Deloitte Touche Tohmatsu comment letters to the IASB.
- links to several hundred international accounting websites.
- e-learning modules for each IAS and IFRS – at no charge.
- complete history of adoption of IFRSs in Europe and information about adoptions of IFRSs elsewhere around the world.
- updates on developments in national accounting standards.

Contents

1 Introduction **1**

2 Scope **2**
- 2.1 General 2
  - 2.1.1 Definitions 2
  - 2.1.2 Types of share-based payment 3
  - 2.1.3 Conflict between IFRS 2 and IAS 32 3
  - 2.1.4 Identifying share-based payment transactions 4
  - 2.1.5 Awards made by shareholders 4
- 2.2 Groups 5
  - 2.2.1 Parent and subsidiaries 5
  - 2.2.2 Associates and joint ventures 5
  - 2.2.3 Meaning of 'entity' 5
- 2.3 Transactions with equity holders as equity holders 6
- 2.4 Business combinations 6
- 2.5 Financial instruments 8
- 2.6 Goods or services cannot be specifically identified (IFRIC 8) 9

3 Recognition **11**
- 3.1 General 11
- 3.2 Timing 11
  - 3.2.1 Equity-settled share-based payment transactions 11
  - 3.2.2 Cash-settled share-based payment transactions 13

4 Measurement: equity-settled transactions **14**
- 4.1 General 14
  - 4.1.1 Fair value 14
  - 4.1.2 Transactions with employees and others providing similar services 14
  - 4.1.3 More than one measurement date 15
- 4.2 Determining the fair value of equity instruments granted 17
  - 4.2.1 Measurement date 17
  - 4.2.2 Transactions measured by reference to the fair value of goods or services 19
  - 4.2.3 Fair value by reference to the fair value of equity instruments 20
  - 4.2.4 Valuation models 22
  - 4.2.5 Basic factors affecting the valuation of share-based payments 22
    - 4.2.5.1 Exercise price 22
    - 4.2.5.2 Current share price 23
    - 4.2.5.3 Expected life 23
    - 4.2.5.4 Expected volatility 24
    - 4.2.5.5 Expected dividends 24
    - 4.2.5.6 Risk-free interest rate 25
  - 4.2.6 Other factors affecting the valuation of share-based payments 25
    - 4.2.6.1 Performance conditions 25
    - 4.2.6.2 Non-transferability 26

4.2.6.3 Stated exercise restrictions 28
4.2.6.4 Behavioural considerations 28
4.2.6.5 Long-term nature 28
4.2.6.6 Effects on the capital structure of an entity 29
4.2.7 Example of employee share purchase plan 29
4.3 Treatment of vesting conditions 31
4.3.1 Basic approach 31
4.3.2 Non-market vesting condition 34
4.3.3 Vesting period varies with a non-market condition 35
4.3.4 Number of options vesting is dependent on a non-market performance condition 37
4.3.5 Exercise price dependent on a non-market condition 38
4.3.6 A market condition and a non-market condition 39
4.3.7 A market condition where the vesting period varies 41
4.3.8 Contingent issue of shares for goods or services from non-employees 43
4.3.9 Equity instruments vesting in instalments 43
4.3.10 Distinguishing market and non-market vesting conditions 43
4.4 Reload features 46
4.5 Adjustments after vesting date 46
4.6 If fair value is not measurable 47
4.7 Share price denominated in a foreign currency 50

5 Modifications including cancellations and settlements 51
5.1 Modifications 51
5.1.1 The modification increases the fair value of the equity instruments granted 51
5.1.2 The modification increases the number of equity instruments granted 53
5.1.3 The vesting conditions are modified in a manner that is beneficial to the employee 53
5.1.4 The terms or conditions are modified in a way that is not beneficial to the employee 54
5.1.5 Modifications involving changes to whether instruments will be equity-settled or cash-settled 55
5.1.6 Modifications that are intended to preserve the rights of the holders 56
5.2 Cancellations and settlements 56

6 Measurement: cash-settled transactions 60
6.1 Basic requirements 60
6.2 Treatment of vesting conditions 63
6.3 Disclosure of liability 64
6.4 Share price denominated in a foreign currency 64

7 Transactions with settlement alternatives 65
7.1 Basic principles 65
7.2 Counterparty's choice 65
7.2.1 Measurement 66
7.2.2 Subsequent accounting 67
7.3 Entity's choice 69

7.4 Changes to method of settlement 72
7.4.1 Addition of a cash alternative 72
7.4.2 Change from cash-settled to equity-settled 74
7.5 Contingent settlement alternatives 75

8 Disclosure and presentation 77
8.1 Nature and extent of share-based payments 77
8.2 How fair value is determined 78
8.3 Effect of share-based payment transactions on the profit or loss and financial position 79
8.4 Illustrative disclosures 79
8.5 Movements in reserves 80
8.5.1 Entries arising from IFRS 2 80
8.5.2 Entries relating to ESOP trusts 80

9 First-time adoption of IFRSs 82
9.1 Equity instruments 82
9.1.1 Limitations on retrospective application 82
9.1.2 Use of hindsight when measuring fair value 83
9.1.3 Modifications to the terms and conditions 84
9.2 Liabilities arising from share-based payment transactions 84

10 Employee share ownership trusts (ESOPs) 85

11 Employment taxes 87

12 Accounting by entities within groups 88
12.1 Share-based payment arrangements involving an entity's own equity instruments 88
12.2 Share-based payment arrangements involving equity instruments of the parent 89
12.2.1 A parent grants rights to its equity to employees of its subsidiary 89
12.2.2 A subsidiary grants rights to equity instruments of its parent to its employees 91
12.2.3 Determining which entity has granted the rights 92
12.3 Accounting in the parent's separate financial statements 92
12.3.1 Equity-settled for the group and the subsidiary 93
12.3.2 Cash-settled for the group and the subsidiary 94
12.3.3 Equity-settled for the group but cash-settled for the subsidiary 95
12.4 Accounting for intra-group recharges 95
12.5 Cash-settled arrangements in the consolidated financial statements 100
12.5.1 Transfers of employees between group entities 101
12.6 Effect of the use of ESOP trusts 103
12.7 Subsidiary purchases parent's shares 103
12.7.1 Hedge accounting under IAS 39 104

13 Current and deferred tax 105

Appendix I – Comparison between IFRSs and US GAAP 111

Appendix 2 – Valuation models 113

Appendix 3 – Presentation and disclosure checklist 116

Abbreviations

Alt	Alternative
CU	Currency Unit (fictional currency)
ED	Exposure Draft
EPS	Earnings per share
ESOP	Employee Share Ownership Plan
GAAP	Generally Accepted Accounting Principles
IAS(s)	International Accounting Standard(s)
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee of the IASB, and title of interpretations issued by that committee
IFRS(s)	International Financial Reporting Standard(s)
SAR(s)	Share appreciation right(s)
SFAS	Statement of Financial Accounting Standards (United States)
SIC	Standing Interpretations Committee of the International Accounting Standards Committee (predecessor to the IASB), and interpretations issued by that committee
TSR	Total Shareholders' Return

Throughout this publication, paragraphs that represent the authors' interpretations and examples other than those cited in IFRSs are highlighted by green shading.

1. Introduction

Until the release of IFRS 2 *Share-based Payment* in 2004, there was no International Financial Reporting Standard (IFRS) that addressed the recognition and measurement of these transactions.This gap in accounting literature had been a major cause for concern – in particular, the International Organization of Securities Commissions (IOSCO) drew attention to this shortcoming in a report in 2000.

The Standard has been effective since 2005. Since its issue, it has been the subject of two Interpretations: IFRIC 8 *Scope of IFRS 2* (issued January 2006) and IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions* (issued November 2006). In addition, just recently, the IASB has issued near-final draft amendments to the Standard dealing with vesting conditions and cancellations These proposed amendments are expected to become effective for periods beginning on or after 1 January 2008, with earlier application permitted.

Inevitably, given its subject matter and the broad range of share-based payment schemes in operation, the application of IFRS 2 presents significant challenges for preparers of financial statements. To provide assistance in this regard, in addition to explaining the detailed provisions of IFRS 2, this guide deals with its application in many practical situations. It is not always possible to be definitive as to what is the “right” answer – but we have shared with you our approach to finding solutions that we believe are in accordance with the objective of the Standard.

When IFRS 2 was issued in 2004, the idea of recording an expense for share-based awards at their fair value in the income statement seemed to be revolutionary. Three years later, despite the ongoing arguments about 'increased volatility' in earnings, preparers and users are generally accustomed to the concept that when an entity grants a share-based award to its service-suppliers (employees and others), it should recognise an expense.

The bigger challenges today lie with more practical concerns. To name just a few:

- how to determine fair value for awards with more complex terms and conditions?
- when to classify transactions as cash- or equity-settled?
- whether amendments to terms and conditions represent modifications or replacements?
- how to account for transactions with multiple features and several potential outcomes?

And perhaps the most common issue in practice:

- how to account for share-based awards in the individual financial statements of group entities in situations when, for example, the parent grants share-based awards to employees of its subsidiaries? IFRIC 11 has partly addressed this issue – but many questions remain.

We hope that you will find this guide a useful tool in your dealings with share-based transactions.

2. Scope

2.1 General

2.1.1 Definitions

IFRS 2 should be applied to each 'share-based payment transaction', defined as follows:

> "A transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity." [IFRS 2 Appendix A]

IFRS 2 also uses the term 'share-based payment arrangement' which is defined as follows:

> "An agreement between the entity and another party (including an employee) to enter into a share-based payment transaction, which thereby entitles the other party to receive cash or other assets of the entity for amounts that are based on the price of the entity's shares or other equity instruments of the entity, or to receive equity instruments of the entity, provided that the specified vesting conditions, if any, are met." [IFRS 2 Appendix A]

'Equity instrument' is defined as follows:

> "A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities." [IFRS 2 Appendix A]

This definition is consistent with paragraph 11 of IAS 32 *Financial Instruments: Presentation*.

'Equity instrument granted' is defined as follows:

> "The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement." [IFRS 2 Appendix A]

The Standard does not include a formal definition of either goods or services, although IFRS 2.5 specifies that goods would include inventories, consumables, property, plant and equipment, intangible assets, and other non-financial assets. IFRIC 8 *Scope of IFRS 2* (issued in January 2006) confirms that the goods or services do not have to be identifiable to be within the scope of IFRS 2 (see section 2.6 below).

2.1.2 Types of share-based payment

Three types of transactions are identified: [IFRS 2.2]

- equity-settled share-based payment transactions, in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options);
- cash-settled share-based payment transactions, in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity. Transactions involving share appreciation rights (SARs) fall into this category; and
- 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.

IFRS 2 includes separate measurement requirements for each of these, which are discussed in the remainder of this guide. Business combinations and certain arrangements within the scope of IAS 32 are excluded from the scope of IFRS 2 as discussed at sections 2.4 and 2.5 below.

2.1.3 Conflict between IFRS 2 and IAS 32

The liability/equity distinction in IFRS 2 is drawn along different lines to the general requirements of IAS 32. This is explained in the following example.

Example 2.1.3

Equity settlement or cash settlement

Company A issues 1,000 share options to an employee with an exercise price of CU15 per share. After completion of the vesting period, the employee will receive shares with the total value equal to the 'intrinsic value' of the options (referred to below as an equity-settled SAR). The intrinsic value of the options is the difference between the fair value of the shares to which the employee has the right to subscribe and the price (in this example CU15) the employee is required to pay for those shares.

The share options should be accounted for as equity-settled because settlement will be by delivery of equity instruments.

The amount of shares that could be issued under the equity-settled SARs and the value of each share issued is variable. IFRS 2.BC106 notes that if the debt/equity requirements of IAS 32 were applied to share-based payment transactions, instruments where the number of shares issued is variable would be considered a liability. They would therefore be treated similar to a cash-settled share-based payment. As a result, IFRS 2.BC110 explains that the debt/equity requirements in IAS 32, whereby some obligations to issue equity instruments are classified as liabilities, should not be applied for the purposes of the IFRS on share-based payment. IFRS 2.BC107 cites an SAR settled in shares as an example of an instrument that would be accounted for differently under IAS 32 and under IFRS 2.

2.1.4 Identifying share-based payment transactions

It may not always be immediately straightforward to identify transactions falling within the scope of IFRS 2 as shown by the following example.

Example 2.1.4

Scope of IFRS 2

Company L provides an interest-free loan in the amount of CU100 to one of its executives to purchase shares with a fair value of CU100 in the open market. The shares are used as collateral for the loan balance and, therefore, cannot be sold by the executive during the four-year vesting period. If the executive remains employed with L at the end of four years, the entire amount of the loan is forgiven and the shares are released from all restrictions. If the executive leaves the employ of L during the vesting period, the shares are returned to L and, regardless of value, are considered full payment of the loan.

Since the executive has no risk of owing more than the shares are worth, the substance of the transaction is the issue of restricted shares that vest at the end of four years and, therefore, the transaction is within the scope of IFRS 2. As a result, the fair value of the restricted shares at the grant date should be expensed over the vesting period.

2.1.5 Awards made by shareholders

Transfers of an entity's equity instruments by its shareholders to parties (including employees) that have supplied goods or services to the entity are share-based payment transactions within the scope of IFRS 2, unless the transfer is clearly for a purpose other than the payment for goods and services. [IFRS 2.3]

Where a shareholder provides shares for the purposes of an employee share scheme, it will generally be clear that these benefits form part of the remuneration of the employees for their services to the entity. A charge to profit or loss will therefore be required in accordance with IFRS 2 for the services received.

On the other hand, a shareholder may make a gift of shares to a close relative who is coincidentally an employee of the entity. Such a gift might not form part of the remuneration of the employee but it will be necessary to look carefully at the facts of each case. For example, it would be necessary to consider whether similar benefits were given to other employees and whether the gift of shares was in any way conditional on continuing employment with the entity.

The most common instance when equity instruments are provided by a shareholder rather than the entity that has received the goods or services is within groups of entities. This situation is considered at section 2.2 below.

2.2 Groups

2.2.1 Parent and subsidiaries

Employees of a subsidiary will often receive part of their remuneration in the form of shares in the parent, or less commonly in some other group entity. Where this is the case, IFRS 2 requires the entity that has received the benefit of the services to recognise an expense. This is so even if the equity instruments issued are those of another entity.

Transfers of equity instruments of the entity's parent, or of equity instruments of another entity in the same group, to parties that have supplied goods or services to the entity are within the scope of IFRS 2 unless the transfer is clearly for a purpose other than payment for goods and services. [IFRS 2.3]

Example 2.2.1

Services received in equity-settled share-based transaction

Company P is a publicly-listed company that applies US Generally Accepted Accounting Principles (US GAAP). P has a majority-owned subsidiary, Company S, which applies IFRSs. Company P issues share options in P's ordinary shares to certain employees of S.

Company S receives the benefit of the services provided by its employees. As a result, S should record the expense related to the share-based payment, regardless of whether S, or another group entity, issues the share options. Where P issues the share options, there may be also a capital contribution to be recognised by P and S (see Chapter 12 of this guide).

2.2.2 Associates and joint ventures

IFRS 2.3 does not address the situation where employees of an associate or a joint venture are granted equity instruments in the investor/venturer in connection with their employment. However, a similar approach should generally be adopted because the associate or joint venture will have received the benefit of services provided by the employees and a capital contribution from the investor/venturer.

2.2.3 Meaning of 'entity'

Various definitions included in Appendix A to IFRS 2 make reference to 'the entity.' In the context of groups, certain such references will sometimes need to be interpreted to mean another group entity.

IFRS 2 is clear that an expense must be recognised in the entity that has received the benefit of the goods or services. It is also clear that, where the parent provides the shares, the other side of this accounting entry is a credit to equity which is in the nature of a capital contribution. However, IFRS 2 does not address the accounting in the other group entity that issued equity instruments or the effect of charges made between group entities in connection with share-based payment arrangements. Neither does it provide guidance on the circumstances where an arrangement is equity-settled from the perspective of the group but may appear to be cash-settled from the perspective of the subsidiary (and vice versa). For example, the subsidiary that receives the benefit of the employee's services might buy shares in its parent in the market for cash to satisfy the arrangement. Some of these questions are addressed in IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions*. The requirements of IFRIC 11 and related issues not specifically dealt with in the Interpretation are considered in detail in Chapter 12 of this guide.

2.3 Transactions with equity holders as equity holders

Transactions with parties (employees) in their capacity as holders of equity instruments of the entity are not share-based payment transactions. For example, a rights issue may be offered to all holders of a particular class of equity. If an employee is offered the chance to participate purely because he/she is a holder of that class of equity, IFRS 2 is not applied. The requirements of the Standard are only relevant for transactions in which goods or services are acquired. [IFRS 2.4]

Example 2.3

Transaction outside the scope of IFRS 2

Company D purchases its own shares from employees for an amount that equals the fair value of those shares. This transaction would be considered a purchase of treasury shares and would not be within the scope of IFRS 2. However, if Company D pays an amount in excess of fair value only to its employees, that excess would be considered remuneration expense.

2.4 Business combinations

IFRS 2 applies to share-based payment transactions in which an entity acquires or receives goods or services. Goods include inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. However, the IFRS is not applied to transactions in which an entity acquires goods as part of the net assets acquired in a business combination to which IFRS 3 *Business Combinations* applies. Therefore, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of the Standard. But equity instruments granted to employees of the acquiree in their capacity as employees (e.g. in return for continued services) are within the scope of IFRS 2. Similarly, the cancellation, replacement or other modification of share-based payment arrangements because of a business combination or other equity restructuring are accounted for in accordance with IFRS 2. [IFRS 2.5]

It is not always easy to determine whether equity instruments that are issued in connection with a business combination are part of the consideration for the acquisition (and, therefore, outside of the scope of IFRS 2) or part of employee remuneration for the post-acquisition period. The following example provides some indicators of the factors to be considered in deciding whether IFRS 2 should be applied to share-based payment transactions associated with a business combination.

Example 2.4

Business combinations

Company P purchased all the outstanding shares of Company S for a combination of cash and ordinary shares of P. The business combination was accounted for using the purchase method. Company S was wholly owned by its management team immediately prior to the purchase by P. In addition to the consideration paid at the acquisition date, P agreed to pay contingent consideration (in the form of P's ordinary shares) to the previous owners if revenues exceed CU100 million over the next 12 months. In addition, each individual must be employed with the new entity for the duration of the contingency period to receive their individual consideration.

The following criteria may help to determine whether contingent consideration should be accounted for as (1) an adjustment of the purchase price of an acquired entity under IFRS 3 or (2) remuneration for services in accordance with IFRS 2. This list of factors or indicators is not exhaustive.

Factors involving continued employment include the following.

Linkage of continued employment and contingent consideration: arrangements in which the contingent payments are not affected by employment termination may be a strong indicator that the contingent payments are additional purchase price rather than remuneration.

Duration of continued employment required: if the length of time of required employment coincides with or is longer than the contingent payment calculation period, that fact may indicate that the contingent payments are, in substance, remuneration.

Level of remuneration: situations in which employee remuneration other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional purchase price rather than remuneration.

An example of a factor involving components of a shareholder group is set out below.

Contingent payout is different for former shareholders based on whether they are employees: the fact that selling shareholders who do not become employees receive lower contingent payments on a per share basis from what the previous owners who become employees of the combined entity receive, may be a strong indicator that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.

Understanding why the acquisition agreement includes a provision for contingent payments may be helpful in assessing the substance of the arrangement. For example, if the initial consideration paid at the acquisition date is based on the low end of a range established in the valuation of the acquired entity and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional purchase price. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that may suggest that the substance of the arrangement is to provide remuneration.

The formula used to determine the contingent payment might be helpful in assessing the substance of the arrangement. For example, a contingent payment of five times earnings may suggest that the formula is intended to establish or verify the fair value of the acquired entity, while a contingent payment of 10 per cent of earnings may suggest a profit-sharing arrangement.

The determination of whether equity instruments issued as contingent consideration in a business combination are remuneration to current employees or part of the purchase price to the former owners is a matter that requires a full assessment of the facts and careful judgement. A provision for payment only upon completion of an employment period is a strong indicator that the agreement should be accounted for as remuneration and, therefore, a presumption would exist that such an arrangement would be included within the scope of IFRS 2.

2.5 Financial instruments

IFRS 2 does not apply to share-based payment transactions in which the entity receives or acquires goods or services under a contract within the scope of IAS 32 *Financial Instruments: Presentation* (paragraphs 8 to 10) or IAS 39 *Financial Instruments: Recognition and Measurement* (paragraphs 5 to 7). [IFRS 2.6]

IAS 32 and IAS 39 both state that they should be applied to contracts to buy or sell a non-financial item that can be settled net in cash or by another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments (subject to one exception). IFRS 2 (paragraph BC28) explains that the IASB concluded that such contracts should remain within the scope of IAS 32 and IAS 39 and, therefore, excluded them from the scope of IFRS 2.

Example 2.5

Interaction with IAS 32 and IAS 39

Company C enters into a forward contract to buy 1,000 units of a commodity at a price equal to 2,000 of Company C's ordinary shares. Company C can settle the contract net, but does not intend to do so (nor does it have a practice of doing so). This transaction would be within the scope of IFRS 2. However, if Company C had a practice of settling these contracts net, or did not intend to take physical delivery, then the forward contract would be within the scope of IAS 32 and IAS 39.

2.6 Goods or services cannot be specifically identified (IFRIC 8)

IFRIC 8 *Scope of IFRS 2* addresses whether IFRS 2 applies to transactions in which the entity cannot identify specifically some or all of the goods or services received. It was issued in January 2006 and applies for annual periods beginning on or after 1 May 2006. Earlier adoption is encouraged. When adopted, the Interpretation should be applied with retrospective effect subject to the general transitional provisions of IFRS 2.

IFRS 2 applies to transactions in which an entity, or an entity's shareholders, have granted equity instruments or incurred a liability to transfer cash or other assets for amounts based on the price (or value) of the entity's shares or other equity instruments. IFRIC 8 applies to such transactions when the identifiable consideration received (or to be received) by the entity, including cash and the fair value of identifiable non-cash consideration, appears to be less than the fair value of the equity instruments granted or the liability incurred. However, the Interpretation does not apply to transactions that are excluded from the scope of IFRS 2 in accordance with paragraphs 3 to 6 of the Standard (e.g. a rights issue at a discount to the market price). [IFRIC 8.6]

IFRS 2 applies to particular transactions in which goods or services are received, such as transactions in which an entity receives goods or services as consideration for equity instruments of the entity. IFRIC 8 confirms that this includes transactions in which the entity cannot identify specifically some or all of the goods or services received. [IFRIC 8.8]

In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been, or will be, received. In this case IFRS 2 applies. If the identifiable consideration received appears to be less than the fair value of the equity instruments granted, or the liability incurred, typically this circumstance indicates that other consideration (i.e. unidentifiable goods or services) has been, or will be received. [IFRIC 8.9]

The entity measures any identifiable goods and services in accordance with IFRS 2. Any unidentifiable goods or services received are then measured as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services received. The unidentifiable goods or services are measured at grant date, although for cash-settled arrangements, the liability is remeasured at each reporting date until it is settled. [IFRIC 8.10 to 12]

IFRIC 8 gives the example of a grant of shares to a charitable organisation for nil consideration as an instance where it might be difficult to demonstrate that goods or services have been, or will be, received. It notes that a similar situation might arise in transactions with other parties. [IFRIC 8.2]

An illustrative example that accompanies IFRIC 8 deals with a situation where an entity grants shares for no consideration to parties who form a particular section of the community, as a means of enhancing its corporate image. The example notes that the economic benefits might take a variety of forms such as increasing the entity's customer base, attracting and retaining employees, and improving its chances of being awarded contracts.

There may be no obvious benefits of this kind in cases where shares are required by law to be issued at below their market value. However, IFRIC 8 should still be applied and an expense recognised. This might be viewed as 'the price of staying in business' or a form of taxation.

For transactions with parties other than employees, IFRS 2 specifies a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. The IFRIC concluded that goods or services that are unidentifiable cannot be reliably measured and so the rebuttable presumption is relevant only for identifiable goods or services. Therefore, in this case, it is necessary to derive the value of the unidentifiable goods or services received from the value of the equity instruments. [IFRIC 8.BC8]

This approach might be seen to imply that it is always necessary to consider the fair value of the equity instruments granted to see if this is greater than the fair value of the goods or services received. This is not so. IFRIC 8.BC7 states that "the IFRIC noted that it is neither necessary nor appropriate to measure the fair value of goods or services as well as the fair value of the share-based payment for every transaction in which the entity receives goods or non-employee services". In practice, it will be necessary to consider this issue only in those cases where the value of the goods and services received 'appears to be' less than the fair value of the equity instruments granted. For example, it would not be necessary to obtain a valuation of unquoted shares issued as consideration for non-employee services unless there were indications that some other non-identifiable goods or services had also been obtained.

