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IASB Publishes IFRS 2 Share-based Payment

The International Accounting Standards Board (IASB) has issued International Financial Reporting Standard (IFRS) 2 **Share-based Payment** that will require share-based payments to be recognised as an expense. This is the first major standard which the IASB itself has developed and is designed to take a leadership position in what has historically been a difficult area for standard setters. Several standard-setting bodies around the world are expected to follow the IASB's lead. IFRS 2 is based on its preceding Exposure Draft, ED2, but there have been important changes especially in the measurement area.

The amount charged as an expense will be measured at the fair value of the goods or services received unless, for equity-settled transactions, that fair value cannot be estimated reliably. In these cases, which are deemed to include employee share options, the fair value of the equity instruments granted should be measured.

IFRS 2 defines a share-based payment as a transaction in which the entity receives or acquires goods or services either as consideration for its equity instruments or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity. The accounting requirements for the share-based payment depend on how the transaction will be settled, i.e. by the issuance of a) equity, b) cash, or c) equity or cash.

IFRS 2 contains considerable guidance dealing with application and implementation. However, as there is no single model for estimating the fair value of share-based payments or consensus for quantifying unique features of share-based payments in valuation models, considerable judgement will still be an essential ingredient in the valuation process.

The following pages highlight some of the more significant requirements of IFRS 2.

Scope

The concept of share-based payments is broader than employee share options. IFRS 2 encompasses the issuance of shares, or rights to shares, in return for services and goods. Examples of items included in the scope of IFRS 2 are share appreciation rights, employee share purchase plans, employee share ownership plans, share option plans and plans where the issuance of shares (or rights to shares) may depend on market or non-market related conditions.

IFRS 2 applies to all entities. There is no exemption for private or smaller entities. Furthermore, subsidiaries using their parent's or fellow subsidiary's equity as consideration for goods or services are within the scope of the Standard.

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There are two exemptions to the general scope principle. First, the issuance of shares in a business combination should be accounted for under the appropriate standard, currently IAS 22 but shortly to be replaced by the Standard arising from ED 3 Business Combinations. However, care should be taken to distinguish share-based payments related to the acquisition from those related to employee services.

Second, IFRS 2 does not address share-based payments within the scope of paragraphs 8-10 of IAS 32 Financial Instruments: Disclosure and Presentation, or paragraphs 5-7 of IAS 39 Financial Instruments: Recognition and Measurement. Therefore, IAS 32 and 39 should be applied for commodity-based derivative contracts that may be settled in shares or rights to shares.

IFRS 2 does not apply to share-based payment transactions other than for the acquisition of goods and services. Share dividends, the purchase of treasury shares and the issuance of additional shares are therefore outside its scope.

Recognition and Measurement

The issuance of shares or rights to shares requires an increase in a component of equity. IFRS 2 requires the offsetting debit entry to be expensed when the payment for goods or services does not represent an asset. The expense should be recognised as the goods or services are consumed. For example, the issuance of shares or rights to shares to purchase inventory would be presented as an increase in inventory and would be expensed only once the inventory is sold or impaired.

The issuance of fully vested shares, or rights to shares, is presumed to relate to past service, requiring the full amount of the grant-date fair value to be expensed immediately. The issuance of shares to employees with, say, a three-year vesting period is considered to relate to services over the vesting period. Therefore, the fair value of the share-based payment, determined at the grant date, should be expensed over the vesting period.

As a general principle, the total expense related to equity-settled share-based payments will equal the multiple of the total instruments that vest and the grant-date fair value of those instruments. In short, there is truing up to reflect what happens during the vesting period. However, if the equity-settled share-based payment has a market related performance feature, the expense would still be recognised if all other vesting features are met. The following example provides an illustration of a typical equity-settled share-based payment.

Companies will be required to take the following action steps for each share-based payment measured under IFRS 2.

- Calculate the fair value of the share-based payment at the date of grant.
- For cash-settled share-based payments, determine the fair value of the share-based payment at each reporting date.
- Calculate the expense for each period based on the company's revised estimate of shares that will vest.
- Develop a system or program to capture the data necessary for fulfilling the disclosure requirements.

Companies may wish to consider whether the employee's perception of the value of an equity-based incentive adequately reflects the expense that must now be recognised, If not, consideration should be given to reviewing the company's incentive plans to ensure that they are value for money.

Illustration – Recognition of Employee Share Option Grant

Company grants a total of 100 share options to 10 members of its executive management team (10 options each) on 1 January 20X5. These options vest at the end of a three-year period. The company has determined that each option has a fair value at the date of grant equal to 15. The company expects that all 100 options will vest and therefore records the following entry at 30 June 20X5 – the end of its first six-month interim reporting period.

Dr. Share Option Expense	250	
Cr. Equity		250

[(100 x 15)*1/6 periods]

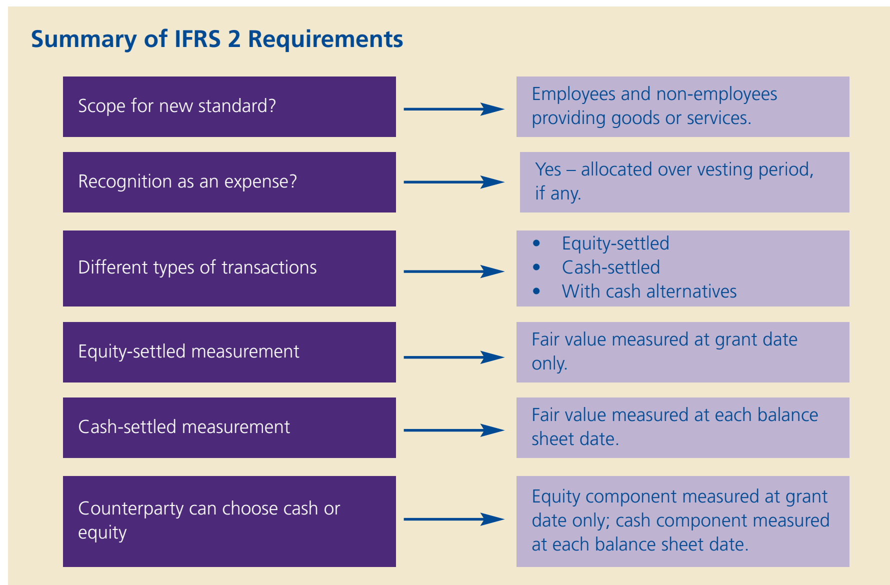
If all 100 shares vest, the above entry would be made at the end of each 6-month reporting period. However, if one member of the executive management team leaves during the second half of 20X6, therefore forfeiting the entire amount of 10 options, the following entry at 31 December 20X6 would be made:

Dr. Share Option Expense	150	
Cr. Equity		150

[(90 x 15)*4/6 periods]-[250+250+250]

Considerable judgement will be required to determine the appropriate valuation of share-based payment transactions.

Depending on the type of share-based payment, fair value may be determined by the value of the shares or rights to shares given up, or by the value of the goods or services received. IFRS 2 has a rebuttable presumption that if the share-based payment is for goods or services other than employees, the share-based payment should be measured by reference to the fair value of the goods or services. If the share-based payment is to employees (or those similar to employees), the transaction should be measured by reference to the fair value of the equity instruments granted.



IFRS 2 requires the share-based payment transaction to be measured at fair value for both listed and unlisted entities. However, there has been an important change from ED2 in that IFRS 2 permits the use of intrinsic value (i.e