The phrase 'the fair value of the share-based payment' refers to the value of the particular share-based payment concerned. For example, an entity might be required by legislation to issue some portion of its shares to nationals of a particular country, which may be transferred only to other nationals of that country. Such transfer restrictions may affect the fair value of the shares concerned. They may have a fair value that is less than the fair value of otherwise identical shares that do not carry the transfer restrictions. In this case, if it is the restricted shares that are granted, the phrase 'the fair value of the share-based payment' in IFRIC 8 refers to the fair value of the restricted shares and not to the fair value of the unrestricted shares. [IFRIC 8.5]

3. Recognition

3.1 General

The goods or services received or acquired in a share-based payment transaction 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 were received in an equity-settled transaction. A liability is recognised if the goods or services were acquired in a cash-settled transaction. [IFRS 2.7]

The goods or services received in a share-based payment transaction may qualify for recognition as an asset. If not, they are recognised as an expense. [IFRS 2.8]

Services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service. Goods might be consumed over a period of time or, in the case of inventories, sold at a later date, in which case an expense is recognised when the goods are consumed or sold. However, sometimes it is necessary to recognise an expense before the goods or services are consumed or sold, because they do not qualify for recognition as assets. For example, an entity might acquire goods as part of the research phase of a project to develop a new product. Although those goods have not been consumed, they might not qualify for recognition as assets under the applicable IFRS. [IFRS 2.9]

3.2 Timing

As explained in section 3.1 above, the goods or services involved in a share-based payment transaction should be recognised when they are acquired/received. It will normally be relatively straightforward to ascertain when goods are received, but this is not necessarily so when services are involved.

3.2.1 Equity-settled share-based payment transactions

The approach to be adopted in relation to the timing of recognition depends largely on the concept of vesting. IFRS 2 defines 'vest' as follows:

> "To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions." [IFRS 2 Appendix A]

If equity instruments vest immediately then, in the absence of evidence to the contrary, it is presumed that the consideration for the instruments (e.g. employee services) has been received. The consideration (i.e. an expense or asset, as appropriate) should, therefore, be recognised in full, with a corresponding increase in equity. [IFRS 2.14]

If equity instruments do not vest immediately, the following two terms, as defined by IFRS 2, are important. 'Vesting conditions' are:

> "The conditions that must be satisfied for the counterparty to become entitled 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 to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time)." [IFRS 2 Appendix A]

In June 2007, the IASB issued a near-final draft of amendments to IFRS 2 dealing with vesting conditions and cancellations (the 2007 draft amendments). The draft amendments are intended to be effective for the periods beginning on or after 1 January 2008, with earlier application permitted.

The 2007 draft amendments clarify that vesting conditions must be either service conditions or performance conditions. They also introduce the concept of a 'non-vesting condition' which is a condition that is neither a service condition nor a performance condition.

The draft amendments define a performance condition as one which requires the counterparty to complete a specified period of service and specified performance targets to be met. An example of a non-vesting condition is a requirement for employees to make contributions to a 'Save as You Earn' scheme.

The Basis for Conclusions to the amendments explains that the feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or implicit service requirement and the latter does not.

The 'vesting period' is:

> "The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied." [IFRS 2 Appendix A]

If the equity instruments granted do not vest until the counterparty completes a specified period of service, it is presumed that the service period equals the vesting period. The services are accounted for as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity. [IFRS 2.15]

A simple scenario would see employees granted share options which vest only once the employees have completed a specified period of employment – say three years. In this scenario, the entity will record an expense over the three-year vesting period. [IFRS 2.15(a)] However, if the employees are granted share options that are conditional upon the employees working for the entity for the three financial years beyond the current one, generally the IFRS 2 expense will be recognised over a vesting period of four years beginning on the date of grant because, in substance, the vesting is conditional on the employee continuing to render service for another four years (i.e. remaining employed for the current year, plus three subsequent years).

If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employ until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity presumes that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity estimates the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition (see Chapter 4 of this guide), the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the entity revises its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates. [IFRS 2.15(b)]

3.2.2 Cash-settled share-based payment transactions

IFRS 2.32 makes it clear that the principles discussed in section 3.2.1 above also apply to cash-settled share-based payments. The consideration for such payments is recognised when it is received (i.e. immediately or over any vesting period), with a corresponding liability.

There are specific requirements that relate to arrangements with a choice of settlement method (see Chapter 7 of this guide).

4. Measurement: equity-settled transactions

4.1 General

4.1.1 Fair value

In an equity-settled transaction, the goods or services received, and the corresponding increase in equity, should be measured at the fair value of those goods/services.

'Fair value' is defined as follows:

> "The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction." [IFRS 2 Appendix A]

For equity-settled share-based payment transactions, the goods or services received and the corresponding increase in equity are measured directly at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If it is not possible to estimate reliably the fair value of the goods or services received, the fair value of the equity instruments granted is used as a proxy. [IFRS 2.10] There is a limited exception to this requirement in rare cases where the entity is unable to estimate reliably the fair value of the equity instruments granted at the measurement date. This exception is considered at section 4.6 below.

4.1.2 Transactions with employees and others providing similar services

The IASB has taken the view that the fair value of the equity instruments granted should be used for transactions with employees and others providing similar services. This is because, in such transactions, "typically it is not possible to estimate reliably the fair value of the services received". The fair value of those equity instruments is measured at grant date. [IFRS 2.11 & 12]

IFRS 2 defines 'employees and others providing similar services' as:

> "Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, i.e. those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors." [IFRS 2 Appendix A]

Further references to employees in this guide will include others providing similar services.

The determination as to whether an individual is similar to an employee is a matter of careful judgement.

The following factors may be considered as indicators of employees and others providing similar services:

- the purchasing entity is paying for the right to use certain individuals and not the actual output from the individuals (i.e. the purchasing entity has the risk of downtime);
- the individuals are under the direct supervision of the purchasing entity;
- the contract depends on the services from a specified individual;
- the purchasing entity receives substantially all of the output from the individual for a specified period of time; or
- the individuals perform services that are similar to services currently provided by employees.

Factors that would indicate an individual is not an employee or providing services similar to an employee include the following:

- the individual performs services that cannot legally be provided by employees; or
- the individual uses technology that is not legally available to the purchasing entity to perform the services.

For transactions with parties other than employees, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. This fair value should be measured at the date the entity receives the relevant goods or services. This presumption should be rebutted only in those ‘rare cases’ in which the fair value of the goods or services received cannot be estimated reliably. In such circumstances, the fair value is measured indirectly by reference to the fair value of the equity instrument granted, measured at the date the entity receives the relevant goods or services. [IFRS 2.13]

4.1.3 More than one measurement date

If the goods or services are received on more than one date, the entity should measure the fair value of the equity instruments granted on each date when goods or services are received. The entity should apply that fair value when measuring the goods or services received on that date. [IFRS 2.IG6]

It is possible to use an approximation in some cases. If an entity received services continuously during a six-month period, and its share price did not change significantly during that period, the entity could use the average share price during the six-month period when estimating the fair value of the equity instruments granted. [IFRS 2.IG7]

These principles are illustrated in the following examples.

Example 4.1A

Issue of shares for goods or services from non-employees

Company P (a private entity) issues shares to its external lawyers for services related to the successful completion of a lawsuit that Company P is currently defending. The lawyers spent 100 hours working on the case. On the basis of recent invoices from the lawyers, Company P determines the fair value of the services received to be CU300 per hour. Because the fair value of the services can be reliably measured, Company P will record an expense for CU30,000 [100 x CU300] and will not be required to determine the fair value of the shares granted to the lawyers.

Example 4.1B

Measurement date for fair valuation purposes

Company G is a start-up entity that wants to build a website. Company G contacts Supplier W on 15 March and offers 100 shares in G if W builds a website to G's specifications. The offer is valid for six months. Supplier W neither rejects nor accepts G's offer. On 30 June, W agrees to build G's website for the 100 shares. On 30 October, the website is delivered to G. On the same date, G delivers the 100 shares to W.

Company G has determined that it cannot measure reliably the fair value of the services received and, therefore, measures the share-based payment by reference to the fair value of the shares issued.

The measurement date under IFRS 2 will be 30 October. For transactions with parties other than employees (and those providing similar services), the measurement date is defined as "… the date the entity obtains the goods or the counterparty renders service". The 100 shares, therefore, would be valued at 30 October, based on current market prices. Since no further action is required by W and the shares issued are fully vested, the full fair value should be expensed or capitalised as an intangible asset in accordance with IAS 38 *Intangible Assets*.

In certain jurisdictions, G may be required to present interim financial statements at 30 June. Under IFRS 2, there is no requirement to recognise an interim expense for this transaction. Therefore, G would need only to provide the disclosures required for such commitments (if material).

4.2 Determining the fair value of equity instruments granted

4.2.1 Measurement date

Where transactions are measured by reference to the fair value of the equity instruments granted, that fair value should be determined at the 'measurement date' which is defined in IFRS 2 as:

> "The date at which the fair value of the equity instruments granted is measured for the purposes of this IFRS. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service." [IFRS 2 Appendix A]

This definition uses the term 'grant date' which is in turn defined as:

> "The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained." [IFRS 2 Appendix A]

Example 4.2.1A

Grant date

On 1 January 20X1, Company A and each of its executives enter into an agreement where A will issue shares to each executive. The number of shares depends on a formula that considers growth in revenue and profits for the year to 31 December 20X1. Depending on audited revenue and profit growth, which will be known at 31 March 20X2, A could issue between nil and 100 restricted shares. The restricted shares will vest in the employees if they remain in A's employment at the end of a further three years. Therefore, the earliest each executive could sell his/her restricted shares is at the end of 20X4. The Board has already approved the formula and no further approvals are needed. The question that arises is whether the grant date is 1 January 20X1 or 31 March 20X2.

Grant date is defined as "the date at which the entity and another party … agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement ...". At 1 January 20X1, all parties understand the terms and, therefore, this should be viewed as the grant date.

An estimate of the number of shares that will vest is made at 1 January 20X1. A fair value is assigned to each share. As the formula is considered a non-market vesting condition that should be accounted for using the true-up method in IFRS 2, the number of shares is adjusted at 31 March 20X2 based on the amount of restricted shares actually issued to the executives. The fair value of each share is based on the value at 1 January 20X1.

Two key factors that need to be considered when deciding on the grant date are:

- both parties need to 'agree' to a share-based payment; and
- both parties must have a shared understanding of the terms and conditions.

The word 'agree' is used in its usual sense and means that there must be both an offer and acceptance of that offer. The date of grant is when the other party accepts an offer and not when the offer is made. In some instances the agreement might be implicit (i.e. not by signing a formal contract) and this is the case for many share-based payment arrangements with employees. In these cases, the employees' agreement is evidenced by their commencing to render services. [IFRS 2.IG2]

For both parties to have agreed to the share-based payment arrangement, they must have a shared understanding of the terms and conditions of the arrangement. If some of the terms and conditions of the arrangement are agreed on one date, with the remainder of the terms and conditions agreed on a later date, then grant date is on that later date, when all of the terms and conditions have been agreed. For example, consider the situation where an entity agrees to issue share options to an employee, but the exercise price of the options will be set by a remuneration committee that meets in three months' time. The grant date is when the exercise price is set by the remuneration committee. [IFRS 2.IG3]

The scenario described in the previous paragraph differs from that described in Example 4.2.1A. In Example 4.2.1A, the number of restricted shares to be issued, although not known, is the subject of an agreed formula which considers revenue and profit growth. In the scenario set out in the previous paragraph, the exercise price is not agreed until it is set by the remuneration committee because until then it remains subject to the committee's discretion.

In some cases, a grant date might occur after the employees to whom the equity instruments were granted have begun rendering services. For example, if a grant of equity instruments is subject to shareholder approval, grant date might occur some months after the employees have begun rendering services in respect of that grant. The IFRS requires the entity to recognise the services when received. In this situation, the entity should estimate the grant date fair value of the equity instruments (e.g. by estimating the fair value of the equity instruments at the end of the reporting period), for the purposes of recognising the services received during the period between service commencement date and grant date. Once the date of grant has been established, the entity should revise the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments. [IFRS 2.IG4]

The following example considers the effect of employee acceptance provisions on the determination of grant date.

Example 4.2.1B

Effect of employee acceptance provisions on grant date

In Country B, an individual is taxed in the period that share-based payments are received. As a result, prior to issuing share-based payments to its employees, Company X first issues an offer letter to each employee detailing the amount of shares or share options and the exercise price. Each employee has 30 days in which to return the offer letter to accept the options.

Is the grant date the date of the offer or the date of the acceptance?

In many cases, the determination of whether the requirements for rejection or acceptance is explicit or implicit requires careful analysis of the facts and circumstances. On the facts presented, the requirement to accept is explicit and has substance, given that the employee will be taxed immediately on the options received. While the employee understands all of the terms and conditions, the employer does not, until acceptance, have a full understanding of how many share options will be issued. Therefore, due to the explicit acceptance requirement, grant date would be the date of acceptance.

The date of grant determines the date the options should be measured, but does not affect the recognition period of the expense. That is, the option should be recognised as an expense over the service period. If the service period begins prior to the date of grant (e.g. the offer date), Company X should begin expensing the share-based payment at the date of offer at an amount that will approximate to the fair value to be determined at grant date. Once an employee accepts, that date would be the grant date and the fair value would be determined at that date.

4.2.2 Transactions measured by reference to the fair value of goods or services

When determining fair value by reference to the value of the goods or services, care should be taken to ensure that volume rebates or other discounts are considered. Where the value of the goods or services received is not commensurate with the value of the equity instruments issued, the difference may be due to volume rebates. If this is the case, the amount recorded should be the fair value net of any volume rebates.

Example 4.2.2

Volume rebates

Assume Company A purchases 1,000 computers in return for 5,000 of Company A's ordinary shares, trading at CU100 each. The seller generally sells the same computers for CU700 each. Company A currently trades several thousand shares a day, such that 5,000 shares would be readily convertible to cash by the seller. The difference between CU500,000 [5,000 x CU100] and CU700,000 [1,000 x CU700] may relate to a volume rebate that should be considered in the valuation. Therefore, CU500,000 may be the more appropriate measure for the computers.

4.2.3 Fair value by reference to the fair value of equity instruments

When share-based payment transactions are measured by reference to the fair value of the equity instruments granted, ideally that fair value should be determined by reference to market prices. For example, in the case of an issuance of shares that must be forfeited if the employee leaves service over a three-year period, the share-based payment will be measured at the fair value of the shares at the date of grant. A share price or valuation of the entity at the date of grant would be sufficient to determine the fair value of those shares and it would not be necessary to recalculate this value unless the grant was modified.

When market prices do not exist for share options, the fair value should be determined by applying a valuation technique, usually in the form of an option pricing model. [IFRS 2.B4]

The three most common models are the Black-Scholes model, the binomial model and the Monte Carlo model. These models are further considered in section 4.2.4 below and in Appendix 2 to this guide.

The entity should consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. For example, employee options are often exercised early, have quite long lives and are usually exercisable during the period between vesting date and the end of the options' life. These factors should be considered when determining the grant date fair value of the options. IFRS 2 states that for many entities "this might preclude the use of the Black-Scholes-Merton formula, which does not allow for the possibility of exercise before the end of the option's life and may not adequately reflect the effects of expected early exercise. It also does not allow for the possibility that expected volatility and other model inputs might vary over the option's life". [IFRS 2.B5]

It may be acceptable, and even necessary, to use different models for different schemes to reflect their particular features. It may also sometimes be appropriate to use different models for different grants under the same scheme, for example to change to a more complex model as amounts become more material. However, other than in the case of material error, the grant date fair value should not be adjusted once it has been determined using a particular model, even if that model is no longer used for new grants.

Appendix B to IFRS 2 discusses measurement of the fair value of shares and share options granted, focusing on specific terms and conditions that are common features of a grant of shares or share options to employees. Examples of the types of decisions related to measurement that entities are required to make include:

Items to determine	Accounting decisions
Pricing model	Black-Scholes, binomial, Monte Carlo, etc.
Expected life assumption/ employee behaviour	For variable exercise dates, assumptions are needed as to when employees are likely to exercise their options (e.g. in a financially optimal manner; when the option is in the money at a certain time, e.g. vesting date; when the share price hits a specified share price ('barrier'); or based on historical behaviour).
Current share price	Share price can be determined on the basis of closing price or average price on grant date.
Expected volatility	There are various methods to calculate this amount (e.g. based on historical experience, implied volatility of traded options, volatility of comparator companies, or industry index).
Expected dividends	This should be the expected future dividends over the expected life of the award. This should be in line with the entity's policy, although it may be derived from historical experience or experience of competitors.
Risk-free interest rate	This should generally be the implied yield available at the date of grant on zero-coupon government issues of the country in whose currency the exercise is expressed and of duration that is similar to the expected life of the award.

These items are addressed in more detail in the sections below.

The fair value of cash-settled share-based payments, such as share appreciation rights (SARs), should be measured by using a model similar to one used for share options. That is, the effects of future share price increases and other variables have a similar effect on the fair value of share options and many forms of cash-settled share-based payment transactions.

4.2.4 Valuation models

As referred to in section 4.2.3 above, the three most common option pricing models are the Black-Scholes model, the binomial model and the Monte Carlo model.

The Black-Scholes model for valuing share options was first published in 1973 and has been used as the basis to value share options and other share-based payments the fair value of which reacts similarly to that of share options. The binomial model was introduced to provide a simplified explanation to the Black-Scholes model and to extend its usefulness beyond some Black-Scholes narrow confines. When awards have market-based vesting conditions, a Monte Carlo (or equivalent numerical approach) that allows for these conditions should be used.

Appendix 2 to this guide compares and contrasts the three models.

4.2.5 Basic factors affecting the valuation of share-based payments

Most employee share-based payments granted will not have an equivalent instrument traded in an active market and, therefore, when the determination of their fair values is required by IFRS 2, valuation models will need to be applied. IFRS 2 requires, at a minimum, that all valuation models consider the following six basic inputs: [IFRS 2.B6]

- the exercise price of the option (see 4.2.5.1 below);
- the current price of the underlying shares (see 4.2.5.2 below);
- the life of the option (see 4.2.5.3 below);
- the expected volatility of the share price (see 4.2.5.4 below);
- the dividends expected on the shares (see 4.2.5.5 below); and
- the risk-free interest rate for the life of the option (see 4.2.5.6 below).

These variables have been widely accepted as required inputs into valuations. Therefore, it is useful first to review these basic inputs. Other factors affecting the valuation of share-based payments are addressed in 4.2.6 below.

For some of the inputs listed above it is likely that there will be a range of reasonable expectations, e.g. for the exercise behaviour of employees. If this is the case, the fair value should be calculated by weighting each amount within the range of probabilities of occurrence. [IFRS 2.B12]

4.2.5.1 Exercise price

IFRS 2 does not provide guidance on the determination of the exercise price. The exercise price should be determined from the agreement.

4.2.5.2 Current share price

IFRS 2 does not provide guidance on the determination of the current share price.

The current share price should be determined in accordance with an entity's accounting policy. That policy may dictate the closing price or average price at the grant date. Whichever method is chosen, it should be used consistently between periods and among plans.

4.2.5.3 Expected life

There are several factors that affect the expected life of a typical non-traded share option given to employees, such as vesting features and various behavioural considerations. These factors and others will be discussed in greater detail in section 4.2.6 below.

Some ways that the expected life of a share option may be determined are:

- by creating a binomial lattice that includes all the appropriate factors – the lattice outcomes will determine when the exercise date is most likely to occur; or
- by taking factors, such as those listed below, employee risk aversion and behaviour into consideration and estimate an expected life that is then used in, for example, a Black-Scholes model.

Factors to consider in estimating the expected exercise of a share option include: [IFRS 2.B18]

- the length of the vesting period, as share options typically cannot be exercised before they vest;
- historical experience related to actual lives of share options;
- the price of underlying shares. Employees may tend to exercise options when the share price reaches a specified level above the exercise price;
- the expected volatility of the underlying shares. Employees tend to exercise options earlier on highly volatile shares; and
- the employee's level within the organisation.

IFRS 2 suggests that different groups of employees may have homogeneous exercise behaviours and, therefore, determining the expected life for each homogeneous group may be more accurate than an expected life for all recipients of an option grant. [IFRS 2.B20] That is, one share option granted to the Chief Executive Officer may have a different value from one share option granted to a factory worker at the same time with the same term. For example, the Chief Executive Officer might have a greater understanding of when it is optimal to exercise the award and might have less restrictive cash flow constraints compared to the average worker. If the Black-Scholes model is used, IFRS 2 requires the use of the expected life of the option. Alternatively, exercise behaviours can be modelled into a binomial or similar option pricing model that uses contractual life.

4.2.5.4 Expected volatility

Volatility is a measure of the amount by which a share price is expected to fluctuate during a period. [IFRS 2.B22] Many of the concerns about determining the fair value of non-traded employee share options relate to determining the estimate of expected volatility over the term of the option.

Volatility may be measured by reference to the implied volatility in traded options. However, the trading of such options is quite thin and the terms tend to be much shorter than the terms of most employee share options. There is also empirical evidence that options with the same term but different strike prices have different implied volatility. This is a factor that cannot be included in the Black-Scholes model, which assumes a constant volatility.

Historical volatility is often used as a rebuttable presumption for long-term options because there is evidence that volatilities are mean-reverting and, therefore, using the long-term average historical volatility for long-term options would be sufficient if there were no reasons to assume that historical volatility would not generally be representative of future volatility. Some have suggested a blended approach utilising both implied volatility and historical volatility.

The historical volatility may be problematic for newly listed and unlisted entities. If a newly listed entity does not have sufficient historical information, it should nevertheless compute historical volatility for the longest period for which trading activity is available. It can also consider the historical volatility of similar entities following a comparable period in their lives. [IFRS 2.B26]

The unlisted entity will not have historical information to consider when estimating expected volatility. Instead, it should consider other factors, including historical or implied volatility of similar listed entities. [IFRS 2.B27 & 28]

Many factors should be considered when estimating expected volatility. For example, the estimate of volatility might first focus on implied volatilities for the terms that were available in the market and compare the implied volatility to the long-term average historical volatility for reasonableness.

In addition to implied and historical volatility, IFRS 2 suggests the following factors to be considered in estimating expected volatility: [IFRS 2.B25]

- the length of time an entity's shares have been publicly traded;
- appropriate and regular intervals for price observations; and
- other factors indicating that expected future volatility might differ from past volatility (e.g. extraordinary volatility in historical share prices).

4.2.5.5 Expected dividends

Whether expected dividends should be included in the measurement of share-based payments depends on whether the holder is entitled to dividends or dividend equivalents. [IFRS 2.B31] If the holder of the option or share is entitled to dividends between the grant date and the exercise date, expected dividends should not be included in the fair value measurement. [IFRS 2.B33] If the holder of the option or share is not entitled to dividends, the fair value of the grant is reduced by the present value of dividends expected to be paid during the vesting period. [IFRS 2.B34]

IFRS 2 notes that assumptions about expected dividends should be based on publicly available information. [IFRS 2.B36] Therefore, an entity that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. Conversely, an entity that expects to pay dividends in the future could use, for example, the mean dividend yield of an appropriate peer group.

Option pricing models usually require expected dividend yield as input into the models. However, the models can be modified to use an amount rather than a yield of expected dividends. If the entity uses the amount, it should consider its historical patterns of increases in dividends. [IFRS 2.B35]

4.2.5.6 Risk-free interest rate

The risk-free interest rate affects the price of an option in a less intuitive way than expected volatility or expected dividends. As interest rates increase, the value of a call option also increases. This is because the present value of the exercise price will decrease.

IFRS 2 states that the risk-free interest rate should be the implied yield available at the date of grant on zero-coupon government issues in whose currency the exercise price is expressed, with a remaining term equal to expected life of the option being valued. It may be necessary to use an appropriate substitute in some circumstances. [IFRS 2.B37]

4.2.6 Other factors affecting the valuation of share-based payments

There are certain variables that impact the value of many employees share options that are not factored into the Standardised Black-Scholes model. The inability to incorporate these factors directly into the Black-Scholes model limits its usefulness in estimating the fair value of the options. While the approach in IFRS 2 attempts to 'fix' this fault through adjustments to the inputs to the Black-Scholes calculation (e.g. expected life versus contractual life), many believe these adjustments are just not enough. This section will discuss in more detail some of these additional assumptions. However, depending upon materiality levels, the costs of preparing a model that involves these assumptions may not be worth the additional benefits derived from that model.

4.2.6.1 Performance conditions

Examples of performance conditions include the vesting of options based upon:

- the Total Shareholder Return of the entity, either in absolute terms or relative to a comparator group or index (market-based);
- meeting a specific target share price (market-based); or
- levels of revenues (non-market-based).

As a result of those conditions, the holder of the right to an option or share may receive some or all of the vested options/shares.

As further explained in section 4.3 below, IFRS 2 requires that market-based performance-related vesting features be included in the determination of the fair value at the date of grant. Additionally, IFRS 2 requires the entity to estimate the vesting period at the date of grant and recognise the related expense over that period. There is no subsequent adjustment to the vesting period when the performance condition is market-based.

Under IFRS 2, a non-market-based performance condition should not be included in the determination of the fair value at the grant date. For grants with such vesting conditions, at each reporting date, the cumulative expense should equal that proportion of the charge that would have been expensed based on the multiple of the latest estimate of the number of awards that will meet that condition and the fair value of each award, i.e. true-up at each reporting date.

4.2.6.2 Non-transferability

Many believe non-transferability after the vesting period does not have a material impact on the valuation of an option from the perspective of the issuer. However, since the share holding is typically a disproportionate part of an employee's wealth, it may have a significant impact on their behaviour and, therefore, the expected life of the option. Several valuation experts have stated that the inability to transfer an employee share option does not violate option pricing model assumptions because there is no assumption about the transferability of the option in the calculation.

When estimating the fair value of an employee share option at the grant date, IFRS 2 requires the use of expected life to exercise instead of the option's contractual life to expiration to take into account the option's non-transferability. However, valuation experts agree that the use of an average expected life to exercise is not a theoretically accurate way to capture the option's non-transferability. They argue that only looking at the average expected life of the share option distribution could not capture information about that distribution. Therefore, some believe employee behaviours that result in early exercise should be explicitly modelled using a more dynamic option pricing model – such as the binomial model.

Furthermore, many valuation experts now believe that no discount is warranted for non-transferability during the vesting period. If the premise of fair value, as discussed above, is to estimate the amount that a hypothetical market participant would pay for such an option, then the estimate should incorporate employee characteristics only to the extent that they would affect the amount and timing of cash flows of the option. The only alternatives facing the employee during the vesting period are to vest or not to vest – and those two alternatives are addressed under the modified grant-date approach in IFRS 2.

Example 4.2.6.2

Effect of post-vesting transfer restrictions when measuring fair value of equity instruments

Company A operates a share purchase plan for its employees. A's shares are listed and are actively traded. There are no vesting conditions. Therefore, the shares vest immediately on grant date.

The plan stipulates post-vesting transfer restrictions as employees cannot sell their shares until the end of a five-year period beginning on the grant date. The sale of those shares is legally prohibited before the end of the five-year period. Consequently, employees are required to pay the subscription price on the grant date, but they are unable to take advantage of market fluctuations during the ensuing five years. The shares are held in a trust until the transfer restrictions expire. Dividends distributed during the restriction period are held by the trust.

In order to measure the effect of the post-vesting transfer restrictions, A considers a methodology that combines bank borrowings as if to acquire unrestricted shares on the market (the same number as granted in the plan) at the beginning of the five-year period and a forward to sell shares kept in the trust at the end of the five-year period. The fair value determined by such a methodology depends mainly on the interest rate applied to the borrowings. Typically, a financial markets participant, such as a bank, would be able to borrow money at a low rate such that the fair value would be less than the fair value determined on the basis of an interest rate applicable to an individual employee who does not have ready access to financial markets.

What interest rate should be applied in the valuation methodology in considering the post-vesting transfer restrictions when determining the fair value of the shares on grant date?

IFRS 2.B3 indicates that post-vesting transfer restrictions shall be taken into account when estimating the fair value of the shares granted, but only to the extent that the post-vesting transfer restrictions affect the price that a knowledgeable willing market participant would pay for those shares. If the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

IFRS 2.Appendix A defines fair value as the "amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction". Based on this definition, under A's valuation methodology, the interest rate applied to the borrowing should be the rate applicable to the instrument. Therefore, an employee's ability to source such a borrowing is not considered.

4.2.6.3 Stated exercise restrictions

Stated exercise restrictions (e.g. restrictions on exercise or sale of shares by employees) will affect the value both directly and through their impact on the behaviour of holders. The easiest way to see this is to note that employees may find themselves holding a large proportion of their wealth in the form of shares whereas, in the absence of such restrictions, they would hold a more diversified portfolio. This, in turn, will affect their behaviour and, generally (but not invariably) will cause them to exercise as early as possible so as to be out of the restricted period as fast as possible. A history of exercising options as early as possible demonstrates that the value given by the employer is less than the amount attributable to the full term of the option.

The effects of exercise restrictions will be similar to the effects of non-transferability features as discussed above. Therefore, stated exercise restrictions should be evaluated when estimating the fair value of employee share options based on their effect on the expected future cash flows from the options.

4.2.6.4 Behavioural considerations

As can be seen from the above discussion, there are many factors that affect the value of share options through their impact on employee behaviour. Behavioural considerations are critical and should be included in the valuation of share options. This is a familiar consideration in the financial markets. The entire mortgage market, for example, revolves around estimation of the behavioural influences on prepayments.

IFRS 2 requires behavioural considerations to be included in the model through an adjustment to the expected life of the option. Many believe, however, that this will generally be inadequate since the life of the option will depend on the returns for both the entity and for the market and the mechanism for this dependency will be determined by the group characteristics noted, such as risk aversion, diversification, and tax considerations. For example, as individuals grow wealthier in a rising market, the costs of poor diversification may decline and that will reduce occurrences of early exercise of the share options.

4.2.6.5 Long-term nature

The long-term nature of employee share option grants is significant and will clearly impact valuation. The Black-Scholes model uses one set of assumptions at grant date that do not change during the expected life of the options, while a binomial model can use varying assumptions at grant date depending on expected changes to the inputs during the expected life. A typical employee share option can have a contractual life of 10 years. Therefore, the use of static model inputs is not grounded in reality. Because changes in those factors over time can have a significant impact on option value, failure to model such changes over the term of the option can result in overstating or understating the fair value of an option.

Based on the results of research and discussions with valuation experts, fair value for an employee share option should incorporate at the measurement date volatility factors for discrete time periods over the term of the option, interest and dividend rates and exercise patterns over the term of the option, to correspond with historical evidence and/or current expectations, to the extent material. It is to be expected that applying a more dynamic option pricing model with changing inputs will be more difficult and therefore a cost benefit analysis (taking into consideration materiality) should be completed.

4.2.6.6 Effects on the capital structure of an entity

Typically, the shares underlying traded options are acquired from existing shareholders and, therefore, have no dilutive effect. [IFRS 2.B38]

Capital structure effects of non-traded options, such as dilution, can be significant and are generally anticipated by the market at the date of grant. Nevertheless, except in most unusual cases, they should have no impact on the individual employee's decision. The market's anticipation will depend, among other matters, on whether the process of share returns is the same or is altered by the dilution and the cash infusion. In many situations the number of employee share options issued relative to the number of shares outstanding is not significant and, therefore, the effect of dilution on share price can be ignored.

IFRS 2 suggests that the issuer should consider whether the possible dilutive effect of the future exercise of options granted has an effect on the fair value of those options at grant date by an adjustment to option pricing models. [IFRS 2.B41]

4.2.7 Example of employee share purchase plan

The following example is taken from the IFRS 2 Implementation Guidance (IG Example 11) and illustrates some issues about valuation of equity instruments.

Example 4.2.7

[IFRS 2 Implementation Guidance (IG Example 11)]

Employee share purchase plan

BACKGROUND

An entity offers all its 1,000 employees the opportunity to participate in an employee share purchase plan. The employees have two weeks to decide whether to accept the offer. Under the terms of the plan, the employees are entitled to purchase a maximum of 100 shares each. The purchase price will be 20 per cent less than the market price of the entity's shares at the date the offer is accepted and the purchase price must be paid immediately upon acceptance of the offer. All shares purchased must be held in trust for the employees, and cannot be sold for five years. The employee is not permitted to withdraw from the plan during that period. For example, if the employee ceases employment during the five-year period, the shares must nevertheless remain in the plan until the end of the five-year period. Any dividends paid during the five-year period will be held in trust for the employees until the end of the five-year period.

In total, 800 employees accept the offer and each employee purchases, on average, 80 shares, i.e. the employees purchase a total of 64,000 shares. The weighted-average market price of the shares at the purchase date is CU30 per share, and the weighted-average purchase price is CU24 per share.

APPLICATION OF REQUIREMENTS

For transactions with employees, IFRS 2 requires the transaction amount to be measured by reference to the fair value of the equity instruments granted [IFRS 2.11]. To apply this requirement, it is necessary first to determine the type of equity instrument granted to the employees. Although the plan is described as an employee share purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, share option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the entity's share price at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan.

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph B3 of IFRS 2 states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the entity should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the entity estimates that the fair value of each restricted share is CU28. In this case, the fair value of the equity instruments granted is CU4 per share (being the fair value of the restricted share of CU28 less the purchase price of CU24). Because 64,000 shares were purchased, the total fair value of the equity instruments granted is CU256,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 14 of IFRS 2, the entity should recognise an expense of CU256,000 immediately.

However, in some cases, the expense relating to an ESPP might not be material. IAS 8 *Accounting Policies, Changes in Accounting Policies and Errors* states that the accounting policies in IFRSs need not be applied when the effect of applying them is immaterial (IAS 8, paragraph 8). IAS 8 also states that an omission or misstatement of an item is material if it could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor [IAS 8.5]. Therefore, in this example, the entity should consider whether the expense of CU256,000 is material.

It is unusual that the example in the IFRS 2 Implementation Guidance explicitly refers to the possibility that the charge might not be material. This might equally be true of most other requirements of this or other Standards. Caution should be exercised in deciding that a charge otherwise required by IFRS 2 is not material. IAS 8 provides guidance on the meaning of 'material' in the context of errors.

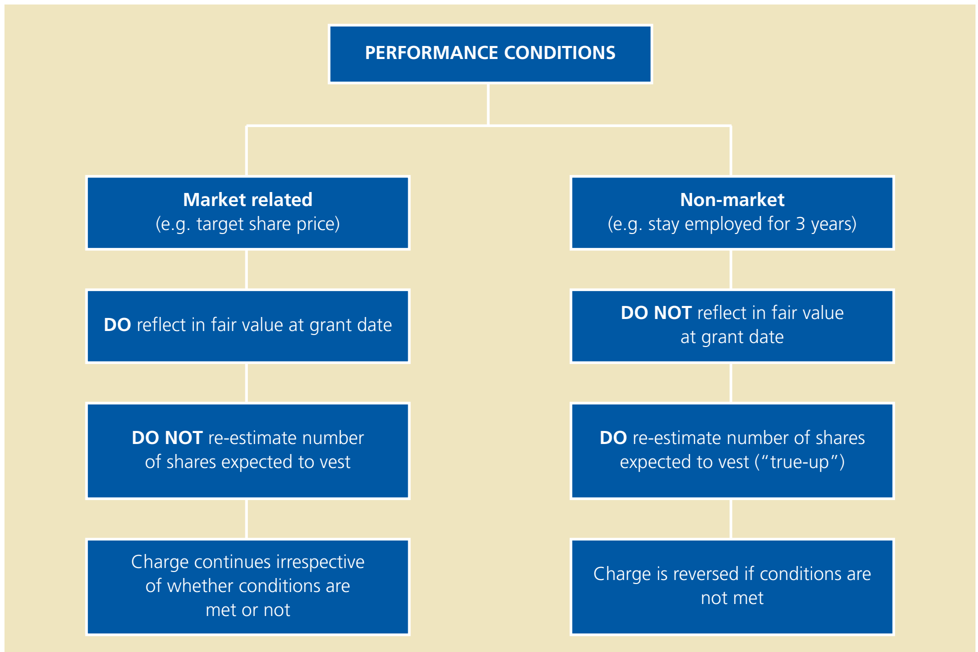
Section 4.6 below looks at the approach to be adopted if it is not possible to estimate reliably the fair value of the equity instrument granted.

4.3 Treatment of vesting conditions

4.3.1 Basic approach

A grant of equity instruments might be conditional upon satisfying specified vesting conditions (see section 3.2.1 above for the definition of vesting conditions). For example, a grant of shares or share options to an employee is often conditional on the employee remaining in the employment of the entity for a specified period of time. Alternatively, or in addition, there may be performance conditions that must be satisfied, such as the entity achieving a specified growth in earnings per share or a specified increase in the entity's share price. [IFRS 2.19]

The following diagram summarises the treatment of vesting conditions in IFRS 2.



IFRS 2 distinguishes between 'market conditions' and conditions other than market conditions (referred to generally as 'non-market conditions'). A market condition is defined by IFRS 2 as:

> "A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities." [IFRS 2 Appendix A]

Market conditions, such as a target share price upon which vesting is conditional, are taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity recognises the goods or services received from a counterparty who satisfies all other vesting conditions (e.g. service conditions) irrespective of whether that market condition is satisfied. [IFRS 2.21]

Vesting conditions other than market conditions are not taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, those non-market vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction so that, ultimately, the amount recognised for goods or services received is based on the number of equity instruments that eventually vest. Therefore, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of a failure to satisfy non-market vesting conditions. For example, this will be the case where an employee fails to complete a specified period of service. [IFRS 2.19]

To apply this requirement for non-market vesting conditions, an amount is recognised for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest. That estimate is revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the estimate is revised to equal the number of equity instruments that ultimately vest. [IFRS 2.20]

This approach, which is generally referred to as the modified grant date method, was adopted by the IASB for two primary reasons: measurement practicalities and US GAAP convergence.

Valuation models used to determine fair value of share-based payments could be modified to incorporate non-market conditions. However, the inclusion of these conditions would increase the difficulty and reduce the reliability of the fair value measurement. Therefore, non-market conditions are not included in the grant-date fair value calculation due to the practical difficulties of measuring these conditions as noted in paragraph BC184 of IFRS 2.

Although IFRS 2 does not achieve complete convergence with US GAAP on the treatment of vesting conditions, the requirement to 'true up' for non-market vesting conditions is similar to US GAAP. In particular, the requirements of IFRS 2 are much closer to US GAAP than those proposed in the Exposure Draft which preceded the Standard, which involved including all performance and service conditions in the measurement of fair value coupled with the 'unit of service' method (see the Basis for Conclusions section of IFRS 2 for further explanations).

The operation of these requirements in practice is illustrated by the examples set out in the following sections.

4.3.2 Non-market vesting condition

4.3.3 Vesting period varies with a non-market condition

4.3.4 Number of options vesting is dependent on a non-market performance condition

4.3.5 Exercise price dependent on a non-market condition

4.3.6 A market condition and a non-market condition

4.3.7 A market condition where the vesting period varies

4.3.8 Contingent issue of shares for goods or services from non-employees

4.3.9 Equity instruments vesting in instalments

4.3.10 Distinguishing market and non-market vesting conditions

The 2007 draft amendments referred to in section 3.2.1 above will introduce the term "non-vesting conditions". They are basically conditions that are neither service nor performance vesting conditions.

Non-vesting conditions, similar to market vesting conditions, should be considered when estimating the fair value of a share-based payment.

Non-vesting conditions might relate to the pre-vesting period, e.g. when a counterparty is supposed to make regular contributions. If this condition is not met, the entity should treat it as a cancellation. However, if neither the entity nor the counterparty can choose whether the condition is met (e.g. commodity index) there will be no accounting impact.

Non-vesting conditions might also relate to the post-vesting period, e.g. some 'non-compete provisions' and transfer restrictions. If such conditions are not met, there will be no accounting impact.

4.3.2 Non-market vesting condition

The following example, which is taken from the IFRS 2 Implementation Guidance (IG Example 1), illustrates the basic approach to be adopted in relation to a non-market vesting condition.

Example 4.3.2

[IFRS 2 Implementation Guidance (IG Example 1)]

Non-market vesting condition

BACKGROUND

An entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share option is CU15.

On the basis of a weighted average probability, the entity estimates that 20 per cent of employees will leave during the three-year period and therefore forfeit their rights to the share options.

APPLICATION OF REQUIREMENTS

Scenario 1

If everything turns out exactly as expected, the entity recognises the following amounts during the vesting period, for services received as consideration for the share options.

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	50,000 options x 80% x CU15 x 1/3 years	200,000	200,000
2	(50,000 options x 80% x CU15 x 2/3 years) – CU200,000	200,000	400,000
3	(50,000 options x 80% x CU15 x 3/3 years) – CU400,000	200,000	600,000

Scenario 2

During year 1, 20 employees leave. The entity revises its estimate of total employee departures over the three-year period from 20 per cent (100 employees) to 15 per cent (75 employees). During year 2, a further 22 employees leave. The entity revises its estimate of total employee departures over the three-year period from 15 per cent to 12 per cent (60 employees). During year 3, a further 15 employees leave. Hence, a total of 57 employees forfeited their rights to the share options during the three-year period, and a total of 44,300 share options (443 employees x 100 options per employee) vested at the end of year 3.

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	50,000 options x 85% x CU15 x 1/3 years	212,500	212,500
2	(50,000 options x 88% x CU15 x 2/3 years) – CU212,500	227,500	440,000
3	(44,300 options x CU15) – CU440,000)	224,500	664,500

4.3.3 Vesting period varies with a non-market condition

The length of the vesting period might vary depending on when a performance condition is met. If an employee is granted share options that are conditional on the achievement of a performance condition and on remaining in employment until that performance condition is satisfied, it is presumed that the services to be rendered by the employee will be received in the future, over the expected vesting period. Where this is the case, the length of the estimated vesting period at grant date is estimated based on the most likely outcome of the performance condition. [IFRS 2.15] If the performance condition is a market condition, the estimated length of the vesting period should be consistent with the assumptions used in estimating the fair value of the options granted and should not be subsequently revised. If the performance condition is a non-market condition, the initial estimate of the length of the vesting period should be revised if subsequent information indicates that the length of the vesting period differs from the previous estimate.

The following example, taken from the IFRS 2 Implementation Guidance (IG Example 2), illustrates the case where the vesting period varies according to the achievement of a non-market condition (a specified increase in earnings).

Example 4.3.3

[IFRS 2 Implementation Guidance (IG Example 2)]

Grant with a performance condition, in which the length of the vesting period varies

BACKGROUND

At the beginning of year 1, the entity grants 100 shares each to 500 employees, conditional upon the employees' remaining in the entity's employ during the vesting period. The shares will vest at the end of year 1 if the entity's earnings increase by more than 18 per cent; at the end of year 2 if the entity's earnings increase by more than an average of 13 per cent per year over the two-year period; and at the end of year 3 if the entity's earnings increase by more than an average of 10 per cent per year over the three-year period. The shares have a fair value of CU30 per share at the start of year 1, which equals the share price at grant date. No dividends are expected to be paid over the three-year period.

By the end of year 1, the entity's earnings have increased by 14 per cent, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that 440 employees will vest in 100 shares each at the end of year 2.

By the end of year 2, the entity's earnings have increased by only 10 per cent and therefore the shares do not vest at the end of year 2. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity's earnings will increase by at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of year 3, 23 employees have left and the entity's earnings had increased by 8 per cent, resulting in an average increase of 10.67 per cent per year. Therefore, 419 employees received 100 shares at the end of year 3.

APPLICATION OF REQUIREMENTS

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	440 employees x 100 shares x CU30 x 1/2	660,000	660,000
2	(417 employees x 100 shares x CU30 x 2/3) – CU660,000	174,000	834,000
3	(419 employees x 100 shares x CU30 x 3/3) – CU834,000	423,000	1,257,000

Granting share options contingent on an Initial Public Offering (IPO) of the entity's shares is another example of an award with a varied non-market vesting period. However, no expense will be recognised unless and until the IPO is probable. This may not be the case on grant date. Therefore, in practice, the expense may sometimes be recognised over a relatively short period between the IPO becoming probable and its taking place.

4.3.4 Number of options vesting is dependent on a non-market performance condition

A similar approach will be adopted where the number of equity instruments that might vest with each employee varies. This is illustrated in the following example which is taken from the IFRS 2 Implementation Guidance (IG Example 3).

Example 4.3.4

[IFRS 2 Implementation Guidance (IG Example 3)]

Grant with a performance condition, in which the number of equity instruments varies

BACKGROUND

At the beginning of year 1, Entity A grants share options to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity's employ, and provided that the volume of sales of a particular product increases by at least an average of 5 per cent per year. If the volume of sales of the product increases by an average of between 5 per cent and 10 per cent per year, each employee will receive 100 share options. If the volume of sales increases by an average of between 10 per cent and 15 per cent each year, each employee will receive 200 share options. If the volume of sales increases by an average of 15 per cent or more, each employee will receive 300 share options.

On grant date, Entity A estimates that the share options have a fair value of CU20 per option. Entity A also estimates that the volume of sales of the product will increase by an average of between 10 per cent and 15 per cent per year, and therefore expects that, for each employee who remains in service until the end of year 3, 200 share options will vest. The entity also estimates, on the basis of a weighted average probability, that 20 per cent of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the entity still expects that a total of 20 employees will leave by the end of year 3. Hence, the entity expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12 per cent and the entity expects this rate of increase to continue over the next 2 years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The entity now expects only three more employees will leave during year 3, and therefore expects a total of 15 employees will have left during the three-year period, and hence 85 employees are expected to remain. Product sales have increased by 18 per cent, resulting in an average of 15 per cent over the two years to date. The entity now expects that sales will average 15 per cent or more over the three-year period, and hence expects each sales employee to receive 300 share options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The entity's sales have increased by an average of 16 per cent over the three years. Therefore, each of the 86 employees receive 300 share options.

APPLICATION OF REQUIREMENTS

Year	Calculation	Remuneration expense for period CU	Cumulative remuneration expense CU
1	80 employees x 200 options x CU20 x 1/3	106,667	106,667
2	(85 employees x 300 options x CU20 x 2/3) – CU106,667	233,333	340,000
3	(86 employees x 300 options x CU20 x 3/3) – CU340,000	176,000	516,000

4.3.5 Exercise price dependent on a non-market condition

The exercise price might vary depending on whether non-market vesting conditions are satisfied. This is illustrated in the following example taken from the IFRS 2 Implementation Guidance (IG Example 4).

Example 4.3.5

[IFRS 2 Implementation Guidance (IG Example 4)]

Grant with a performance condition, in which the exercise price varies

BACKGROUND

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive's remaining in the entity's employ until the end of year 3. The exercise price is CU40. However, the exercise price drops to CU30 if the entity's earnings increase by at least an average of 10 per cent per year over the three-year period.

On grant date, the entity estimates that the fair value of the share options, with an exercise price of CU30, is CU16 per option. If the exercise price is CU40, the entity estimates that the share options have a fair value of CU12 per option.

During year 1, the entity's earnings increased by 12 per cent, and the entity expects that earnings will continue to increase at this rate over the next two years. The entity therefore expects that the earnings target will be achieved, and hence the share options will have an exercise price of CU30.

During year 2, the entity's earnings increased by 13 per cent, and the entity continues to expect that the earnings target will be achieved.

During year 3, the entity's earnings increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested share options have an exercise price of CU40.

APPLICATION OF REQUIREMENTS

Because the exercise price varies depending on the outcome of a performance condition that is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be CU40 and the possibility that the exercise price might be CU30) is not taken into account when estimating the fair value of the share options at grant date. Instead, the entity estimates the fair value of the share options at grant date under each scenario (i.e. exercise price of CU40 and exercise price of CU30) and ultimately revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	10,000 options x CU16 x 1/3	53,333	53,333
2	(10,000 options x CU16 x 2/3) – CU53,333	53,334	106,667
3	(10,000 options x CU12 x 3/3) – CU106,667	13,333	120,000

4.3.6 A market condition and a non-market condition

The following example, taken from the IFRS 2 Implementation Guidance (IG Example 5), illustrates the operation of the requirements of IFRS 2 for a grant of options with a market condition (a specified increase in share price) and a non-market service condition (continuing employment).

Example 4.3.6A

[IFRS 2 Implementation Guidance (IG Example 5)]

Grant with a market condition

BACKGROUND

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity's employ until the end of year 3. However, the share options cannot be exercised unless the share price has increased from CU50 at the beginning of year 1 to above CU65 at the end of year 3. If the share price is above CU65 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e. by the end of year 10.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price will exceed CU65 at the end of year 3 (and hence the share options become exercisable) and the possibility that the share price will not exceed CU65 at the end of year 3 (and hence the options will be forfeited). It estimates the fair value of the share options with this market condition to be CU24 per option.

APPLICATION OF REQUIREMENTS

Because paragraph 21 of IFRS 2 requires the entity to recognise the services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date. Therefore, if the entity expects the executive to complete the three-year service period, and the executive does so, the entity recognises the following amounts in years 1, 2 and 3:

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	10,000 options x CU24 x 1/3	80,000	80,000
2	(10,000 options x CU24 x 2/3) – CU80,000	80,000	160,000
3	(10,000 options x CU24) – CU160,000	80,000	240,000

As noted above, these amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2 (or year 3), the amount recognised during year 1 (and year 2) would be reversed in year 2 (or year 3). This is because the service condition, in contrast to the market condition, was not taken into account when estimating the fair value of the share options at grant date. Instead, the service condition is taken into account by adjusting the transaction amount to be based on the number of equity instruments that ultimately vest, in accordance with paragraphs 19 and 20 of the IFRS.

Another example of the case where share options are granted with both market conditions and non-market conditions is set out below.

Example 4.3.6B

Share option grant with both market and non-market performance conditions

Company H issued 100 share options to certain of its employees that will vest once revenues reach CU1 billion and its share price exceeds CU50. The employees will have to be employed with Company H at the time the share options vest to receive the options. The share options will expire in 10 years.

Paragraph 21 of IFRS 2 states that the grant date fair value of the share-based payment with market-based performance conditions that has met all its other vesting conditions should be recognised, irrespective of whether that market condition is achieved. Company H determines the grant date fair value of the share-based payment excluding the non-market based performance factor, but including the market-based performance factor.

Assuming Company H determines the fair value of the share-based payment at the date of grant is CU20 per option, the expense recorded over the expected vesting period in the following fact patterns would be:

- If all options vest, CU2,000 [100 options x CU20].
- If all vesting conditions are met, except the market-based performance condition of share price exceeding CU50, CU2,000 [100 options x CU20].
- If all vesting conditions are met, except the non-market based performance condition of revenues reaching CU1billion is not achieved, nil expense.
- If all vesting conditions are met, except half of the employees who received options left the entity prior to the vesting date, CU1,000 [50 options x CU20].

Therefore, where there are both market and non-market conditions, an entity will still need to estimate whether non-market conditions will be satisfied even if ultimately no share options vest due to market conditions.

The 2007 draft amendments will clarify that a condition based on a commodity index is a non-vesting condition, for which neither the entity nor the counterparty can choose whether the condition is met.

As a result, this non-vesting condition is considered in estimating the fair value of a share-based payment and, if this condition is not met, similar to a market vesting condition, there is no accounting impact.

4.3.7 A market condition where the vesting period varies

The effect of a vesting condition may be to change the length of the vesting period. In this case, paragraph 15 of the IFRS requires the entity to presume that the services to be rendered by the employees as consideration for the equity instruments granted will be received in the future, over the expected vesting period. Hence, the entity will have to estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period must be consistent with the assumptions used in estimating the fair value of the share options granted and is not subsequently revised.

The following example, taken from the IFRS 2 Implementation Guidance (IG Example 6), illustrates the application of IFRS 2 where the vesting period varies with a market condition (a specified increase in the share price).

Example 4.3.7

[IFRS 2 Implementation Guidance (IG Example 6)]

Grant with a market condition, in which the length of the vesting period varies

BACKGROUND

At the beginning of year 1, an entity grants 10,000 share options with a ten-year life to each of ten senior executives. The share options will vest and become exercisable immediately if and when the entity's share price increases from CU50 to CU70, provided that the executive remains in service until the share price target is achieved.

The entity applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The entity estimates that the fair value of the share options at grant date is CU25 per option. From the option pricing model, the entity determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the entity estimates that the expected vesting period is five years. The entity also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 share options (10,000 share options x 8 executives) will vest at the end of year 5.

Throughout years 1 to 4, the entity continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

APPLICATION OF REQUIREMENTS

Paragraph 15 of the IFRS requires the entity to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the entity not to revise that estimate. Therefore, the entity recognises the services received from the executives over years 1 to 5. Hence, the transaction amount is ultimately based on 70,000 share options (10,000 share options x 7 executives) who remain in service at the end of year 5. Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years. Therefore, the entity recognises the following amounts in years 1 to 5:

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	80,000 options x CU25 x 1/5	400,000	400,000
2	(80,000 options x CU25 x 2/5) – CU400,000	400,000	800,000
3	(80,000 options x CU25 x 3/5) – CU800,000	400,000	1,200,000
4	(80,000 options x CU25 x 4/5) – CU1,200,000	400,000	1,600,000
5	(70,000 options x CU25) – CU1,600,000	150,000	1,750,000

4.3.8 Contingent issue of shares for goods or services from non-employees

Example 4.3.8

Contingent issue of shares for goods or services from non-employees

Company G enters into an agreement with its lawyers currently assisting G in defending a lawsuit. If G is successful in winning the case, it will issue 100 of its own shares to the lawyers. If G is not successful in winning the case, it will issue 20 of its own shares to its lawyers. G expenses the amount it expects to pay to the lawyers over the service period. At the end of each reporting period, G should make its best estimate of whether the lawyers will win the case as well as the most likely outcome of the period over which the case will be settled. This estimate should be revised at the end of each reporting period as long as the case is not settled. In the end, the expense should equal the multiple of the shares issued and their fair value (determined by either reference to the value of the services received, or, if not reliable, the fair value of the equity instruments granted, in accordance with the measurement guidance for share-based payment transactions with non-employees).

4.3.9 Equity instruments vesting in instalments

Example 4.3.9

Equity instruments vesting in instalments

Company A grants its employees 1,000 share options each, which will vest in instalments of 200 share options at the end of each year over the next five years.

To apply the requirements of the IFRS, the entity should treat each instalment as a separate share option grant, because each instalment has a different vesting period and hence the fair value of each instalment is likely to be different. This is because the length of the vesting period will affect, for example, the likely timing of cash flows arising from the exercise of the options.

4.3.10 Distinguishing market and non-market vesting conditions

For the majority of vesting conditions, it is straightforward to determine whether they should be viewed as market or non-market conditions. However, it is not always so straightforward to make this distinction as illustrated in the following examples.

Example 4.3.10A

Market and non-market vesting conditions (index)

Company A issues share options to certain of its employees that vest if, and when, A's share price growth (as a percentage) exceeds the average share price growth of A's 10 most significant competitors. Share price growth is calculated based on share prices only and does not factor in dividends or other factors.

IFRS 2 defines one form of a market condition as a condition upon which the exercise price, vesting, or exercisability of an equity instrument depends on "… achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities". IFRS 2 does not provide guidance on what constitutes an index.

While the term 'index' would appear to require a comparison of more than one entity, there clearly is no requirement that the index be a published, standard index. The following criteria should be considered in determining whether an index exists:

- the fair value at the date of grant can be reliably determined by reference to the index;
- the share prices of the entities in the index are readily available in an active market such that accurate and reliable measurements of fair value can be determined at a specific point in time; and
- a consistent and reasonable formula is used to determine the effects of the entities' performance on the performance of the index.

If these criteria are met, A would have a strong case for demonstrating that the vesting condition was a market condition.

Example 4.3.10B

Ranking of shares within a population

Company A issues share options to certain employees that vest if A's share price growth (as a percentage) ranks in the top quartile of the largest 100 companies in its market. Share price growth is calculated based on share price only and does not take account of dividends or other factors.

Should this vesting condition be considered a market condition?

Yes. The ranking within an index or group of companies may be representative of an index if it meets the criteria for an index described in Exampled 4.3.10A above. Notably, the vesting condition is measurable based on quoted market prices and a consistent formula is used. Therefore, a vesting condition based on a ranking should be considered a market condition.

Example 4.3.10C

TSR as a market condition

Total Shareholders' Return (TSR) is the internal rate of return on the entity's shares calculated by assuming that (a) someone bought the share at the start of the performance period, (b) any dividends received on the share had been used to buy more shares when received, and (c) the shares (plus dividend shares) were sold at the end of the performance period. For example, if no dividends were paid and the share price increased from CU100 to CU107 after one year, the TSR would be 7 per cent. The way that TSR performance conditions typically work is by comparing the entity's TSR with those of an index of other entities. For example, if the entity's TSR were to be placed in the top 30th percentile, then 90 per cent of an award may vest.

Is a performance condition based on TSR considered a market condition under IFRS 2?

The TSR calculation includes not only changes in the entity's share price, but the effects of dividends. Market conditions are required to be included in the grant-date fair value calculation, while non-market conditions are excluded from the grant-date fair value calculation. IFRS 2, BC184 provides support for this distinction by stating that it is difficult to distinguish between market conditions, such as a target share price, and the market condition inherent in the option itself. IFRS 2 defines a market condition as:

"A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities."

Paragraph BC184 further states that IFRS 2 applies the "… same approach as is applied in SFAS 123". SFAS 123 states that performance conditions based on a "… target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned" should be included in the grant-date fair value of the share-based payment. The wording in SFAS 123 was more specific than in IFRS 2 in that it limited the conditions included in the grant-date fair value to only those conditions related to a target share price – excluding all other factors. Nevertheless, it is generally accepted TSR should be accounted for similar to a market condition under US GAAP.

A vesting condition based on TSR can be measured as most, if not all, of the condition is based on movement of the share price. Therefore, the ability to measure provides further support that TSR should be considered a market condition.

4.4 Reload features

Some share options have a 'reload feature'. This entitles the employee to automatic grants of additional share options whenever he/she exercises previously-granted share options and pays the exercise price in the entity's shares rather than in cash. Typically, the employee is granted a new share option, called a reload option, for each share surrendered when exercising the previous share option. The exercise price of the reload option is usually set at the market price of the shares on the date the reload option is granted. [IFRS 2.BC188]

A 'reload feature' is defined in IFRS 2 as:

> "A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price." [IFRS 2 Appendix A]

A 'reload option' is defined as:

> "A new share option granted when a share is used to satisfy the exercise price of a previous share option." [IFRS 2 Appendix A]

IFRS 2 requires that for options with a reload feature, the feature should not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a reload option should be accounted for as a new option grant, if and when a reload option is subsequently granted. [IFRS 2.22]

> As discussed in paragraphs BC189 to BC192 of IFRS 2, it may theoretically be preferable to take account of reload features when measuring the fair value of options granted. ED 2 proposed this treatment "where practicable". However, in the light of comments received, the IASB decided to require the treatment set out above in all cases.

4.5 Adjustments after vesting date

Having recognised the goods or services received in accordance with the requirements of IFRS 2 (and a corresponding increase in equity), no subsequent adjustment should be made to equity after vesting date. For example, the amount recognised for services received from an employee is not subsequently reversed if the vested equity instruments are later forfeited or, in the case of share options, are not exercised. This requirement does not, however, preclude a transfer from one component of equity to another. [IFRS 2.23]

> For example, the expense recognised in accordance with IFRS 2 is not reversed if options vest but are not exercised because they are 'out of the money' or simply because the employee elects not to do so.

4.6 If fair value is not measurable

IFRS 2 provides an exemption from fair value when the fair value of the equity instruments issued cannot be reliably measured. In these rare cases, the grant is initially measured at its intrinsic value and adjusted at each reporting date for any change in intrinsic value until the options are either exercised, forfeited or lapse.

IFRS 2 defines 'intrinsic value' as:

> "The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares." [IFRS 2 Appendix A]

For example, a share option with an exercise price of CU15 on a share with a fair value of CU20 has an intrinsic value of CU5.

When the IASB developed the Exposure Draft preceding IFRS 2, it concluded that there should be no exceptions to the requirement to apply a fair value measurement basis. It therefore was not necessary to include in the proposed IFRS specific requirements for share options that were difficult to value. The IASB noted that share options form part of the employee's remuneration package and that it seemed reasonable to presume that an entity's management would consider the value of the share options to satisfy itself that the package was fair and reasonable. However, after considering respondents' comments, particularly with regard to unlisted entities, the IASB reconsidered this issue.

The IASB concluded that 'in rare cases only' in which it is not possible to estimate the grant date fair value of the equity instrument granted, the alternative treatment of using intrinsic values should be permitted. [IFRS 2.BC199]

No further guidance is provided in IFRS 2 regarding the nature of the rare circumstances which would justify the use of this approach. Although unlisted entities may find it particularly difficult to apply IFRS 2, it should be remembered that even when the intrinsic value approach is used, it will still be necessary to have an estimate of the fair value of the shares at each reporting date. Also, entities may be discouraged from following this route because the expense recognised using the intrinsic value approach will, in most circumstances, be higher (and more volatile) than that which would be recognised on the basis of fair value at grant date.

In the rare cases described above, the equity instruments granted are measured at their intrinsic value, initially at the date when the entity obtains the goods or the counterparty renders the services. The instrument is subsequently remeasured at intrinsic value at each reporting date and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, are forfeited (e.g. upon cessation of employment) or lapse (e.g. at the end of the option's life). [IFRS 2.24(a)]

When this approach is used, the goods or services received should be recognised based on the number of equity instruments that ultimately vest or, where applicable, are ultimately exercised. This means that in the case of share options, the goods or services received are recognised during the vesting period in accordance with paragraphs 14 and 15 of the Standard (see section 3.2.1 above) except that the requirements of paragraph 15(b) concerning market conditions do not apply. The amount recognised for goods or services received during the vesting period is based on the number of share options expected to vest. That estimate is revised if subsequent information indicates that the number of options expected to vest differs from previous estimates. On vesting date, the estimate is revised to equal the number of equity instruments that ultimately vested. After vesting date, the amount recognised for goods or services received is reversed if the options are later forfeited, or lapse at the end of the option's life. [IFRS 2.24(b)]

If the intrinsic value approach is used, it is not necessary to apply paragraphs 26 to 29 of the Standard which deal with modifications to the terms and conditions on which equity instruments were granted, including cancellation and settlement (see Chapter 5 of this guide). This is because any modifications to the terms and conditions on which the equity instruments were granted will be taken into account when applying the intrinsic value method described above. [IFRS 2.25]

However, if an equity instrument to which the intrinsic value method has been applied is settled and the settlement occurs during the vesting period, the settlement is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised for services received over the remainder of the vesting period is therefore recognised immediately. In this case, any payment made on settlement is accounted for as the repurchase of equity instruments (i.e. as a deduction from equity) except to the extent that the payment exceeds the intrinsic value of the equity instruments measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2.25]

The application of the intrinsic value method is illustrated in the following example which is taken from the IFRS 2 Implementation Guidance (IG Example 10).

Example 4.6

[IFRS 2 Implementation Guidance (IG Example 10)]

Grant of share options that is accounted for by applying the intrinsic value method

BACKGROUND

At the beginning of year 1, an entity grants 1,000 share options to 50 employees. The share options will vest at the end of year 3, provided the employees remain in service until then. The share options have a life of 10 years. The exercise price is CU60 and the entity's share price is also CU60 at the date of grant.

At the date of grant, the entity concludes that it cannot estimate reliably the fair value of the share options granted.

At the end of year 1, three employees have ceased employment and the entity estimates that a further seven employees will leave during years 2 and 3. Hence, the entity estimates that 80 per cent of the share options will vest.

Two employees leave during year 2, and the entity revises its estimate of the number of share options that it expects will vest to 86 per cent.

Two employees leave during year 3. Hence, 43,000 share options vested at the end of year 3.

The entity's share price during years 1-10, and the number of share options exercised during years 4-10, are set out below. Share options that were exercised during a particular year were all exercised at the end of that year.

Year	Share price at year-end	Number of share options exercised exercised at year-end
1	63	0
2	65	0
3	75	0
4	88	6,000
5	100	8,000
6	90	5,000
7	96	9,000
8	105	8,000
9	108	5,000
10	115	2,000

APPLICATION OF REQUIREMENTS

In accordance with paragraph 24 of the IFRS, the entity recognises the following amounts in years 1-10.

Year	Calculation	Expense for period CU	Cumulative expense CU
1	50,000 options x 80% x (CU63 – CU60) x 1/3 years	40,000	40,000
2	50,000 options x 86% x (CU65 – CU60) x 2/3 years – CU40,000	103,333	143,333
3	43,000 options x (CU75 – CU60) – CU143,333	501,667	645,000
4	37,000 outstanding options x (CU88 – CU75) + 6,000 exercised options x (CU88 – CU75)	559,000	1,204,000

Year	Calculation	Expense for period CU	Cumulative expense CU
5	29,000 outstanding options x (CU100 – CU88) + 8,000 exercised options x (CU100 – CU88)	444,000	1,648,000
6	24,000 outstanding options x (CU90 – CU100) + 5,000 exercised options x (CU90 – CU100)	(290,000)	1,358,000
7	15,000 outstanding options x (CU96 – CU90) + 9,000 exercised options x (CU96 – CU90)	144,000	1,502,000
8	7,000 outstanding options x (CU105 – CU96) + 8,000 exercised options x (CU105 – CU96)	135,000	1,637,000
9	2,000 outstanding options x (CU108 – CU105) + 5,000 exercised options x (CU108 – CU105)	21,000	1,658,000
10	2,000 exercised options x (CU115 – CU108)	14,000	1,672,000

4.7 Share price denominated in a foreign currency

Example 4.7

Share price denominated in a foreign currency

Company E has the Currency Unit (CU) as its functional currency. E is registered on the New York Stock Exchange with a current market price of US$15 per share. E issues 100 options to its employees with an exercise price of US$15 per share and a vesting period of three years. The share options can only be equity settled. How should these arrangements be accounted for given that the share price is quoted in a currency other than the functional currency of the entity?

E does not have an embedded derivative in this share-based payment to employees that needs to be accounted for under IAS 39 *Financial Instruments: Recognition and Measurement*. Equity-settled share-based payments do not give rise to assets or liabilities that would be denominated in a currency other than the entity's own functional currency. That is, the transaction is an equity transaction that should be denominated in CU for E. For example, if the total fair value of the options was determined to be US$1,500 at the date of grant and the exchange rate was US$1.5/CU1, the total amount that would be expensed under IFRS 2 would be CU1,000 [1,500/1.5] or CU10 per share. This amount would not change over the life of the options even if the exchange rate fluctuates.

For cash-settled share options, the liability recorded would be considered a US$ denominated liability and would need to be remeasured at each balance sheet date. Since the remeasurement is at fair value with changes recognised in profit or loss, no embedded derivative would need to be identified and separated.

5. Modifications including cancellations and settlements

5.1 Modifications

An entity may decide to modify the terms of an existing equity instrument granted in a share-based payment transaction. For example, if there is decline in the entity's share price, an employer may decide to reduce the exercise price of options previously issued to employees, thus increasing their fair value. The requirements of the Standard in this area are expressed in the context of transactions with employees. However, the requirements also apply to share-based payment transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted. In this case, any references to grant date are instead used to refer to the date the entity obtains the goods or the counterparty renders service. [IFRS 2.26]

As a minimum, the services received are measured at the grant date fair value, unless the instruments do not vest because of a failure to satisfy a non-market vesting condition that was specified at grant date. This applies irrespective of any modifications to the terms and conditions on which the instruments were granted (including cancellation or settlement). In addition, the effects of modifications that increase the total fair value of the share-based payment arrangement, or are otherwise beneficial to the employee, are recognised. [IFRS 2.27]

Therefore, a modification that results in a decrease in the fair value of equity instruments does not result in a reduction in the expense recognised in future periods. However, the effects of modifications that increase fair value are recognised. Appendix B of IFRS 2 provides guidance on how this requirement should be implemented. This guidance, which forms an 'integral part' of the Standard, is summarised below.

5.1.1 The modification increases the fair value of the equity instruments granted

The fair value of the equity instruments granted may be increased, for example by reducing the exercise price of share options. Where this happens, the incremental fair value is measured by comparing the fair value of the instrument immediately before and immediately after the modification. This incremental fair value is then included in the measurement of the amount recognised for services received.

If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest. The amount based on the grant date fair value of the original equity instruments continues to be recognised over the remainder of the original vesting period.

If the modification occurs after vesting date, the incremental fair value granted is recognised immediately. If the employee is required to complete an additional period of service before becoming unconditionally entitled to the modified equity instruments, the incremental fair value granted will be recognised over the vesting period. [IFRS 2.B43(a)]

The following example, which is taken from the IFRS 2 Implementation Guidance (IG Example 7) illustrates the approach that should be adopted for a simple option repricing.

Example 5.1.1

[IFRS 2 Implementation Guidance (IG Example 7)]

Grant of share options that are subsequently repriced

BACKGROUND

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is CU15. On the basis of a weighted average probability, the entity estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the entity's share price has dropped, and the entity reprices its share options, and that the repriced share options vest at the end of year 3. The entity estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of year 3.

The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e. before taking into account the repricing) is CU5 and that the fair value of each repriced share option is CU8.

APPLICATION OF REQUIREMENTS

Paragraph 27 of the IFRS requires the entity to recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. If the modification increases the fair value of the equity instruments granted (e.g. by reducing the exercise price), measured immediately before and after the modification, paragraph B43(a) of Appendix B requires the entity to include the incremental fair value granted (i.e. the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the equity instruments granted. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

The incremental value is CU3 per share option (CU8 – CU5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of CU15.

The amounts recognised in years 1-3 are as follows:

Year	Calculation	Remuneration expense for period	Cumulative remuneration expense
		CU	CU
1	(500 – 110 employees) x100 options x CU15 x 1/3	195,000	195,000
2	(500 – 105 employees) x 100 options x [(CU15 x 2/3) + (CU3 x 1/2)] – CU195,000	259,250	454,250
3	(500 – 103 employees) x 100 options x (CU15 + CU3) – CU454,250	260,350	714,600

5.1.2 The modification increases the number of equity instruments granted

If the modification increases the number of equity instruments granted, the fair value of the additional equity instruments granted, measured at the date of the modification, is included in the measurement of the amount recognised for services received, consistent with the requirements in section 5.1.1 above.

For example, if the modification occurs during the vesting period, the fair value of the additional equity instruments granted is included in the amount recognised for services received over the period from the modification date until the date when the additional equity instruments vest. This is in addition to the amount based on the grant date fair value of the equity instruments originally granted which is recognised over the remainder of the original vesting period. [IFRS 2.B43(b)]

5.1.3 The vesting conditions are modified in a manner that is beneficial to the employee

The vesting conditions may be modified in a way that is beneficial to the employee. For example, the vesting period may be reduced or a performance condition might be eliminated or made less demanding. Where the modification affects a market condition it is accounted for as described at section 5.1.1 above. In all other cases, the modified vesting conditions are taken into account when applying the requirements of paragraphs 19 to 21 of the Standard (see section 4.3 above). [IFRS 2.B43(c)]

5.1.4 The terms or conditions are modified in a way that is not beneficial to the employee

The terms and conditions of the equity instruments granted may be varied in a manner that reduces the total fair value of the share-based payment arrangement, or is otherwise not beneficial to the employee. In this case, the entity continues to account for the services received as if the modification had not occurred (other than for a cancellation of some or all of the equity instruments granted which is considered at section 5.2). [IFRS 2.B44]

This situation is unlikely to be common in practice because it is difficult to see why employees would consent to their agreed benefits being made less attractive. However, if this requirement of the Standard did not exist it would be possible for management to reduce or eliminate the expense for 'out-of-the money' options because the employees might accept that they would receive no benefit anyway.

If the modification reduces the fair value of the equity instruments granted, measured immediately before and after the modification, the decrease in fair value is not taken into account. The amount recognised for services received continues to be measured based on the grant date fair value of the instrument originally granted. [IFRS 2.B44(a)]

If the modification reduces the number of equity instruments granted to an employee, the reduction is accounted for as a cancellation of that portion of the grant (see section 5.2 below). [IFRS 2.B44(b)]

If the vesting conditions are modified in a manner that is not beneficial to the employee, for example by increasing the vesting period, the modified vesting conditions are not taken into account when applying the requirements of paragraphs 19 to 21 of the Standard (see section 4.3 above). [IFRS 2.B44(c)]

The following example, taken from the IFRS 2 Implementation Guidance (IG Example 8), illustrates the application of this requirement.

Example 5.1.4

[IFRS 2 Implementation Guidance (IG Example 8)]

Grant of share options with a vesting condition that is subsequently modified

BACKGROUND

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, conditional upon the employee's remaining in the entity's employ for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is CU15 per option at the date of grant.

During year 2, the entity increases the sales target to 100,000 units. By the end of year 3, the entity has sold 55,000 units, and the share options are forfeited. Twelve members of the sales team have remained in service for the three-year period.

APPLICATION OF REQUIREMENTS

Paragraph 20 of the IFRS requires, for a performance condition that is not a market condition, the entity to recognise the services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vested. However, paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received, measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition that was specified at grant date). Furthermore, paragraph B44(c) of Appendix B specifies that, if the entity modifies the vesting conditions in a manner that is not beneficial to the employee, the entity does not take the modified vesting conditions into account when applying the requirements of paragraphs 19-21 of the IFRS.

Therefore, because the modification to the performance condition made it less likely that the share options will vest, which was not beneficial to the employee, the entity takes no account of the modified performance condition when recognising the services received. Instead, it continues to recognise the services received over the three-year period based on the original vesting conditions. Hence, the entity ultimately recognises cumulative remuneration expense of CU180,000 over the three-year period (12 employees x 1,000 options x CU15).

The same result would have occurred if, instead of modifying the performance target, the entity had increased the number of years of service required for the share options to vest from three years to ten years. Because such a modification would make it less likely that the options will vest, which would not be beneficial to the employees, the entity would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service over the original three-year vesting period.

5.1.5 Modifications involving changes to whether instruments will be equity-settled or cash-settled

Paragraph 27 of IFRS 2 which is considered in this Chapter deals only with modifications of the terms and conditions on which equity instruments were granted. This would include the addition of a cash alternative to share options originally issued on terms that they would be equity settled. Guidance on changes regarding terms of settlement are dealt with in Chapter 7 of this guide.

5.1.6 Modifications that are intended to preserve the rights of the holders

The terms of share options or other share-based payment arrangements may be modified with the intention of preserving the rights of the holders in the case of capital changes such as bonus issues, rights issues and demergers. For example, in the event of a one-for-one bonus issue, the number of shares in issue will double and the share price will fall by half. Therefore, to avoid the option holders being disadvantaged, it would be usual to adjust the terms of the options by halving the exercise price and doubling the number of options.

Such an adjustment will be a modification for the purposes of IFRS 2. However:

- an additional expense should not arise where the clear intention of the modification is just to preserve the existing rights of the option holders;
- it will not be necessary to value the options using an option pricing model immediately before and after the modification where it is clear that the formula used achieves that intention (e.g. in the case of a one-for-one bonus issue, the number of options is doubled and the exercise price is halved); and
- this is so even if there is not strictly a contractual obligation to make the adjustment. It is not necessary to take the view that by making an adjustment that is not contractually required, the entity has conferred an extra benefit on the employees. It has instead merely reinstated what would have been taken away without the modification.

In cases where it is not clear whether the formula used confers any additional benefit on the employees, it will be necessary to compare the fair value of the rights immediately before and immediately after the modification in accordance with IFRS 2.

5.2 Cancellations and settlements

An entity may cancel or settle a grant of equity instruments during the vesting period. IFRS 2 includes requirements that deal with such situations. This guidance does not cover those cases when a grant is cancelled by forfeiture when the vesting conditions are not satisfied which are dealt with in accordance with the requirements of the Standard for vesting conditions (see section 4.3 above).

The cancellation or settlement of an equity instrument is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised for services received over the reminder of the vesting period is therefore recognised immediately. [IFRS 2.28(a)]

Any payment made to the employee on cancellation or settlement is accounted for as a repurchase of an equity interest (i.e. as a deduction from equity) except to the extent that the payment exceeds the fair value of the equity instrument granted, measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2.28(b)]

The 2007 draft amendments will add the following guidance to paragraph 2.28(b): "However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability."

IFRS 2 also deals with the situation where new equity instruments may be granted to an employee in connection with the cancellation of existing equity instruments. If new equity instruments are granted and they are identified, on the date when they are granted, as replacement equity instruments for the cancelled equity instruments, this is accounted for as a modification of the original equity instruments (see section 5.1 above). The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee that is accounted for as deduction from equity as described in the previous paragraph. [IFRS 2.28(c)]

If the entity does not identify new equity instruments granted as replacement equity instruments for those cancelled, the new equity instruments are accounted for as a new grant.

The Standard appears to imply a free choice as to whether an entity decides to identify replacement instruments. As indicated by Example 5.2A below, it will often be attractive to identify the new options as replacements because this will avoid accelerating the expense recognised for the original options. However, it would not give a fair presentation to characterise equity instruments as replacements when they were clearly unrelated to the cancelled instruments.

The determination of whether the issue of new options is a replacement of cancelled options requires careful assessment of the facts and circumstances surrounding those transactions. IFRS 2 does not provide specific guidance in this area. Factors that may indicate that a new issue of options identified as a replacement of the cancelled options is a replacement include:

- the new share options are with the same participants as the cancelled options;
- the new share options are issued at a fair value that is broadly consistent with the fair value of the cancelled options determined either at their original grant date (indicating a repricing) or the cancellation date (indicating a replacement);
- the transactions to issue and cancel the options are part of the same arrangement;
- the cancellation of the options would not have occurred unless the new options were issued; and
- the cancellation of the options does not make commercial sense without the issue of the new options (and vice-versa).

If vested equity instruments are repurchased from employees, the payment made is accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the repurchased instruments, measured at the repurchase date. Any such excess is recognised as an expense. [IFRS 2.29]

These requirements are illustrated by the following example.

Example 5.2A

Replacement of share options

Company O issued options with a 4-year vesting period to employees in 20X3. The options had an exercise price of CU10 per share and the fair value determined at the grant date was CU100,000. In 20X5, O cancelled those options and issued new options with an exercise price of CU3 per share. The fair value of the new share options at the grant date is CU75,000. If the new issue of share options is not considered a replacement of the existing share options, the remaining portion of the original fair value of CU100,000 should be expensed immediately and the fair value of the new issue should be recognised over its vesting period. Therefore, a total of CU175,000 would be expensed related to these options, much of the expense in earlier periods.

However, if O identifies the new issue of options as a replacement of the cancelled options, O accounts for the transaction similar to a modification. Therefore, O will continue to expense the portion of the CU100,000 not yet recognised over the original vesting period. Additionally, O will expense the incremental fair value of the new instruments over the old instruments determined at the date of modification over the remaining vesting period. If the old share options had a fair value of CU20,000 at the date they were cancelled, an incremental expense of CU55,000 [75,000-20,000] should be recognised. Therefore, a total of CU155,000 would be expensed related to these options.

The following example considers the situation where the replacement options are issued by a different entity in a group.

Example 5.2B

Issue of new options as a replacement of cancelled options

Company S is a publicly-listed subsidiary of Company P which is also publicly-listed. P decides to de-list S by purchasing all of its outstanding shares from existing shareholders at an amount determined to be fair value. As part of the transaction, all outstanding share options in S were cancelled. In return, P issued share options in P to the same employees of S whose share options in S were cancelled. The fair value of the new share options determined at the grant date approximate the fair value of the replaced options determined at the cancellation date. In addition, the vesting terms and option lives of the new share options were adjusted to ensure consistency with the cancelled options.

Even though the share options are in a different entity that has different risks than S, the intention is to replace value held by the employees. Therefore, the transaction should be considered a replacement of equity instruments and accounted for in accordance with IFRS 2.28(c).

The 2007 draft amendments will clarify that a cancellation by a counterparty should be treated in the same way as a cancellation by the entity.

The principal issue that the amendment is intended to address is the treatment when members of a Save As You Earn (SAYE) scheme stop contributing to the scheme and therefore forfeit their right to exercise their share options. Some took the view that the payment of the contributions to the scheme was a non-market vesting condition and that therefore any expense should be reversed when a member ceased to make contributions and left the scheme. However, the IASB concluded that the payment of contributions was a non-vesting condition because it was neither a service condition nor a performance condition. It also concluded that withdrawal from the scheme should be treated as a cancellation by the member and that this should be accounted for in the same way as prescribed in IFRS 2 for cancellations by the entity.

6. Measurement: cash-settled transactions

6.1 Basic requirements

As indicated in section 2.1 above, IFRS 2 applies to transactions in which the entity acquires goods or services by incurring a liability to transfer cash or other assets for amounts based on the price (or value of the entity's shares or other equity instruments of the entity).

The most common example of such arrangements are cash-settled Share Appreciation Rights (SARs) which are also sometimes referred to as 'phantom option schemes'. Typically, these schemes put the employees in the same position as if they had been granted options. But they involve a cash payment to the employees equal to the gain that would have been made by exercising the notional options and immediately selling the shares in the market.

It may not be immediately apparent why such arrangements are within the scope of the Standard. Paragraph BC242 of IFRS 2 notes that because cash-settled SARs involve an outflow of cash, rather than the issue of equity instruments, they should be accounted for 'in accordance with usual accounting for similar liabilities'. The paragraph goes on to note that while this sounds straightforward, there are some questions to consider. The Standard therefore provides guidance, for example, on how the liability should be measured (see IFRS 2 paragraphs BC243 to BC255 for further details).

For cash-settled share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability. Until the liability is settled, the liability is remeasured at fair value at each reporting date (and the settlement date). Any changes in fair value are recognised in profit or loss for the period. [IFRS 2.30]

The services received and the liability to pay for those services are recognised as the employees render service. For example, some SARs vest immediately and the employees are not therefore required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, it should be presumed that the services rendered by the employees in exchange for the SARs have been received. In this case, the expense for the services received and the liability to pay for them should be recognised immediately. But if the rights do not vest until the employees have completed a specified period of service, the services received and the liability to pay for them should be recognised as the employees render service during the period. [IFRS 2.32]

The liability is measured, initially and at each reporting date until settled, at the fair value of the SARs by applying an option pricing model, taking into account the terms and conditions upon which the rights were granted and the extent to which the employees have rendered service to date.

A simpler approach would have been to base the liability on the intrinsic value of the SARs at the reporting date. It can be argued that the additional cost and effort of using an option pricing model is not justified given that the cumulative expense is always trued-up to the actual cash payment. However, the IASB rejected this approach and concluded that measuring SARs at intrinsic value would be inconsistent with the fair value measurement basis applied in the rest of the IFRS.

The following example, which is taken from the IFRS 2 Implementation Guidance (IG Example 12), illustrates the application of these requirements.

Example 6.1

[IFRS 2 Implementation Guidance (IG Example 12)]

Cash-settled Share Appreciation Rights

BACKGROUND

An entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employ for the next three years.

During year 1, 35 employees leave. The entity estimates that a further 60 will leave during years 2 and 3. During year 2, 40 employees leave and the entity estimates that a further 25 will leave during year 3. During year 3, 22 employees leave. At the end of year 3, 150 employees exercise their SARs, another 140 employees exercise their SARs at the end of year 4 and the remaining 113 employees exercise their SARs at the end of year 5.

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below. At the end of year 3, all SARs held by the remaining employees vest. The intrinsic values of the SARs at the date of exercise (which equal the cash paid out) at the end of years 3, 4 and 5 are also shown below.

Year	Fair value	Intrinsic value
1	CU14.40	
2	CU15.50	
3	CU18.20	CU15.00
4	CU21.40	CU20.00
5		CU25.00

APPLICATION OF REQUIREMENTS

Year	Calculation		Expense CU	Liability CU
1	(500 – 95 employees) x 100 SARs x CU14.40 x 1/3		194,400	194,400
2	(500 – 100 employees) x 100 SARs x CU15.50 x 2/3 – CU194,400		218,933	413,333
3	(500 – 97 – 150 employees) x 100 SARs x CU18.20 – CU413,333	47,127		460,460
	+ 150 employees x 100 SARs x CU15.00	225,000		
	Total		272,127	
4	(253 – 140 employees) x 100 SARs x CU21.40 – CU460,460	(218,640)		241,820
	+ 140 employees x 100 SARs x CU20.00	280,000		
	Total		61,360	
5	CU0 – CU241,820	(241,820)		0
	+ 113 employees x 100 SARs x CU25.00	282,500		
	Total		40,680	
	Total		787,500	

Note that re-measurement of the liability is not recognised as one amount immediately. Instead this amount is spread over the remaining vesting period of the liability.

6.2 Treatment of vesting conditions

An issue which arises is whether vesting conditions should be considered in determining the fair value of cash-settled share-based payments. IFRS 2 provides no specific requirements about this.

IFRS 2.30 requires that the liability incurred from a cash-settled share-based payment transaction should be measured at the fair value of the liability. IFRS 2.BC248 states that the fair value of one form of cash-settled share-based payment (share appreciation rights or SARs) includes both the intrinsic value and the time value. Time value in this context is explained as "… the value of the right to participate in future increases in the share price, if any, that may occur between the valuation date and the settlement date". Furthermore, IFRS 2.BC250 states that the exclusion of time value would lead to an inadequate measure of the liability. There is no mention in IFRS 2 of whether the fair value of the liability for a cash-settled share-based payment should include the effects of vesting conditions.

Example 6.1 above (which is taken from the Implementation Guidance to IFRS 2) provides an illustration of the accounting for SARs. In this illustration, employees must remain in the entity's employment for the next 3 years for their SARs to vest. The illustration does not include the effects of this vesting condition in determining the fair value of the SARs at each balance sheet date, but bases the total liability on the best estimate of SARs that will vest. Non-market vesting conditions are excluded from the grant-date fair value of equity-settled share-based payment because the 'true-up' model is applied to those transactions. As noted in IFRS 2.19, the exclusion of vesting conditions from the measurement of equity-settled share-based payment has the effect of creating a measurement that is not a true fair value measurement. Similar statements are not made for the measurement of cash-settled share-based payment.

While Example 6.1 excludes one type of non-market vesting condition (remaining in the employment of an entity for a specified period of time), it is not clear whether the implication of this exclusion should extend to vesting conditions based on achieving a target revenue or share price. The definition of fair value is "the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction". From this perspective, the fair value measurement should include all terms and conditions, including all vesting conditions.

From a pragmatic perspective, the effect of including vesting conditions in the measurement of fair value may not be materially different from applying the approach described in IFRS 2 (IG Example 12) using a best estimate approach. While this approach may provide a materially similar measurement when the only vesting condition is to remain in employment, this may not be the case if the vesting conditions are based on achieving a target share price or level of revenues.

6.3 Disclosure of liability

The following example considers the presentation and disclosure of the liability for cash-settled SARs.

Example 6.3

Presentation and disclosure of SARs

Company C issues twelve cash-settled share appreciation rights (SARs) to certain of its employees. The SARs vest over a three-year period. At the end of the vesting period, C expects that three of the SARs will be exercised within one year and the remaining nine SARs will be exercised after one year. The question is how C should present the liability for share-based payments?

IFRS 2 does not require a separate presentation of the carrying amount of liabilities relating to share-based payments in the balance sheet but requires this information to be disclosed in the financial statements. Liabilities arising from share-based payments are financial liabilities, although they are excluded from the scope of IAS 32 and IAS 39.

Therefore, an entity should consider whether share-based payment liabilities are grouped with other financial liabilities on the face of the balance sheet. In any case, IAS 1.29 to 31 should be applied to determine if the liability should be presented separately on the face of the balance sheet.

IAS 1.51 requires separate presentation on the face of the balance sheet for current and non-current liabilities. Based on the above facts, since all SARs can be exercised within the next year, the liabilities should be presented as current liabilities. If C determines that presentation on a liquidity basis is more relevant, the current portion of the liability should be disclosed in accordance with IAS 1.52.

6.4 Share price denominated in a foreign currency

This issue is considered at section 4.7 above in relation to equity-settled share-based payments.

Consider the situation where an entity has Currency Units (CU) as its functional currency but its share price is quoted in US$. For cash-settled share options, the liability recorded would be considered a US$ denominated liability and would need to be remeasured at each balance sheet date. Since the remeasurement is at fair value with changes recognised in profit or loss, no embedded derivative would need to be identified and separated.

7. Transactions with settlement alternatives

7.1 Basic principles

In certain circumstances, share-based payment transactions may provide either the entity or the counterparty with a choice as to whether settlement occurs in equity instruments or cash. The basic principle to be applied is as follows.

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the transaction, or the components of that transaction, are accounted for: [IFRS 2.34]

- as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets; or
- as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IFRS 2 contains more detailed requirements concerning the application of this principle to share-based payment transactions in which the terms of the arrangement:

- provide the counterparty with a choice of settlement (see 7.2 below); and
- provide the entity with a choice of settlement (see 7.3 below).

Circumstances where there is a modification to the terms of settlement are considered at 7.4 below.

There are some share-based transactions where the method of settlement is determined by events outside of the employee's or employer's control (see 7.5 below).

References to cash, in the remainder of this chapter, also include other assets.

7.2 Counterparty's choice

If the counterparty has the choice as to whether the entity settles a share-based payment transaction in cash or with equity instruments, the entity has granted a compound financial instrument, similar to convertible debt. The instrument has:

- a debt component – the counterparty's right to demand cash; and
- an equity component – the counterparty's option to receive equity instruments rather than cash.

Each component is accounted for separately, similar to the equivalent requirements of IAS 32 as described below.

The following example illustrates the need to consider the substance of the arrangement where the cash alternative is provided through a separate agreement.

Example 7.2

Counterparty choice in settlement of a share-based payment

Company A grants share options to its employees that vest over a three-year period. These share options can only be settled by the issue of A's shares at the end of the vesting period. In a separate legal agreement consummated at the same time as the grant of the share options, A issues a put option to its employees that can (at the option of the employee) require A to settle the share options in cash based on the higher of a predetermined price (equal to the grant date fair value) or the fair value of the shares underlying the options. The put is only exercisable between the vesting date and the expiration of the options.

The two contracts (share options and written put) should be linked and the transaction accounted for as a cash alternative.

The substance of this arrangement is to issue an equity instrument to employees with a cash alternative. Therefore, the accounting should not be different depending on whether the transaction is consummated through one or more contracts. As a result, A should fair value the liability component and any residual should be assigned to the equity component. Since the remaining amount to be assigned to equity in this example would be nil (see section 7.2.1 below), the transaction is accounted for similar to a cash-settled share-based payment up to the date of exercise.

7.2.1 Measurement

For transactions with parties other than employees, the fair value of goods or services is measured directly (if that is possible with sufficient reliability – see section 4.1 above). For such transactions, the equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when goods or services are received. [IFRS 2.35] This is the basic approach that is adopted for compound instruments that are accounted for under IAS 32.

For other transactions, including those with employees, the fair value of the compound financial instrument is measured at the measurement date, taking into account the terms and conditions on which the rights to cash or equity instruments were granted. [IFRS 2.36] To do this, the debt component is measured first and then the equity component is measured. The fact that the counterparty must forfeit the right to receive cash to receive the equity instrument should be taken into account. The fair value of the compound financial instrument is the sum of the fair values of the two components. [IFRS 2.37]

Under IAS 32.32 the carrying amount of the equity instruments is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. This is straightforward when the fair value of the combined instrument is reliably known, for example where it is the proceeds of an issue for cash. However, IFRS 2.BC260 explains that, where this is not the case, it will be necessary to estimate the fair value of the compound instrument itself. The IASB therefore concluded, as stated above, that the compound instrument should be measured first by valuing the liability component (i.e. the cash alternative) and then valuing the equity component and adding the two components together.

Entities will often structure share-based payment transactions in which the counterparty has the choice of settlement in such a way that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. [IFRS 2.37]

IFRS 2 notes that, conversely, if the fair value of the settlement alternatives differ, the fair value of the equity component will usually be greater than zero. In this case, the fair value of the compound financial instrument will be greater than the fair value of the debt component.

IFRS 2.BC259 explains that the fair value of the compound financial instrument will usually exceed both:

- the individual fair value of the cash alternative – because of the possibility that the shares or share options may be more valuable than the cash alternative; and
- that of the shares or options – because of the possibility that the cash alternative may be more valuable than the shares or options.

But, as explained above, in many practical situations the fair value of the settlement alternatives will be the same and there will be no equity component.

7.2.2 Subsequent accounting

Once the debt and equity components have been separately identified and measured, the goods or services received in respect of each component are accounted for separately. For the debt component, the goods or services received, and a corresponding liability, are recognised in accordance with the requirements applying to cash-settled transactions (see Chapter 6 of this guide). For the equity component, if any, the goods or services received are recognised as the counterparty supplies goods or renders services in accordance with the requirements for equity-settled transactions (see Chapter 4 of this guide). [IFRS 2.38]

At the date of settlement, the liability is remeasured at its fair value. If equity instruments are issued in settlement rather than cash, the liability is transferred direct to equity as the consideration for the equity instruments issued. [IFRS 2.39]

If settlement is in cash rather than equity instruments, the payment made is applied to settle the liability in full. Any equity component previously recognised remains in equity. By electing to receive cash settlement, the counterparty forfeited the right to receive equity instruments. But this does not preclude a transfer from one component of equity to another. [IFRS 2.40]

The application of these requirements is illustrated by the following example which is taken from the IFRS 2 Implementation Guidance (IG Example 13). It illustrates the circumstances where the cash alternative is less favourable than the equity-settled alternative and so the equity component is not zero.

Example 7.2.2

[IFRS 2 Implementation Guidance (IG Example 13)]

Subsequent accounting where counter-party has choice of settlement

BACKGROUND

An entity grants to an employee the right to choose either 1,000 phantom shares (i.e. a right to a cash payment equal to the value of 1,000 shares) or 1,200 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At grant date, the entity's share price is CU50 per share. At the end of years 1, 2 and 3, the share price is CU52, CU55 and CU60 respectively. The entity does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is CU48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

APPLICATION OF REQUIREMENTS

The fair value of the equity alternative is CU57,600 (1,200 shares x CU48). The fair value of the cash alternative is CU50,000 (1,000 phantom shares x CU50). Therefore, the fair value of the equity component of the compound instrument is CU7,600 (CU57,600 – CU50,000).

The entity recognises the following amounts:

Year		Expense CU	Equity CU	Liability CU
1	Liability component: (1,000 x CU52 x 1/3)	17,333		17,333
	Equity component: (CU7,600 x 1/3)	2,533	2,533	
2	Liability component: (1,000 x CU55 x 2/3) – CU17,333	19,333		19,333
	Equity component: (CU7,600 x 1/3)	2,533	2,533	
3	Liability component: (1,000 x CU60) – CU36,666	23,334		23,334
	Equity component: (CU7,600 x 1/3)	2,534	2,534	

	Expense	Equity	Liability
End Year 3	CU	CU	CU
Scenario 1: cash of CU60,000 paid			(60,000)
Scenario 1 totals	67,600	7,600	0
Scenario 2: 1,200 shares issued		60,000	(60,000)
Scenario 2 totals	67,600	67,600	0

7.3 Entity's choice

The terms of a share-based payment transaction may provide an entity with the choice as to whether to settle in cash or by issuing equity instruments. In this case, it is necessary to determine whether the entity has a present obligation to settle in cash and to account for the transaction accordingly. IFRS 2 states that the entity has a present obligation to settle in cash if: [IFRS 2.41]

- the choice of settlement in equity instruments has no commercial substance, for example because the entity is legally prohibited from issuing shares; or
- the entity has a past practice or stated policy of settling in cash; or
- the entity generally settles in cash whenever the counterparty asks for cash settlement.

When the entity has a present obligation to settle in cash, the transaction is accounted for as a cash-settled transaction (see Chapter 6 of this guide). [IFRS 2.42]

If no such obligation exists, the transaction is accounted for in accordance with the requirements of the Standard applying to equity-settled transactions (see Chapter 4 of this guide).

The application of these classification requirements is illustrated by the following example:

Example 7.3

Classification of an employee share option plan in which the entity has the choice of settlement

Company A, a listed entity, grants its employees options to acquire ordinary shares in A. A's shares trade in an active market. The exercise of the options is conditional upon the achievement of certain performance conditions during the vesting period. In addition, the holders of the options have to be employed within the group headed by A or can be retired, if they retire at the normal retirement age.

Employees can exercise the options over a period of 5 years. Following the exercise of an option, the employee is required to sell the shares obtained immediately. Company A has first right to purchase these shares at a price equal to the market price at the moment employees exercise the underlying options. Should the entity not purchase the shares, there are no constraints on how the employees dispose of the shares, or to whom. There is no enforcement mechanism by the entity.

Company A has the legal ability to buy its own shares in the market, and has sufficient authorised capital to issue new shares to deliver the required number of shares to the employees upon exercise.

The granted share option scheme is a new arrangement, and there have been no other arrangements in the past where the entity has had a choice of cash or equity settlement. Hence, there is no historical fact pattern of A exercising its rights. The share option scheme has been approved by the shareholders without objection, and no indication was provided as to what course of action the entity would take when the exercise date is reached — whether the entity would seek to acquire the shares based on its pre-emptive right or choose not to do so.

Company A represents that it will act in its own interest every time it has the right to buy back shares, and that it does not believe any situation exists which would force it to buy back the shares given to the employees under the scheme.

According to the listing rules, employees cannot exercise their rights during a 'closed period'. Therefore, employees will not be able to sell shares in a closed period.

When employees exercise the options granted by A, they are obliged to sell the shares on the date of exercise. Company A has first right to purchase these shares. In substance, this right to repurchase shares immediately gives A an option to settle the share-based payment transaction in cash. Therefore, paragraphs 41 to 43 of the IFRS apply.

Paragraph 41 of the IFRS requires an entity that has a choice of settlement to determine whether it has a present obligation to settle the share-based payment transaction in cash.

The entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (e.g. because the entity is legally prohibited from issuing shares), or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

If an entity with a choice of settlement has no present obligation to settle the transaction in cash, paragraph 43 of the IFRS states "the entity shall account for the transaction in accordance with the requirements applying to equity-settled share-based payment transactions, in paragraphs 10 – 29".

The management of Company A considers all facts and circumstances to determine whether there are any factors that could create an obligation to deliver cash and concludes that there are no situations in which the entity would have a legal obligation, or has created a constructive obligation, to repurchase the shares and thereby deliver cash.

In particular:

- there is an active market in which the shares could be sold;
- from a legal perspective, A has sufficient authorised share capital in order to be able to issue new shares;

- current shareholders raised no objection to the scheme in the general shareholders' meeting and the entity did not raise an expectation of particular action;
- no restrictions on trading in a closed period apply as exercise is prohibited in this period; and
- there is no stated policy or constructive obligation created by past practice.

Hence, this scheme should be accounted for as an equity-settled share-based payment.

On settlement: [IFRS 2.43]

- if the entity elects to settle in cash, the cash payment is accounted for as the repurchase of an equity interest. It is therefore treated as a deduction from equity except as described below; and
- if the entity elects to settle by issuing equity instruments, no further accounting is required except as noted below and except for a transfer from one component of equity to another component of equity, if necessary.

These requirements are not consistent with the requirements of IAS 32 for other circumstances where the entity has a choice of settlement. IAS 32 requires such arrangements to be classified wholly as a liability (if the contract is a derivative contract) or as a compound instrument (if the contract is a non-derivative contract). The IASB decided to retain this difference pending the outcome of its longer term project on the distinction between liabilities and equity. [IFRS 2.BC266]

If the entity elects for the settlement alternative with the higher fair value, as at the date of settlement, the entity should recognise an additional expense for the excess value given. That is: [IFRS 2.43]

- the difference between the cash paid and the fair value of the equity instruments that would have been issued; or
- the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid.

Thus, there is an additional expense recognised when an entity elects to use the settlement alternative with the higher fair value. But this does not mean that the expense recognised will be the same as it would have been if the method of settlement assumed at the outset was the same as the actual method of settlement. For example, consider the case of share appreciation rights where the cash-settled and equity-settled alternatives have the same fair value because the cash payment is equal to the gain that would arise on exercise of the options. If these were assumed to be cash-settled from the outset, the cumulative expense recognised would be based on the actual cash payment made (i.e. intrinsic value) on exercise. If these were assumed to be equity-settled from the outset, the cumulative expense recognised would be based on fair value at grant date (which would usually be lower).

Now suppose that the entity concluded, at the outset, that there was no obligation to settle in cash but subsequently did so. The expense recognised would be based on fair value at grant date and would not be adjusted to the amount of the cash payment made. The IASB considered and rejected the argument that an additional expense should be recognised in these circumstances as described in IFRS 2.BC267.

Where the entity has the choice of settlement, it may therefore appear advantageous to conclude that there is no obligation to settle in cash and to account for the arrangements as equity-settled. Where the entity has no past practice or stated policy of settling in cash, there is nothing in the Standard to prevent this. But an entity that tried to exploit this could do so only for a limited time because it would, in due course, establish a practice of settling in cash.

7.4 Changes to method of settlement

IFRS 2 contains specific requirements for modifications to the terms and conditions on which equity instruments are granted (see Chapter 5 of this guide). It also deals with circumstances where there is choice between cash settlement and equity settlement (see sections 7.1 to 7.3 above). But it contains no specific requirements relating to the variation of terms to alter the method of settlement.

7.4.1 Addition of a cash alternative

An entity may decide, during the vesting period for an equity-settled transaction, to add an employee option to choose a cash alternative. From the date of such a modification, the transaction should be accounted for as a compound instrument as outlined at section 7.2 above. This approach is illustrated in the following example which is taken from the IFRS 2 Implementation Guidance (IG Example 9).

Example 7.4.1

[IFRS 2 Implementation Guidance (IG Example 9)]

Grant of shares, with a cash alternative subsequently added

BACKGROUND

At the beginning of year 1, the entity grants 10,000 shares with a fair value of CU33 per share to a senior executive, conditional upon the completion of three years' service. By the end of year 2, the share price has dropped to CU25 per share. At that date, the entity adds a cash alternative to the grant, whereby the executive can choose whether to receive 10,000 shares or cash equal to the value of 10,000 shares on vesting date. The share price is CU22 on vesting date.

APPLICATION OF REQUIREMENTS

Paragraph 27 of the IFRS requires, irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments, the entity to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Therefore, the entity recognises the services received over the three-year period, based on the grant date fair value of the shares.

Furthermore, the addition of the cash alternative at the end of year 2 creates an obligation to settle in cash. In accordance with the requirements for cash-settled share-based payment transactions (paragraphs 30 to 33 of the IFRS), the entity recognises the liability to settle in cash at the modification date, based on the fair value of the shares at the modification date and the extent to which the specified services have been received. Furthermore, the entity remeasures the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognised in profit or loss for the period. Therefore, the entity recognises the following amounts:

Year	Calculation	Expense	Equity	Liability
		CU	CU	CU
1	Remuneration expense for year: 10,000 shares x CU33 x 1/3	110,000	110,000	
2	Remuneration expense for year: (10,000 shares x CU33 x 2/3) – CU110,000	110,000	110,000	
	Reclassify equity to liabilities: 10,000 shares x CU25 x 2/3		(166,667)	166,667
3	Remuneration expense for year: (10,000 shares x CU33 x 3/3 – CU220,000)	110,000	26,667*	83,333*
	Adjust liability to closing fair value: (CU166,667 + CU83,333) – (CU22 x 10,000) shares	(30,000)		(30,000)
	Total	300,000	80,000	220,000

* Allocated between liabilities and equity, to bring in the final third of the liability based on the fair value of the shares as at the date of the modification.

7.4.2 Change from cash-settled to equity-settled

The following example considers a change in the terms whereby options that were originally to be cash-settled will be equity-settled.

Example 7.4.2

Change from cash-settled to equity-settled

On 1 January 20X1, Company A issued 100 share options to certain of its employees with an exercise price of CU15 per option. The options vest if the employee remains in A's employ after four years. The share options can only be cash-settled. A determined the fair value of the instruments to be CU5 per option at the date of grant.

As of 31 December 20X2, A determined the fair value of the cash-settled share-based payment to be CU6 and, therefore, has recorded a cumulative expense of CU300 [(CU6 x 100) x 2/4 years] as A expects all options to vest. On 1 January 20X3, A modified the options such that they can only be settled by delivery of A's equity instruments and, therefore, are classified as equity-settled share-based payments.

At the date of modification, 1 January 20X3, A is required to eliminate the liability of CU300. The guidance in IFRS 2.27 to 29, which applies to modifications of equity-settled share-based payments that continue to be accounted for as equity-settled share-based payments after the modification, can be used by analogy.

IFRS 2.27 requires that, at a minimum, the grant-date fair value of the equity instruments granted is recognised as remuneration expense over the vesting period unless those instruments do not vest because of failure to satisfy a non-market condition. Any incremental fair value, as a result of the modification, is recognised over the remaining vesting period. Based on that principle, an entity recognises cumulative remuneration expense at the amount that would have been recognised as of the date of the modification had the liability award been accounted for as equity from the date of grant unless the modification date fair value of the liability award exceeds the grant date fair value of the liability award, had it been accounted for as equity.

If the modification date fair value of the liability award exceeds the grant date fair value of the liability award, had it been accounted for as equity, the higher amount becomes the basis for recognising cumulative remuneration expense of the modified award over the remaining vesting period. In that situation, the liability is reclassified as equity and unrecognised remuneration expense is recognised over the remaining vesting period.

If the grant date fair value of the liability award, had it been accounted for as equity, exceeds the modification date fair value of the liability award, the higher amount becomes the basis for recognising cumulative remuneration expense over the vesting period. In that situation, the liability is reclassified to equity. In addition, the excess of the cumulative remuneration expense that would have been recognised to date, had the liability been accounted for as equity, is immediately recognised as remuneration expense with a corresponding increase in equity. The unrecognised remuneration expense is recognised over the remaining vesting period.

7.5 Contingent settlement alternatives

There might be some share-based transactions where the method of settlement is determined by events outside of the employee's or employer's choice.

Example 7.5

Share-based payment contingently settled in cash

Assume an entity enters into an equity-settled share-option arrangement. If a change in ownership takes place before the end of the exercise period of the plan, the employer shall repurchase the remaining share options, as well as the shares issued under the plan, at fair value.

The first question is whether or not such a change in ownership constitutes an event that should be considered to be within the control of the entity so that the plan described above would be classified as a share-based payment transaction with a cash alternative?

A change in ownership normally requires approval of the board of directors and/or shareholders. IFRS 2.3 states that transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity (including employees) are share-based payment transactions, unless the transfer is clearly for a purpose other than payment for goods or services supplied to the entity. Shareholders of an entity are generally not considered to be a part of the entity because they act as investors and not on behalf of the entity. When a shareholder is faced with a decision to sell his shares, he makes such a decision as an investor and not as part of the entity. Therefore, a change in ownership by way of an Initial Public Offering or some other means should be regarded as an event that is not within the control of the entity because it is within the control of the shareholders (acting as investors). Consequently, such share-based payment transactions should not be considered to provide the entity with a choice of settlement; they are not share-based payments with a cash alternative for either the employee or the employer.

Thus, the next question is how should a share-based payment transaction that is normally equity-settled, but will be cash-settled upon the occurrence of a future event that is outside the control of the entity, be classified?

There is no specific guidance in IFRS 2 as to how to classify share-based payment transactions that are contingently cash-settleable and whose contingent event is not within the control of the entity. Guidance exists in IAS 32 *Financial Instruments: Presentation* for the classification as a financial liability of an equity instrument with contingent cash settlement terms. However, the IASB concluded that the requirements in IAS 32 should not be applied in IFRS 2 (see IFRS 2.BC106 to BC110 and IFRS 2.BC266). Consequently, an entity should not refer to IAS 32 to determine the classification of a share-based payment transaction under IFRS 2.

By analogy with the treatment of contingent liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the classification of a contingently cash-settleable plan whose contingent event is not within the control of the entity depends on whether the contingent event is probable. If the event's occurrence is not probable, and the share-based payment would otherwise be classified as equity, then it shall be classified as equity-settled. If the event's occurrence is probable, then the share-based payment shall be classified as cash-settled. The assessment of whether or not the occurrence of the contingent event is probable shall be made at the grant date and subsequently in the same way as IAS 37.30 requires a continuous assessment of contingent liabilities. If the assessment of the occurrence of the contingent event changes after the grant date, accounting for a change from an equity-settled share-based payment to a cash-settled share-based payment applies. This is discussed in section 7.4 above.

8. Disclosure and presentation

Paragraphs 44 to 52 of IFRS 2 include detailed disclosure requirements for share-based payments. These requirements are set out in full in Appendix 3 to this guide. The main provisions are summarised below. Additional information should be disclosed if the detailed information required to be disclosed by the IFRS does not satisfy the principles in paragraphs 44, 46 and 50 of the Standard (see sections 8.1, 8.2 and 8.3 below). [IFRS 2.52]

Where separate financial statements of the parent are presented using IFRSs, these disclosures will be required for both the parent entity's separate financial statements and for the consolidated financial statements of the group. Some of the disclosures (e.g. regarding the nature of the schemes and the option pricing models used) will be common to both and need not be repeated. However, some details (e.g. the numerical details regarding the options outstanding etc.) will have to be given separately for the parent entity as well as for the group.

8.1 Nature and extent of share-based payments

An entity should disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period. [IFRS 2.44] To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed: [IFRS 2.45]

- a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement such as:
  - the vesting requirements;
  - the maximum term of options granted; and
  - the method of settlement (e.g. whether in cash or equity).

  An entity with substantially similar types of share-based payment arrangements may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 44 of the Standard;

- the number and weighted average exercise prices of share options for each of the following groups of options:
  - outstanding at the beginning of the period;
  - granted during the period;
  - forfeited during the period;
  - exercised during the period;
  - expired during the period;

  - outstanding at the end of the period; and
  - exercisable at the end of the period;
- for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the weighted average share price during the period may instead be disclosed; and
- for share options outstanding at the end of the period, the range of exercise prices and weighted average contractual life. If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

8.2 How fair value is determined

An entity should disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined. [IFRS 2.46]

To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed if the entity has measured the fair value of goods and services received indirectly, by reference to the fair value of the equity instruments granted: [IFRS 2.47]

- for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how the fair value was measured, including:
  - the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
  - how expected volatility was determined, including an explanation of the extent to which it was based on historical volatility; and
  - whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition;
- for other equity instruments granted during the period (i.e. other than share options) the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was determined, including:
  - if the fair value was not measured on the basis of observable market price, how it was determined;
  - whether and how expected dividends were incorporated into the measurement of fair value; and
  - whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value; and

- for share-based payment arrangements that were modified during the period:
  - an explanation of those modifications;
  - the incremental fair value granted as a result of those modifications; and
  - information on how the incremental fair value was measured.

If the entity has measured directly the fair value of goods or services received during the period, disclosure is required of how that fair value was determined (e.g. whether fair value was measured at a market price for those goods or services). [IFRS 2.48]

If the presumption in paragraph 13 of the Standard has been rebutted, that fact should be disclosed together with an explanation of why the presumption was rebutted. The presumption in paragraph 13 is that in the case of transactions with parties other than employees, the fair value of the goods or services received can be estimated reliably (see section 4.1 above). [IFRS 2.49]

8.3 Effect of share-based payment transactions on the profit or loss and financial position

An entity should disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on its profit or loss for the period and on its financial position. [IFRS 2.50] To give effect to this principle, IFRS 2 specifies that at least the following should be disclosed: [IFRS 2.51]

- the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions; and
- for liabilities arising from share-based payment transactions:
  - the total carrying amount at the end of the period; and
  - the total intrinsic value at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period (e.g. vested share appreciation rights).

8.4 Illustrative disclosures

Illustrative disclosures for share-based payment transactions are included in the IFRS 2 Implementation Guidance at paragraph IG32 and also in Deloitte's IFRS Model Financial Statements, available for download from www.iasplus.com.

8.5 Movements in reserves

8.5.1 Entries arising from IFRS 2

For the IFRS 2 expense, the Standard requires a "corresponding increase in equity". There is nothing in IFRSs to require or prohibit the credit entry going to a separate component of equity.

There is also nothing in IFRSs to prevent the credit entry being taken to retained earnings. Paragraph 48W of the Basis for Conclusions to IAS 19 explains that the phrase 'retained earnings' is not a defined term and, in particular, it is not defined as the cumulative total of profit or loss less amounts distributed to owners.

Local legal and regulatory requirements may have to be taken into account when determining the most appropriate treatment. Local and regulatory requirements in some jurisdictions may require the credit entry to be regarded as capital and therefore prohibit its inclusion in retained earnings

The position becomes more complicated where an ESOP trust is involved, which is often the case with employee share schemes. For example, it may appear to be attractive to take the IFRS 2 credit entry to the 'ESOP reserve' which represents the deduction within equity for own shares held. However, the IFRS 2 credit entry based on grant date fair value is unlikely to equal the purchase price of the shares in the trust less any exercise price, so a difference will build up. These issues are addressed at section 8.5.2 below.

8.5.2 Entries relating to ESOP trusts

The use of ESOP trusts is considered in Chapter 10 of this guide. This section considers the accounting entries that may be required within consolidated reserves when an entity's own shares are held by the trust. From the perspective of the consolidated financial statements, such shares are 'treasury shares' and are deducted from equity in accordance with IAS 32.33. In accordance with IAS 32.34, the amount of treasury shares held may be disclosed either on the face of the balance sheet (e.g. as a separate component of equity) or in the notes (e.g. as a component of retained earnings).

If the deduction is not shown as a separate reserve, (e.g. because it is deducted from the balance of retained earnings) the amount included should be shown by way of note. It will generally be clearer to use a separate reserve where the amount is material.

For the purposes of the following illustration, it is assumed that a separate ESOP reserve is maintained.

Where shares are purchased in the market by an ESOP trust, they will initially be recorded as a debit to the ESOP reserve for the price paid. For example, assuming that the price paid is CU1,000:

	Dr	Cr
Dr ESOP reserve	CU1,000	
Cr Cash		CU1,000

Now if options are granted over these shares with an exercise price of CU800, the following entry will be necessary on exercise:

Dr Cash	CU800	
Dr Retained earnings	CU200	
Cr ESOP reserve		CU1,000

This is because it is illogical to leave a balance on the ESOP reserve which relates to shares that are no longer held. The difference must go somewhere and retained earnings will generally be the most appropriate caption.

However, this does not deal with the accounting entries in reserves that may be required by IFRS 2. These are discussed at section 8.5.1 above. They will generally involve a credit to equity equal to the expense recognised. This credit will usually be taken to retained earnings but there is nothing to prohibit it from being credited to a separate reserve.

It may be tempting to take this credit entry to the ESOP reserve where one exists and the options are to be satisfied by using the shares held by the trust. But, in practice, this does not generally make sense. The credit entry is based on fair value at grant date and is unlikely to coincide with the difference between the purchase price of the shares by the trust and the option exercise price (if any). Therefore, taking the credit entry to the ESOP reserve would be likely to result in that reserve increasing each year and never being eliminated. It is therefore generally preferable for the credit entry arising from IFRS 2 to be taken to retained earnings and for the effects of any purchase of own shares through the ESOP trust to be considered separately.

9. First-time adoption of IFRSs

IFRS 1 *First-time Adoption of International Financial Reporting Standards* includes an optional exemption for share-based payment transactions that was inserted by IFRS 2. The requirements of IFRS 1 when this exemption is used are very similar to the transitional provisions in IFRS 2 itself in that entities are not required (or in practice permitted) to apply the Standard to certain options previously granted. The relevant requirements of IFRS 1 are described below.

9.1 Equity instruments

9.1.1 Limitations on retrospective application

A first-time adopter is encouraged, but not required, to apply IFRS 2 to equity instruments that were: [IFRS 1.25B]

- granted on or before 7 November 2002; or
- granted after 7 November 2002 and vested before the later of the date of transition to IFRSs and 1 January 2005.

The reference to 1 January 2005 is now of limited relevance because entities adopting IFRSs for the first time will almost invariably have a date of transition that is later than 1 January 2005. Therefore, the practical effect of this exemption is that equity instruments that vested before the date of transition can be ignored. This is logical because there would be no expense to recognise in the first IFRS reporting period or comparative period for such instruments. Equity instruments granted on or before 7 November 2002 can also be ignored, even if they have not vested at the date of transition, but this is likely to be of limited relevance now.

However, if a first-time adopter elects to apply IFRS 2 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in IFRS 2. [IFRS 1.25B]

The effect of this requirement is to prohibit full retrospective application of IFRS 2 by most entities because they will not have disclosed publicly the fair value of the equity instruments granted in previous years. The Standard does not elaborate on what is meant by 'disclosed publicly' but it appears that the IASB had in mind disclosure in the financial statements in the year when the instruments were granted. Paragraph IG8 in the Implementation Guidance to IFRS 2 gives, as an example, disclosures made in the notes to the financial statements of the information required in the US by SFAS 123. Although the Basis for Conclusions to IFRS 2 does not explain the reasons for the effective prohibition on full retrospective application, it appears that this was due to concerns about the difficulty of obtaining valuations at earlier dates without being influenced by the benefit of hindsight. Therefore, although the letter of the requirement to have publicly disclosed the fair values might be met in other ways (for example a press release prior to the first IFRS financial statements) it is clear that only contemporaneous disclosure in the financial statements would meet the intentions of the Standard.

For all grants of equity instruments to which IFRS 2 has not been applied (e.g. equity instruments granted on or before 7 November 2002), a first-time adopter should nevertheless disclose the information required by paragraphs 44 and 45 of IFRS 2 (see Chapter 8 of this guide). [IFRS 1.25B]

9.1.2 Use of hindsight when measuring fair value

The following example illustrates the requirements limiting the use of hindsight when measuring equity instruments within the scope of IFRS 2.

Example 9.1.2

Use of hindsight when measuring fair value

Company R adopted IFRSs for the first time with a date of transition of 1 January 2004 and a reporting date of 31 December 2005. Company R issued share options on 30 June 2003 that do not vest until 30 June 2006. The transaction is classified as equity-settled. In accordance with IFRS 1, Company R is required to apply IFRS 2 to the June 2003 grant of share options. Under Company R's previous GAAP, it had not estimated or disclosed fair values as of 30 June 2003 in accordance with IFRS 2. Therefore it had not determined expected volatility, expected life, expected dividends etc.

Should the measurement of the 30 June 2003 share-based payment be based on information available at 30 June 2003 (grant date) or 1 January 2004 (date of transition)?

The application guidance for measurement in Appendix B of IFRS 2 states that inputs to the pricing model relate to expectations about the future based on both historical experience and future expectations. Therefore, estimates should not be based simply on historical data without considering whether past experience is expected to be reasonably predictive of the future.

IFRS 1.33 states that to achieve consistency with IAS 10, estimates under IFRSs that were not required under previous GAAP should reflect conditions that exist at the date of transition to IFRSs. Therefore, Company R should use information available at 1 January 2004 to determine expected volatility, expected dividends, expected life etc.

However, some inputs to the model are based purely on contractual or historical fact. In those cases, that historical information should be used. Therefore, the share price, exercise price and risk free rate should be based on information available at grant date (30 June 2003).

The amount of expense would be recognised over the vesting period. The amount related to the vesting period prior to the date of transition would be recognised directly in equity upon transition to IFRSs.

9.1.3 Modifications to the terms and conditions

If a first-time adopter modifies the terms or conditions of a grant of equity instruments to which IFRS 2 has not been applied, paragraphs 26 to 29 of IFRS 2 need not be applied if the modifications occurred before the later of the date of transition to IFRSs and 1 January 2005. [IFRS 1.25B]

9.2 Liabilities arising from share-based payment transactions

A first-time adopter is encouraged, but not required, to apply IFRS 2 to liabilities arising from share-based payment transactions that were:

- settled before the date of transition to IFRSs; or
- settled before 1 January 2005.

For liabilities to which IFRS 2 is applied, a first-time adopter 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. [IFRS 1.25C]

The following example illustrates these requirements.

Example 9.2

Measurement of liability on first-time adoption

Company Q adopted IFRSs for the first time with a date of transition of 1 January 2004 and a reporting date of 31 December 2005. Company Q issued share options on 30 November 2003 that did not vest until 30 November 2006. The options can only be cash-settled and, therefore, they are classified as such. In accordance with IFRS 1, Company Q is required to apply IFRS 2 to the November 2003 grant of share options, as the liability is not settled before 1 January 2005. Under Company Q's previous GAAP, it has not estimated or disclosed fair value determined as at 30 November 2003 in accordance with IFRS 2. However, it recognised and measured the liability in the previous GAAP financial statements at an amount equal to the difference between the exercise price and the current share price at 31 December 2003.

Can the amount recognised under previous GAAP at 31 December 2003, which is based on the difference between the exercise price and the current share price at 31 December 2003, be used as an approximation of fair value of the options under IFRS 2 at 1 January 2004?

No. The liability is measured at the date of transition (1 January 2004) and at each reporting date until it is settled at its fair value by applying an option pricing model, taking into account the terms and conditions on which the share options were granted and the extent to which the employees have rendered services to date. IFRS 2.BC248 states that the fair value of cash-settled share-based payment includes both the intrinsic value and the time value. Time value in this context is defined as "… the value of the right to participate in future increases in the share price, if any, that may occur between the valuation date and the settlement date". Furthermore, IFRS 2.BC250 states that the exclusion of the time value would lead to an inadequate measure of the liability.

10. Employee share ownership trusts (ESOPs)

Trusts created by a sponsoring entity for employees are designed to facilitate employee shareholding and are often used as vehicles for distributing shares to employees under remuneration schemes. The detailed structures of individual trusts are many and varied, as are the reasons for establishing them.

The IFRIC was asked by the IASB to consider whether the scope exclusion in SIC-12 *Consolidation – Special Purpose Entities* for equity compensation plans should be removed when IFRS 2 became effective. Prior to IFRS 2 becoming effective, these plans were within the scope of IAS 19, although the Standard did not specify any recognition and measurement requirements for such benefits. Once IFRS 2 became effective, IAS 19 no longer applied to equity compensation plans. Also, IFRS 2 amended IAS 32 so that its requirement to deduct treasury shares from equity also applies to shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans and all other share-based payment arrangements.

The IFRIC concluded that, to ensure consistency with IFRS 2 and IAS 32, the scope of SIC-12 should be amended to remove the scope exclusion for equity compensation plans. This proposal was approved and issued in final form in November 2004. The amendment was effective for annual periods beginning on or after 1 January 2005 (i.e. the same as IFRS 2). The Press Release issued by the IASB on publication of the amendment commented that, as a consequence of the amendment "an entity that controls an employee benefit trust (or similar entity set up for the purposes of a share-based payment arrangement) will be required to consolidate that trust".

When considering the amendment to SIC-12 to remove the exemption for equity compensation plans, the IFRIC noted that there were further issues about such arrangements that might be considered. These included the question of whether the arrangements should be accounted for by consolidation or by inclusion in the separate financial statements of the sponsoring entity. However, this matter is not on the IFRIC's current agenda and, in the absence of further clarification from the IFRIC, it is reasonable to assume that, at least in some circumstances, accounting for trust assets and liabilities may be required only in the consolidated financial statements (see also the discussion below).

Trusts created by a sponsoring entity for employees are designated to facilitate employee shareholdings and often used as vehicles for distributing shares to employees under remuneration schemes. The sponsoring entity must consolidate these trusts if the sponsoring entity has control over them. As noted above, IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 contain the primary criteria for determining whether the entity has control over an ESOP trust. In addition to those factors, the following indicators may also provide evidence of control over the trust. However, no one factor, or the absence of one factor, is a determinant of control, or absence of control, without a complete analysis of all the relevant facts and circumstances.

Indicators of control:

- the trust is designed to serve the purposes of the sponsoring entity – that is to compensate the sponsoring entity's employees;
- the sponsoring entity appoints trustees to the trust;
- trustees usually act on advice from the sponsoring entity, e.g. letter of wishes indicating how funds of the trust might be allocated;
- the assets of the trust can be recaptured by the sponsoring entity or its creditors (e.g. in a bankruptcy situation);
- the liabilities of the trust are guaranteed by the sponsoring entity;
- the assets of the trust revert to the sponsoring entity if shares do not vest;
- the sponsoring entity determines the level of future funding to the trust;
- the sponsoring entity has a practice of buying shares from the trust (instead of requiring the trust to sell the shares on the market to be able to pay the employee who wants to exercise his/her right);
- the sponsoring entity determines the allocation of shares to employees;
- the sponsoring entity provides guarantees (or other contracts to protect the trust from liquidity risks);
- at the end of the life of the trust, any surplus in the trust is to be paid to the entity, and any shortfall owing to the entity will constitute a loss by it (or the subsidiaries);
- if the trust makes any profit during a year (with its portfolio), this profit is ceded to the sponsoring entity; and
- the sponsoring entity guarantees a minimum value of the shares.

When a sponsoring entity has control, the assets, liabilities and treasury shares should be recognised in the consolidated financial statements, and:

- consideration paid or received for the purchase or sale of the entity's own shares in a trust should be shown as separate amounts in the reconciliation of movements in equity;
- no gain or loss should be recognised in profit or loss on purchase, sale, issue or cancellation of the entity's own shares;
- finance costs and any administration expenses should be charged as they accrue and not as funding payments are made to the trust; and
- any dividend income on the entity's own shares should be excluded in determining profit before tax and deducted from the aggregate of dividends paid and proposed.

Sufficient information should be disclosed in the financial statements of the sponsoring entity to enable readers to understand the significance of the trust in the context of the sponsoring entity.

11. Employment taxes

In some jurisdictions, employment taxes may be payable which are determined by reference to the gain made by the employee on the exercise of shares options. Such payments of tax are outside the scope of IFRS 2 because they are not payments to the suppliers of goods or services. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would be relevant to the recognition and measurement of such liabilities but provides no specific guidance.

When the amount of tax is based on the gain made by the employee (i.e. intrinsic value at exercise date) the following issues may arise:

- does the entity have a liability before the employee exercises the options?
- if so, how should that liability be measured at each balance sheet date?

These are similar to the questions addressed in IFRS 2 for cash-settled share-based payments. A liability should therefore be recognised at each balance sheet date for such tax. This is consistent with the requirements of IAS 37 as well as IFRS 2 because the 'obligating event' is the granting of the options by the entity rather than the exercise of them by the employees. The liability could be measured on the same basis as required by IFRS 2, although it is acceptable to use intrinsic value at the balance sheet date rather than fair value determined using an option pricing model, given that the liability is outside the scope of IFRS 2. Measuring the liability at fair value in accordance with IFRS 2 is nevertheless to be preferred. Under IFRSs, staff costs generally are within the scope of IAS 19 and that Standard recognises staff costs over the period that services are provided. Therefore, in the absence of any conflicting interpretation by the IFRIC, the liability could be built up over the vesting period.

12. Accounting by entities within groups

As explained at section 2.2 above, it is often the case that employees of a subsidiary will receive part of their remuneration in the form of the shares in the parent, or less commonly in some other group entity. Where this is the case, IFRS 2 requires the entity that has received the benefit of the services to recognise the expense. This is so even if the equity instruments issued are those of another entity within the group. However, IFRS 2 provides no further guidance on the issues that arise from applying IFRS 2 to the individual entities within the group.

Further guidance provided in IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions* is dealt with in sections 12.1 and 12.2 below. Although IFRIC 11 focuses on transactions with employees, it also applies to similar share-based payment transactions with other suppliers of goods or services. [IFRIC 11.6]

IFRIC 11 applies to periods beginning on or after 1 March 2007, with earlier application permitted. If an entity applies IFRIC 11 for an earlier period, it must disclose that fact. [IFRIC 11.12] IFRIC 11 must be applied retrospectively in accordance with IAS 8, subject to the transitional provisions of IFRS 2. [IFRIC 11.13]

12.1 Share-based payment arrangements involving an entity's own equity instruments

The first issue addressed by IFRIC 11 is whether the following transactions should be accounted for as equity-settled or cash-settled under the requirements of IFRS 2: [IFRIC 11.1]

- an entity grants to its employees rights to equity instruments of the entity (e.g. share options) and either chooses or is required (either by contract or necessity) to buy equity instruments (i.e. treasury shares) from another party, to satisfy its obligation to its employees; and
- an entity's employees are granted rights to equity instruments of the entity (e.g. share options), either by the entity itself or by its shareholders, and the shareholders of the entity provide the equity instruments needed.

Share-based payment transactions in which an entity receives services as consideration for its own equity instruments are accounted for as equity-settled. IFRIC 11 confirms that this applies regardless of whether the entity chooses or is required to buy those equity instruments from another party to satisfy its obligations to its employees. This also applies regardless of whether: [IFRIC 11.7]

- the employee's rights to the entity's equity instruments were granted by the entity itself or by its shareholders; or
- the share-based payment arrangement was settled by the entity or by its shareholders.

These requirements of IFRIC 11 are straightforward and simply remove any residual doubt that such transactions should be accounted for as equity-settled even though the entity may not itself issue or transfer any equity instruments as part of the transaction.

IFRIC 11.BC6 notes that an entity should recognise a separate financial liability when it enters into a contractual arrangement to acquire its own equity instruments. This is not dealt with in IFRIC 11 because the requirements of IAS 32 were thought to be clear in this respect.

12.2 Share-based payment arrangements involving equity instruments of the parent

The second issue addressed by IFRIC 11 concerns share-based payment arrangements that involve two or more entities within the same group. For example, the employees of a subsidiary may be granted rights to equity instruments of its parent as consideration for the services they provide to the subsidiary. It is clear from IFRS 2.3 that such arrangements are within the scope of IFRS 2. However, the Standard does not give guidance on how to account for such transactions in the individual or separate financial statements of each group entity. [IFRC 11.2]

IFRIC 11 addresses the following share-based payment arrangements:

- a parent grants rights to its equity instruments direct to the employees of its subsidiary so that the parent (and not the subsidiary) has the obligation to provide the employees of the subsidiary with the equity instruments needed (addressed in section 12.2.1 below); and
- a subsidiary grants rights to equity instruments of its parent to its employees so that the subsidiary (and not the parent) has the obligation to provide its employees with the equity instruments needed (addressed in section 12.2.2 below). [IFRIC 11.3]

IFRIC 11 assumes that it is clear whether the parent or the subsidiary granted the rights to equity instruments and prescribes a different accounting treatment in each case. It may not, in practice, be clear which entity in a group granted the rights to the employees. Often this is done by mutual agreement between the subsidiary and the parent. How to apply IFRIC 11 in these circumstances is considered at section 12.2.3 below.

IFRIC 11 does not address the accounting in the parent entity (which is considered at 12.3 below); nor does it address accounting for any intra-group payments that may be made in the scenarios described (addressed in 12.4 below). However, it does state that classification of the share-based arrangement is not affected by the existence (or otherwise) of payment arrangements between a subsidiary and parent.

12.2.1 A parent grants rights to its equity to employees of its subsidiary

Where a parent grants rights to its equity instruments to employees of its subsidiary, and the arrangement is accounted for as equity-settled in the consolidated financial statements, the subsidiary should in its own separate financial statements measure the services received from its employees in accordance with the requirements of IFRS 2 applicable to equity-settled share-based payment transactions. There will be a corresponding increase recognised in equity as a capital contribution from the parent. [IFRIC 11.8]

IFRIC 11.BC8 explains that from the perspective of the subsidiary, such a transaction does not meet the definition of either an equity-settled transaction or a cash-settled transaction in IFRS 2. The IFRIC concluded that it is not appropriate to account for such an arrangement as cash-settled in the subsidiary's financial statements because the subsidiary does not have an obligation to deliver cash or other assets to its employees. The IFRIC concluded that the equity-settled basis was more consistent with the principles of IFRS 2.

This requirement of IFRIC 11 is straightforward to apply. The expense recognised in the consolidated financial statements is 'pushed down' into the accounts of the relevant subsidiaries that receive the services of the employees.

Example 12.2.1

A parent, P, grants 100 of subsidiary S's employees 30 shares in P each, provided that they remain in employment for 3 years and provided that S meets a particular profit target. The fair value on grant date is CU5 per share. Assume that at the outset, and at the end of years 1 and 2, it is expected that the profit target will be met and that no employees leave.

At the end of year 3, the profit target is met.

Accounting by S

In years 1 to 3, S will record an IFRS 2 charge in profit or loss, and a corresponding entry in equity which reflects the capital contribution it is receiving from P:

Dr	profit or loss	CU5,000 [(CU5 x 30 x 100)/ 3 years]	
Cr	equity (capital contribution)		CU5,000

S makes no further entries when the shares are provided to the employees by its parent.

There is no requirement in IFRSs to credit the capital contribution to a separate component of equity. Therefore, it may be credited to retained earnings if this is permitted in the legal jurisdiction in which S operates (see general discussion of this issue at section 8.5 above).

A parent may grant rights to its equity instruments to the employees of its subsidiaries which are conditional upon the completion of continuing service with the group (rather than a specified subsidiary) for a specified period. An employee may therefore transfer employment from one subsidiary to another during the specified vesting period without the employee's rights under the arrangements being affected. Where this is the case, each subsidiary measures the services received from its employee by reference to the fair value of the equity instruments at the date when the rights were originally granted by the parent and the proportion of the vesting period served by the employee with that subsidiary. [IFRIC 11.9]

Such an employee, after transferring between group entities, may fail to satisfy a vesting condition (e.g. the employee may leave the group before completing the required period of service) other than a market condition. In this case, each subsidiary adjusts the amount previously recognised in respect of the services received from the employee in accordance with IFRS 2.19. Consequently, if the rights to equity instruments do not vest because of a failure to meet a vesting condition (other than a market condition), no amount is recognised on a cumulative basis for the services received from that employee in the financial statements of both subsidiaries. [IFRIC 11.10]

This requirement for all affected group entities to 'true up' at vesting date means that a subsidiary may need to make adjustments to share-based payment expense several years after an employee has transferred elsewhere within the group.

IFRIC 11 does not address the effect of employees transferring between group entities for cash-settled arrangements. Guidance on this issue is provided at section 12.5 below.

12.2.2 A subsidiary grants rights to equity instruments of its parent to its employees

Where the subsidiary grants rights to equity instruments of its parent to employees, the subsidiary accounts for the transaction with its employees as cash-settled. This requirement applies irrespective of how the subsidiary obtains the equity instruments to satisfy the obligations to its employees. [IFRIC 11.11]

IFRIC 11.BC13 explains that from the perspective of the subsidiary, such a transaction does not meet the definition of either an equity-settled transaction or a cash-settled transaction in IFRS 2. The IFRIC concluded that accounting for this transaction as cash-settled is more consistent with the principles of IFRS 2 because the subsidiary has an obligation to provide its employees with equity instruments of the parent, which are treated as assets of the subsidiary when acquired by the subsidiary. The practical implications of accounting for arrangements as cash-settled in the subsidiary while they are equity-settled from the perspective of the group are considered further at section 12.7 below.

IFRIC 11 does not address the accounting required in the subsidiary when it has recognised a liability for an arrangement as cash-settled but subsequently makes no cash payment because the parent provides the shares without any reimbursement. IFRS 2 addresses transactions with settlement alternatives (see Chapter 7 of this guide) but these do not apply to this situation because they envisage only the grantor of the rights or the counterparty having the choice, whereas in this case the choice lies with a third party – the parent. If the parent satisfies the subsidiary's obligation, the liability will be removed from the balance sheet of the subsidiary with the credit recognised in equity as a capital contribution from the parent. The expense recognised in respect of the services received is not reversed.

12.2.3 Determining which entity has granted the rights

To apply the requirements of IFRIC 11 set out at section 12.2.1 and 12.2.2 above, it will be necessary to determine which entity in the group granted the rights to the employees. This will require a careful assessment of the particular facts and circumstances. The factors to be considered include but are not limited to:

- the contractual terms of the share scheme;
- any formal documentation provided to the employees that are granted the rights;
- any other communications provided to employees;
- whether the scheme is specific to one subsidiary or covers a number of subsidiaries within a group; and
- any other aspects of the arrangements, whether formally documented or not.

As explained above, IFRIC 11 states that the arrangements should be accounted for as cash-settled by the subsidiary where it is the subsidiary that has granted the rights to equity instruments of the parent, irrespective of how the subsidiary obtains the equity instruments to satisfy the obligation to the employees.

12.3 Accounting in the parent's separate financial statements

IFRIC 11 addresses whether arrangements that are accounted for as equity-settled in the consolidated financial statements should be accounted for as equity-settled or cash-settled in the financial statements of the subsidiary. It does not address the accounting in the parent entity.

The illustrative example accompanying IFRIC D17 (the exposure draft upon which IFRIC 11 is based) included accounting entries for the separate financial statements of the parent. These entries are omitted from the illustrative example accompanying IFRIC 11 because the IFRIC decided that accounting by the parent was outside of the scope of the Interpretation. The illustrative example accompanying D17 dealt with the case where the parent has granted the rights so that the arrangement is equity settled for both the group and the subsidiary but it is possible to apply the same principles in other cases (see sections 12.3.1 to 12.3.3 below).

12.3.1 Equity-settled for the group and the subsidiary

The illustrative example accompanying D17 suggested that the parent should record an entry each year to debit the cost of investment in subsidiary and credit equity with an amount equal to the expense recognised in the subsidiary in accordance with IFRS 2. This was not explained in the Basis for Conclusions which accompanied D17 but the rationale was that the parent had made a capital contribution to the subsidiary (assuming the subsidiary has not paid fair value) as the reimbursement to the parent by taking on the cost of remunerating the subsidiary's employees that the subsidiary would otherwise have had to bear, and had also granted an equity instrument in accepting the obligation to those employees. This is consistent with the credit to equity recognised in the subsidiary which IFRIC 11 refers to as 'contribution from parent'. It is understood that the entry illustrated in D17 was not explained or justified because the members of the IFRIC regarded it as uncontentious generally accepted practice. Such an entry should be recorded as a necessary consequence of the requirement to follow GAAP.

Increasing the cost of investment in a subsidiary may in rare cases give rise to impairment issues, and this should be considered where appropriate.

Example 12.3.1A

The facts are the same as in Example 12.2.1 above.

<u>*Accounting by P*</u>

In years 1 to 3, P will record the enhancement to its investment in S, and a corresponding entry in equity which reflects the capital contribution being made to S and the equity instrument being granted to S's employees:

Dr cost of investment	CU5,000	
Cr equity		CU5,000

P will have to make further entries when it transfers the shares to the employees. These entries will depend on whether P issues new shares or utilises shares purchased in the market and held as treasury shares. The entries may also be affected by the involvement of an ESOP trust.

In the same way that the subsidiary will true-up the IFRS 2 expense to reflect changes in non-market vesting conditions, so will the parent 'true-up' its contributions to the subsidiary. This will usually result in symmetrical accounting for the capital contribution between the parent and subsidiary.

Example 12.3.1B

The facts are the same as in Example 12.2.1 above except that at the end of year 3, the profit target is not met.

Accounting by P

In years 1 and 2, P will record an enhancement to its investment in S, and a corresponding entry in equity which reflects the capital contribution being made to S and the equity instrument being granted to S's employees:

Dr cost of investment	CU5,000	
Cr equity		CU5,000

At the end of year 3, the profit target is not met, so P must true-up the amounts recorded to reflect the non-market vesting condition not being met:

Dr equity	CU10,000	
Cr cost of investment		CU10,000

This true-up in P therefore mirrors the accounting entries posted by S.

12.3.2 Cash-settled for the group and the subsidiary

There are two different scenarios in which a scheme might be accounted for as cash-settled both by the group and by the subsidiary. The first is where the subsidiary itself has the obligation to transfer cash or other assets (other than equity instruments of the group) to its employees. The second is where the parent has the obligation to transfer cash or other assets (other than equity instruments of the group) to its subsidiary's employees.

No accounting is required by the parent when the subsidiary has the obligation to its employees and makes a cash payment to satisfy the obligation. Where the parent makes a cash payment to satisfy the obligation of its subsidiary, the parent records the amount of the cash payment as a capital contribution, increasing the cost of investment in its subsidiary. Such arrangements are considered further at section 12.5 below.

Where the parent has the obligation to its subsidiary's employees, it will need to record a liability in accordance with IFRS 2, and should record the other side of the entry as an increase in the cost of investment in its subsidiary, as it is effectively making a capital contribution by taking on the liability on behalf of its subsidiary.

12.3.3 Equity-settled for the group but cash-settled for the subsidiary

No accounting is required by the parent when the subsidiary has the obligation to its employees and satisfies that obligation, for example by purchasing its parent's shares in the market.

Assuming that no formal intra-group settlement arrangements were in place, where the parent subsequently provides shares to the subsidiary's employees for no consideration, the subsidiary records the credit arising from derecognition of the liability as a capital contribution in equity (see section 12.3.2 above). There are two possible views on the amount that should be recognised as a capital contribution by the parent:

- the equity-settled amount recognised in the consolidated financial statements; or
- the cash-settled amount recognised in the subsidiary's financial statements.

Where the parent has not made a cash payment but has issued equity securities to satisfy the obligation, some might argue that the credit to equity in the parent's separate financial statements should be the same as the equivalent credit in the consolidated financial statements because they relate to the same equity instrument.

The second view is, however, more logical and consistent with IFRIC 11. The reasoning implicit in IFRIC 11 means that, although the group has created an equity instrument at grant date, the parent has not; instead, the parent first creates an equity instrument when it actually issues the shares. Moreover, the parent has relieved the subsidiary of its obligation, which means the contribution received by the subsidiary equals the amount of the obligation recorded in its financial statements. Thus, it is this amount that should be recognised by the parent.

Practical application of these principles is considered further at section 12.7 below.

12.4 Accounting for intra-group recharges

The IFRIC discussed whether IFRIC 11 should address how to account for an intra-group payment arrangement under which the subsidiary pays the parent for the provision of equity instruments to the employees. As explained in IFRIC 11.BC12, the IFRIC decided not to address the issue because it did not wish to widen the scope of the Interpretation to an issue that relates to the accounting for intra-group payment arrangements generally.

The illustrative example accompanying IFRIC D17 (the exposure draft upon which IFRIC 11 is based) included guidance on this issue. This guidance is omitted from the illustrative example accompanying IFRIC 11.

The illustrative example accompanying D17 stated that if the parent levies an inter-company charge on the subsidiary, the amount of that charge is offset against the capital contribution in the individual and separate financial statements of the subsidiary and the parent. It also stated that if the amount of the charge exceeds the capital contribution, that excess is accounted for as a distribution from the subsidiary to the parent. Thus, in effect, D17 proposed to account for any difference between expense and reimbursement as a transaction with shareholders, i.e. a capital contribution or distribution.

The same logic applies irrespective of whether an arrangement is an equity-settled share-based payment arrangement or a cash-settled one.

There is no specific requirement in IFRS literature to present inter-company recharges of share-based payments in this way, but the net approach illustrated in D17 appears reasonable and has been used as the basis for the guidance set out below. Nevertheless, other approaches may also be acceptable, providing they do not misstate the amount recorded in respect of share-based payment expense. For example, an entity might instead account separately for services received (as a capital contribution) and for payments made (as a distribution), without offsetting the two. Moreover, where the amount payable to the parent is conditional on share awards vesting, a subsidiary might account for a reimbursement obligation as a derivative financial instrument. Whatever the approach adopted, careful judgement should be applied to ensure that the accounting properly reflects the substance of the arrangement.

Some complexities may arise if the timing of the inter-company charges is different from the recognition of the expense under IFRS 2. For example, it is possible that the charge might be levied only when the options are exercised by the employees. Some of these issues are considered in the illustrative examples below.

Where the charge made is greater than the expense recognised in accordance with IFRS 2, as will typically be the case where the charge is based on the intrinsic value on exercise of options, the excess will be accounted for as a distribution. Consequently, it will not be recognised as an expense in the subsidiary but will be recognised as income in the parent.

The fact that the excess charge will be accounted for as a distribution does not necessarily mean that it will be a distribution as a matter of law. The position may vary according to the legal jurisdiction. Legal advice should be sought where necessary.

Example 12.4A

Reimbursement over the term of the arrangement

P grants 100 of S's employees 30 shares in P each, provided that the employees remain in employment for 3 years. Assume that at the outset, and at the end of years 1 and 2, it is expected that all of the employees will remain in employment for the full 3 years. At the end of year 3, none of the employees have left. The fair value of the shares on grant date is CU5 per share.

Assume further that S will pay P an amount equal to 75% of the final charge reflected in S's income statement. S agrees to pay P over the term of the arrangement. Over that period, it expects to charge a total amount of CU15,000, and so expects to pay P CU11,250 (CU15,000 x 75%). S therefore pays P CU3,750 (CU11,250 / 3 each year).

Accounting by S

In years 1 to 3, S will record an IFRS 2 expense in profit or loss, the cash paid to P, and the balance being the capital contribution it is receiving from P:

Dr income statement	CU5,000	
Cr cash		CU3,750
Cr equity (capital contribution)		CU1,250

Accounting by P

In years 1 to 3, P will record an entry to equity for the instruments being granted, the cash reimbursed by S, and the balance being the capital contribution it has made to S:

Dr cost of investment	CU1,250	
Dr cash	CU3,750	
Cr equity		CU5,000

Example 12.4B

Reimbursement (if any) at the end of the arrangement – no right to reimbursement

The facts are as in Example 12.4A, except that S pays P at the end of the arrangement, i.e. when shares vest. This example assumes that there is no right to reimbursement, i.e. reimbursement (if any) is agreed at vesting.

Accounting by S

In years 1 to 3, S will record the IFRS 2 expense in profit or loss and a capital contribution from P:

Dr profit or loss	CU5,000	
Cr equity (capital contribution)		CU5,000

At the end of year 3, all the shares vest, and S pays P CU11,250. The payment is treated as a distribution to P:

Dr equity (distribution)	CU11,250	
Cr cash		CU11,250

Accounting by P

In years 1 to 3, P will record an entry to equity for the instruments being granted and the capital contribution made to S:

Dr cost of investment	CU5,000	
Cr equity		CU5,000

At the end of year 3, all the shares vest and S pays P CU11,250. The payment is treated as dividend income, unless it can be demonstrated that it is in substance a return of capital by S:

Dr cash	CU11,250	
Cr dividend income		CU11,250

Where necessary, P should also record an impairment charge for the cost of its investment in S.

Example 12.4C

Reimbursement at the end of the arrangement – right to reimbursement

The facts are as in Example 12.4A, except that S pays P at the end of the arrangement, i.e. when shares vest. This example assumes that there is, from the outset, a binding agreement between S and P that S will pay P an amount equal to 75% of the final charge reflected in S's income statement.

Accounting by S

In years 1 to 3, S will record the IFRS 2 expense in profit or loss, a creditor for 75% of this amount and a capital contribution from P for the balance:

Dr profit or loss	CU5,000	
Cr intra-group creditors		CU3,750
Cr equity (capital contribution)		CU1,250

At the end of year 3, all the shares vest, and S pays P CU11,250, settling the liability recorded.

Accounting by P

In years 1 to 3, P will record an entry to equity for the instruments being granted and a receivable from S:

Dr intra-group debtors	CU3,750	
Dr cost of investment	CU1,250	
Cr equity		CU5,000

At the end of year 3, all the shares vest and S pays P CU11,250:

Dr cash	CU11,250	
Cr intra-group debtors		CU11,250

(Discounting has been ignored for simplicity.)

A common situation is where the reimbursement is made based on the intrinsic value on vesting (or on actual exercise in the case of options). This will often result in a reimbursement that exceeds the grant date fair value recognised under IFRS 2. The excess of the amount of the reimbursement over the IFRS 2 expense will be accounted for as a distribution by the subsidiary. This is illustrated in the following example. For simplicity, it has been assumed that there is no entitlement to the reimbursement and that it is therefore accounted for only when made. Otherwise it would be necessary for S to estimate the amount of the accrued reimbursement to be recognised at each balance sheet date.

Example 12.4D

Reimbursement at the end of the arrangement equal to the intrinsic value at that date – no right to reimbursement

The facts are as in Example 12.4A, except that S pays P at the end of the arrangement an amount equal to the intrinsic value at that date. This amount is assumed to be CU25,000.

Accounting by S

In years 1 to 3, S will record the IFRS 2 expense in profit or loss and a capital contribution from P:

Dr profit or loss	CU5,000	
Cr equity (capital contribution)		CU5,000

At the end of year 3, all the shares vest, and S pays P CU25,000, which is accounted for as a distribution.

Dr equity (distribution)	CU25,000	
Cr cash		CU25,000

Accounting by P

In years 1 to 3, P will record an entry to equity for the instruments being granted and the capital contribution made to S:

Dr cost of investment	CU5,000	
Cr equity		CU5,000

At the end of year 3, all the shares vest and S pays P CU25,000, which is accounted for a distribution from S and therefore recognised as income by P.

Dr cash	CU25,000	
Cr income statement (distribution from subsidiary)		CU25,000

12.5 Cash-settled arrangements in the consolidated financial statements

IFRIC 11 deals with the case when share-based payments arrangements are accounted for as equity-settled in the consolidated financial statements but may be cash-settled from the perspective of a subsidiary. It does not include any requirements in the case where the arrangement is accounted for as cash-settled in the consolidated financial statements.

The position is straightforward in the simple case when the subsidiary has the obligation to its employee and makes a cash payment to satisfy the obligation. The expense recognised in the consolidated financial statements and in the financial statements of the subsidiary will be the same amount. No entries will be recorded by the parent.

In a cash-settled arrangement like share appreciation rights where cash is payable by the parent to the employees of a subsidiary the subsidiary has no obligation to make any cash payments or to issue any of its own equity instruments.

Applying the principles of IFRIC 11, the subsidiary would recognise an expense of the same amount as that recognised in the consolidated financial statements with the credit going to equity as a capital contribution from the parent. The parent will debit the cash payment to the cost of investment in the subsidiary as a capital contribution.

12.5.1 Transfers of employees between group entities

IFRIC 11 addresses the effect of employees transferring between group companies for equity-settled arrangements (addressed in section 12.2.1 above) but not for cash-settled arrangements. In each case it will be necessary to consider which entity or entities in the group have the obligation to settle with the employee and recognise their liabilities accordingly. This will depend on the particular terms of the scheme.

It may be that the subsidiary which has the obligation to settle the liability to the employee is the one where he or she is employed at vesting. The question that arises is how, on movement of employment between subsidiaries, the transfer of the accrued liability should be treated. The first subsidiary has received a capital contribution while the second has made a distribution by relieving the sister subsidiary of its obligation for no charge (i.e. it has effectively made a distribution on direction of the parent). The first subsidiary should credit the release of the liability to equity while the second charges the recognition of the liability to equity.

Although the first subsidiary derecognises the liability; it also neither reverses nor adjusts the expense it had previously recognised for the cash-settled amount. This is consistent with the guidance in IFRS 2.IG19 which says that the amount recognised for the services received and included in the carrying amount of an asset recognised for the entity's balance sheet should not be adjusted for subsequent re-measurements of the liability.

In situations when the parent has the obligation to settle the liability, subsidiaries treat their liabilities in the same way as in the previous scenario. The expense amount, however, should continue to be adjusted until vesting so that the subsidiary bears the proportion of the total cash-settled amount related to the period of the employee's employment with that subsidiary (see Example 12.5.1 below). This is consistent with the IFRIC 11's logic in respect of the transfers of employees in equity-settled arrangements. [IFRIC 11.9] This adjustment is taken to equity as an adjustment to the amount credited to equity when the liability was derecognised.

Example 12.5.1

Parent has obligation to settle the liability

A group employee is awarded a cash-settled share-based payment by the group's parent, P, such that an amount will be payable if he works for the group for three years. The amount payable will be cash to the value of 1,000 shares of P. The share price of P is CU10 at the grant date, CU14 at the end of year 1, CU13 at the end of year 2 and CU16 at vesting date. The award will be settled by P, and there are no intra-group payment arrangements.

The employee works for subsidiary A throughout the first year, but transfers to subsidiary B for years 2 and 3.

The expense to be recorded by the group is as follows:

	Cumulative	Charge in year
	CU	CU
Year 1: 1,000 x CU14 x 1/3	4,667	4,667
Year 2: 1,000 x CU13 x 2/3	8,667	4,000
Year 3: 1,000 x CU16 x 3/3	16,000	7,333

This is allocated between subsidiaries A and B as follows:

	Subsidiary A		Subsidiary B	
	Cumulative	Charge in year	Cumulative	Charge in year
	CU	CU	CU	CU
Year 1:				
A = 1,000 x CU14 x 1/3	4,667	4,667	–	–
Year 2:				
A = 1,000 x CU13 x 1/3	4,333	(334)		
B = 1,000 x CU13 x 1/3		4,334		4,334
Year 3:				
A = 1,000 x CU16 x 1/3	5,333	1,000		
B = 1,000 x CU16 x 2/3			10,667	6,333

12.6 Effect of the use of ESOP trusts

ESOP trusts may potentially be accounted for in two different ways depending on the circumstances (see Chapter 10 of this guide). Where the assets and liabilities of the trust are recognised as those of the sponsoring entity, any obligations of the trust will be regarded as obligations of the sponsoring entity.

The analysis will be different where the trust is regarded as a subsidiary undertaking. In this case the rights and obligations of the trust will be reflected in its own individual financial statements, rather than those of the sponsoring entity.

It will be necessary to apply the requirements of IFRIC 11 and the other guidance in this chapter to the particular facts of each case. In particular, the guidance at section 12.2.3 above will be relevant to determining which entity has granted the rights and therefore has the obligation to employees.

The analysis might be further complicated when in practice three entities are involved in the arrangement. The third entity might be a fellow subsidiary or intermediate parent which grants the options and delivers the shares to the employees (either directly or via an ESOP trust).

12.7 Subsidiary purchases parent's shares

In order to settle its obligation to employees, the subsidiary will often need to acquire parent's shares either in the market or directly from the parent.

When the subsidiary purchases shares in the market to satisfy its obligation at the vesting date, the price paid will normally be the same as the liability recognised so that no gain or loss will arise on settlement. The subsidiary will not have any entries in equity arising from the arrangements because it has not issued any equity instruments and has not received any capital contribution from its parent. The parent will have no entries to record because it is not a party to the arrangement.

Alternatively, the subsidiary may purchase shares in the market prior to vesting date, and hold them as an asset to provide an economic hedge against the uncertain liability for the cash-settled amount. Such arrangements cannot qualify for hedge accounting under IAS 39 for the reasons explained at section 12.7.1 below. They are, however, sometimes referred to in practice as hedging arrangements because they may eliminate or reduce uncertainty about the cash cost of meeting the cash-settled obligation.

When the parent issues its shares to the subsidiary at the market price, from the subsidiary's perspective this is no different from purchasing shares in the market and the guidance above is relevant. The parent would record an issue of shares for full consideration in the normal way.

If a subsidiary purchases shares in its parent they will be financial assets in the individual financial statements of the subsidiary even though they will be treasury shares in the consolidated financial statements of the parent. They will therefore either be classified as 'available-for-sale' (which is the default category) or designated as 'at fair value through profit or loss' if the relevant requirements of IAS 39 can be met.

One of the circumstances in which an asset may be designated as 'at fair value through profit or loss' is where doing so results in more relevant information because it eliminates or significantly reduces a measurement or recognition inconsistency) sometimes referred to as 'an accounting mismatch' that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. Judgement on whether designation as at fair value through profit or loss would significantly reduce a measurement or recognition inconsistency will need to be based on a careful analysis of the specific facts and circumstances in each case.

Where shares are classified as available-for-sale, the cumulative gains or losses taken to equity will be recycled on disposal (i.e. when the shares are delivered to employees).

12.7.1 Hedge accounting under IAS 39

Although 'economic hedges' can be achieved for some share-based arrangements, as described in section 12.7 above, IAS 39 *Financial Instruments: Recognition and Measurement* sets out detailed rules on hedge accounting, including which items can be hedged and which instruments can qualify as hedging instruments.

Under IAS 39, it is not possible to apply hedge accounting to an equity-settled share-based payment arrangement as the Standard prohibits own equity as a hedged item.

A liability recognised under a cash-settled share-based payment arrangement can qualify as a hedged item. But it is important to note that the subsidiary cannot designate shares in its parent (whether held directly or via an ESOP trust) as a hedging instrument. A subsidiary might consider purchasing options over parent shares and designating them as a hedging instrument in hedging the forecast employee expense. However, it will still need to meet the detailed requirements of IAS 39 in order to achieve hedge accounting, including those relating to effectiveness. In practice, many groups may conclude that the benefits of obtaining hedge accounting in a subsidiary are insufficient to outweigh the associated practical difficulties.

13. Current and deferred tax

The impact of share-based payments on current and deferred tax is dealt with in IAS 12 *Income Taxes*.

In some tax jurisdictions, an entity receives a tax deduction that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with IFRS 2, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise. [IAS 12.68A]

The difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it should be estimated, based on information available at the end of the period. For example, if the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. [IAS 12.68B]

The amount of the tax deduction (or estimated future tax deduction) may differ from the related cumulative remuneration expense. Paragraph 58 of IAS 12 requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event which is recognised, in the same or a different period, directly in equity, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) for a share-based payment exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity. [IAS 12.68C]

When recognising such an excess in equity, the amount is considered to relate to the issuance of equity instruments rather than the entity's performance and, accordingly, is not included in the Statement of Recognised Income and Expense (SORIE).

Although IAS 12.68C does not explicitly state that it deals only with equity-settled share-based payments, the justification given for the accounting treatment is that the excess deduction indicates that the deduction relates to an equity item as well as to the remuneration expense. In the case of a cash-settled share-based payment, there is no equity item recognised to which the deduction could relate and, accordingly, it is appropriate to recognise the entire deduction in profit or loss.

Where employee share schemes are modified (e.g. from being equity-settled to cash-settled), these modifications can change the accounting for the scheme (e.g. by requiring that a liability be recorded). It is important to note that the modification may also affect any deferred tax balances recorded.

Appendix B to IAS 12 contains the following example of how to calculate the deferred tax asset associated with an employee share remuneration scheme.

Example 13

Deferred tax on employee share remuneration schemes

[IAS 12, Appendix B, Example 5]

In accordance with IFRS 2 *Share-based Payment*, an entity has recognised an expense for the consumption of employee services received as consideration for share options granted. A tax deduction will not arise until the options are exercised, and the deduction is based on the options' intrinsic value at exercise date.

As explained in paragraph 68B of [IAS 12], the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods in respect of those services), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. Paragraph 68B requires that, if the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it should be estimated, based on information available at the end of the period. If the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. Therefore, in this example, the estimated future tax deduction (and hence the measurement of the deferred tax asset) should be based on the options' intrinsic value at the end of the period.

As explained in paragraph 68C of the [IAS 12], if the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, paragraph 68C requires that the excess of the associated current or deferred tax should be recognised directly in equity.

The entity's tax rate is 40 per cent. The options were granted at the start of year 1, vested at the end of year 3 and were exercised at the end of year 5. Details of the expense recognised for employee services received and consumed in each accounting period, the number of options outstanding at each year-end, and the intrinsic value of the options at each year-end, are as follows:

	Employee services expense	Number of options at year-end	Intrinsic value per option
Year 1	188,000	50,000	5
Year 2	185,000	45,000	8
Year 3	190,000	40,000	13
Year 4	0	40,000	17
Year 5	0	40,000	20

The entity recognises a deferred tax asset and deferred tax income in years 1 – 4 and current tax income in year 5 as follows. In years 4 and 5, some of the deferred and current tax income is recognised directly in equity, because the estimated (and actual) tax deduction exceeds the cumulative remuneration expense.

Year 1

Deferred tax asset and deferred tax income:

(50,000 x 5 x 1/3[1] x 0.40) = 33,333

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 83,333 (50,000 x 5 x 1/3) is less than the cumulative remuneration expense of 188,000.

Year 2

Deferred tax asset at year-end:

(45,000 x 8 x 2/3 x 0.40) =	96,000
Less deferred tax asset at start of year	(33,333)
Deferred tax income for year	62,667*

* This amount consists of the following:

Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their carrying amount of nil:

(45,000 x 8 x 1/3 x 0.40)	48,000
Tax income resulting from an adjustment to the tax base of employee services received in previous years:	
(a) increase in intrinsic value: (45,000 x 3 x 1/3 x 0.40)	18,000
(b) decrease in number of options: (5,000 x 5 x 1/3 x 0.40)	(3,333)
Deferred tax income for year	62,667

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 240,000 (45,000 x 8 x 2/3) is less than the cumulative remuneration expense of 373,000 (188,000 + 185,000).

Year 3

Deferred tax asset at year-end:

(40,000 x 13 x 0.40) =	208,000
Less deferred tax asset at start of year	(96,000)
Deferred tax income for year	112,000

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 520,000 (40,000 x 13) is less than the cumulative remuneration expense of 563,000 (188,000 + 185,000 + 190,000).

Year 4

Deferred tax asset at year-end:

(40,000 x 17 x 0.40) =	272,000
Less deferred tax asset at start of year	(208,000)
Deferred tax income for year	64,000

The deferred tax income is recognised partly in profit or loss and partly directly in equity as follows:

Estimated future tax deduction (40,000 x 17) =	680,000
Cumulative remuneration expense	563,000
Excess tax deduction	117,000
Deferred tax income for year	64,000
Excess recognised directly in equity (117,000 x 0.40) =	46,800
Recognised in profit or loss	17,200

Year 5

Deferred tax expense (reversal of deferred tax asset)	272,000
Amount recognised directly in equity (reversal of cumulative deferred tax income recognised directly in equity)	46,800
Amount recognised in profit or loss	225,200
Current tax income based on intrinsic value of options at exercise date (40,000 x 20 x 0.40) =	320,000
Amount recognised in profit or loss (563,000 x 0.40) =	225,200
Amount recognised directly in equity	94,800

Summary

	Income statement				Balance sheet	
	Employee services expense	Current tax expense (income)	Deferred tax expense (income)	Total tax expense (income)	Equity	Deferred tax asset
Year 1	188,000	0	(33,333)	(33,333)	0	33,333
Year 2	185,000	0	(62,667)	(62,667)	0	96,000
Year 3	190,000	0	(112,000)	(112,000)	0	208,000
Year 4	0	0	(17,200)	(17,200)	(46,800)	272,000
Year 5	0	(225,200)	225,200	0	46,800	0
					(94,800)	
Totals	563,000	(225,200)	0	(225,200)	(94,800)	0

Footnotes

1 The tax base of the employee services received is based on the intrinsic value of the options, and those options were granted for three years' services. Because only one year's services have been received to date, it is necessary to multiply the option's intrinsic value by one-third to arrive at the tax base of the employee services received in year 1.

Appendix 1

Comparison between IFRSs and US GAAP

The following is a very brief comparison of the requirements of IFRS 2 with those of the US standard SFAS 123 *Accounting for Stock-Based Compensation*. The key differences are highlighted. The summary does not attempt to capture all of the differences that exist or that may be material to a particular entity's financial statements. Our focus is on differences that are commonly found in practice.

Topic	IFRSs	US GAAP
Date for measuring share-based payment to non-employees	Modified grant date method.	Earlier of counterparty's commitment to perform (where a sufficiently large disincentive for non-performance exists) or actual performance.
Modification of an award by change in performance condition (improbable to probable) (Type III modifications)	Expense determined based on the grant date fair value.	Expense determined based on fair value at the modification date.
Share-based payments with graded vesting features	Charge is recognised on an accelerated basis to reflect the vesting as it occurs.	An accounting policy choice exists for awards with a service condition only to either: (a) amortise the entire grant on a straight-line basis over the longest vesting period; or (b) recognise a charge similar to IFRSs.
Balance sheet classification of share-based payment arrangements	Focus on whether the award can be cash settled.	More detailed requirements that may result in more share-based arrangements being classified as liabilities.
Recognition of payroll taxes levied on share-based payments	Liability is recognised at the grant date or as services are provided over the vesting period.	Liability is recognised in the period when the tax is levied (e.g. at exercise of award).

Topic	IFRSs	US GAAP
Calculation of tax benefits related to share-based payments	Deferred tax is computed based on the tax deduction for the share-based payment under the applicable tax law (i.e. intrinsic value).	Deferred tax is computed based on the GAAP expense recognised and trued up or down at realisation of the tax benefit/deficit.

Source: IFRSs and US GAAP: A pocket comparison (March 2007)

Appendix 2

Valuation models

This appendix provides a brief description of the three most common option pricing models, and the strengths and wealnesses of each of those models.

Black-Scholes

Application of the Black-Scholes model tends to be a straight-forward calculation, which requires only six inputs. These are:

- share price at grant date;
- exercise price;
- dividend yield;
- expected life;
- risk-free interest rate; and
- volatility.

The Black-Scholes approach assumes that exercise of the option can only take place at one point in time. It requires an expected life assumption as to when the option is likely to be exercised and does not allow for variable exercise dates.

The strengths of the Black-Scholes model are:

- generally accepted method for valuing share options, with wide acceptance in the market;
- many companies with share option plans use the Black-Scholes model to compute the fair value of their share awards. The consistent use of this model also enhances the comparability between the entities; and
- formula required to calculate the fair value is straight-forward and can be easily included in spreadsheets.

The weaknesses of the Black-Scholes model are:

- the Black-Scholes model assumes that the exercise of the option can only take place at one point in time. It does not allow for variable exercise dates. This model may undervalue the plan option as options that are out-of-the money at the end of the expected life are assumed to expire worthless. However, there is additional value arising from the possibility that the options may subsequently come back into the money before the end of the full contractual term. This can be a major issue for options that have a long exercise window, where one point in the exercise window has to be chosen when exercise takes place;

- the Black-Scholes model is described as a 'closed form solution' because inputs and assumptions are made to cover the entire period during which the option is outstanding. For example, volatility of the underlying shares may be expected to change over the period. The Black-Scholes model cannot take this into account; and
- the Black-Scholes model cannot typically take account of most market-based performance conditions (although certain variations are possible to cope with some such conditions).

Binomial model

The binomial model breaks down the time to expiration into potentially a large number of time intervals or steps. A tree of share prices is initially produced working forward from the present time to expiration of the option. At each step it is assumed that the share price will move up or down by an amount calculated using the volatility assumption and the length of each time interval. The probabilities of upwards and downward movements are calculated using risk-neutral probabilities derived from the size of the upward and downward steps and the risk-free rate of return. This produces a binomial distribution, or tree, of underlying share prices. The tree represents all possible paths that the share price could take during the life of the option. Factors that affect the share price, such as dividends, are adjusted for in the binomial tree as they are paid during the contractual life. At the end of the tree – that is, the expiration of the option – all the terminal option payoffs for each of the final possible share prices are known as they simply equal their intrinsic values.

Next, the option values at each step of the tree are calculated working back from expiration to the present. The option values at each step are used to derive the option values at the preceding step of the tree using a risk-neutral valuation. This risk-neutral valuation uses the risk-free rate of interest as a discount factor and risk-neutral probabilities of the share price moving up or down. Certain adjustments to option prices (e.g. market-based vesting features) can be worked into the calculations at the required point in time (although not all market-based conditions can be incorporated), meaning that another approach, e.g. Monte Carlo, may be required – see below. At the start of the tree, the option's fair value is obtained.

If the inputs and assumptions used in the Black-Scholes and the binomial models were the same, the results would be similar.

The strengths of the binomial model are:

- the binomial model is described as an 'open form solution' as it can incorporate different values for variables (such as volatility) over the term of the option. Therefore, many believe the inputs into the model are better reflective of an option with a longer term. In particular, it can take account of exercise on variable dates, whereas the Black-Scholes model assumes any exercise takes place at one particular time;
- the model can be adjusted to take account of market conditions and other factors; and

- the binomial model has also been generally accepted as a more flexible alternative to the Black-Scholes model.

The weaknesses of the binomial model are:

- the Black-Scholes model allows the value of an option to be calculated using a relatively simple spreadsheet. However, the binomial model requires a considerably more complex spreadsheet or program to calculate the option value; and
- in addition, it is necessary to make a number of judgemental decisions as to how various factors (e.g. employee exercise behaviour) are taken into account.

Monte Carlo model

A Monte Carlo model works by simulating a large number of projected random outcomes for how the share price may move in future. The relevant share price may be that of the entity and, if applicable, those of comparator entities (for example, where there are market-based performance conditions based on relative Total Shareholder Return rankings).

Based on each simulated share price (or set of comparator entity share prices), the proportion of awards that would vest and the resultant pay-off is determined. This is then discounted back to the valuation date at the risk-free interest rate. The procedure is then repeated a large number of times to determine the expected (average) value of the award at the valuation date.

The strengths of the Monte Carlo model are:

- it is the most flexible of the models described. It can take account of complex market-based vesting conditions, exercise behaviours and factors;
- it may be easier to explain/understand the results; and
- it can be used to look at the distribution of payoffs.

The weaknesses of the Monte Carlo model are:

- it requires a program or complex spreadsheet with an embedded program to calculate the option value; and
- it may require in excess of 10,000 simulations or more to obtain a sufficiently accurate answer. Depending on the features of the model, this can require a large amount of computer processing time and as such it would generally be used only where it is not possible or appropriate to use other methods.

Appendix 3

IFRS 2: Presentation and disclosure checklist

Reference	Presentation/disclosure requirement
	The Implementation Guidance accompanying IFRS 2 provides an illustration of one way of satisfying the disclosure requirements of paragraphs 44 to 52 of IFRS 2. Note that the illustrative example if not exhaustive and, in particular, it does not illustrate the disclosure requirements in paragraphs 47(c), 48 and 49 of IFRS 2.
	The nature and extent of share-based payment arrangements that existed in the period
IFRS 2.44	The entity shall disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.
	Note: Paragraph 45 of IFRS 2, set out below, specifies the minimum disclosures required to satisfy this requirement.
	The entity shall disclose the following (at a minimum):
IFRS 2.45(a)	a) a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement;
	Notes:
IFRS 2.45(a)	*1) The general terms and conditions of share-based payment arrangements will include items such as vesting requirements, the maximum term of the options granted, and the method of settlement (cash or equity or both).*
IFRS 2.45(a)	*2) An entity with substantially similar types of share-based payment arrangements may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 44 of IFRS 2 (see above).*

Reference	Presentation/disclosure requirement
IFRS 2.45(b)	b) the number and weighted average exercise prices of share options for each of the following groups of options: i) outstanding at the beginning of the period; ii) granted during the period; iii) forfeited during the period; iv) exercised during the period; v) expired during the period; vi) outstanding at the end of the period; and vii) exercisable at the end of the period;
IFRS 2.45(c)	c) for share options exercised during the period, the weighted average share price at the date of exercise; and
IFRS 2.45(c)	*Note: If options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.*
IFRS 2.45(d)	d) for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life.
IFRS 2.45(d)	*Note: If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.*
	The basis of determination of the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period
IFRS 2.46	The entity shall disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.
	Note: Paragraphs 47 to 49 of IFRS 2, set out below, specify the minimum disclosures required to satisfy this requirement.

Reference	Presentation/disclosure requirement
FRS 2.47(a)	If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, the entity shall disclose the following for share options granted during the period (at a minimum): a) the weighted average fair value of those share options at the measurement date; and b) information on how the fair value of the share options was measured, including: i) the option pricing model used; ii) the inputs to that model, including the weighted average share price, the exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of early exercise; iii) how the expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and iv) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.
IFRS 2.47(b)	If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, the entity shall disclose the following for equity instruments other than share options granted during the period (at a minimum): a) the number and weighted average fair value of those equity instruments, determined at the measurement date; and b) information on how the fair value of the equity instruments was measured, including: i) if fair value was not measured on the basis of an observable market price, how it was determined; ii) whether and how expected dividends were incorporated into the measurement of fair value; and iii) whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value.

Reference	Presentation/disclosure requirement
IFRS 2.47(c)	If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, the entity shall disclose the following for share-based payment arrangements that were modified during the period (at a minimum): a) an explanation of those modifications; b) the incremental fair value granted as a result of those modifications; and c) information on how the incremental fair value granted was measured, consistently with the requirements set out in paragraphs 47(a) and 47(b) of IFRS 2 (see above), where applicable.
IFRS 2.48	If share-based payment transactions were measured directly, using the fair value of goods or services received during the period, the entity shall disclose how the fair value of the goods or services received was determined (e.g. whether fair value was measured at a market price for those goods and services).
IFRS 2.49	If the entity has rebutted the presumption in paragraph 13 of IFRS 2 that the fair value of the goods or services received from parties other than employees can be measured reliably (and, consequently, the entity has measured the fair value of goods and services received from such parties by reference to the equity instruments granted), the entity shall disclose: a) that fact; and b) an explanation of why the presumption was rebutted.
	The effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position
IFRS 2.50	The entity shall disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.
	Note: Paragraph 51 of IFRS 2, set out below, specifies the minimum disclosures required to satisfy this requirement.

Reference	Presentation/disclosure requirement
	The entity shall disclose the following (at a minimum):
IFRS 2.51(a)	a) the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets;
IFRS 2.51(a)	b) the portion of the total expense recognised for the period that arises from transactions accounted for as equity-settled share-based payment transactions;
IFRS 2.51(b)	c) the total carrying amount at the end of the period for liabilities arising from share-based payment transactions; and
IFRS 2.51(b)	d) the total intrinsic value at the end of the period of liabilities arising from share-based payment transactions for which the counterparty's right to cash or other assets had vested by the end of the period (e.g. vested share appreciation rights).
	Additional information
IFRS 2.52	If the detailed information specified for disclosure by IFRS 2 (as set out above) does not satisfy the principles in paragraphs 44, 46 and 50 of IFRS 2, the entity shall disclose such additional information as is necessary to satisfy those principles.

Deloitte IFRS resources

In addition to this publication, Deloitte Touche Tohmatsu has a range of tools and publications to assist in implementing and reporting under IFRSs. These include:

www.iasplus.com	Updated daily, iasplus.com is your one-stop shop for information related to IFRSs.
Deloitte's IFRS e-Learning Modules	e-Learning IFRS training materials, one module for each IAS and IFRS and the Framework, with self-tests, available without charge at **www.iasplus.com**
IAS Plus Newsletter	A quarterly newsletter on recent developments in International Financial Reporting Standards and accounting updates for individual countries. In addition, special editions are issued for important developments. To subscribe, visit **www.iasplus.com**
IFRSs in your Pocket	Published in English, French, Spanish, Polish, Finnish, Chinese, and other languages, this pocket-sized guide includes summaries of all IASB Standards and Interpretations, updates on agenda projects, and other IASB-related information.
IFRSs and US GAAP: A pocket comparison	A summary of the principal differences in pocket-sized format, including a status report as to what is being done about each difference.
Presentation and disclosure checklist	Checklist incorporating all of the presentation and disclosure requirements of Standards.
Model financial statements	Model financial statements illustrating the presentation and disclosure requirements of IFRSs.
iGAAP 2007 Financial instruments: IAS 32, IAS 39 and IFRS 7 Explained	3rd edition (March 2007). Guidance on how to apply these complex Standards, including illustrative examples and interpretations.
First-time adoption: A guide to IFRS 1	Application guidance for the "stable platform" Standards effective in 2005.
Business combinations: A guide to IFRS 3	Supplements the IASB's own guidance for applying this Standard.
Interim financial reporting: A guide to IAS 34	3rd edition (June 2007). Guidance on applying the interim reporting Standard, including a model interim financial report and an IAS 34 compliance checklist.

For more information on Deloitte Touche Tohmatsu, please access our website at http://www.deloitte.com

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms, and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is an organisation of member firms around the world devoted to excellence in providing professional services and advice, focused on client service through a global strategy executed locally in nearly 140 countries. With access to the deep intellectual capital of approximately 135,000 people worldwide, Deloitte delivers services in four professional areas – audit, tax, consulting and financial advisory services – and serves more than 80 per cent of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global growth companies. Services are not provided by the Deloitte Touche Tohmatsu Verein, and, for regulatory and other reasons, certain member firms do not provide services in all four professional areas.

As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte", "Deloitte & Touche", "Deloitte Touche Tohmatsu", or other related names.

This publication contains general information only and is not intended to be comprehensive nor to provide specific accounting, business, financial, investment, legal, tax or other professional advice or services. This publication is not a substitute for such professional advice or services, and it should not be acted on or relied upon or used as a basis for any decision or action that may affect you or your business. Before making any decision or taking any action that may affect you or your business, you should consult a qualified professional advisor.

Whilst every effort has been made to ensure the accuracy of the information contained in this publication, this cannot be guaranteed, and neither Deloitte Touche Tohmatsu nor any related entity shall have any liability to any person or entity that relies on the information contained in this publication. Any such reliance is solely at the user's risk.

© Deloitte Touche Tohmatsu 2007. All rights reserved.

Designed and produced by The Creative Studio at Deloitte, London. 18914B

Deloitte
Touche
Tohmatsu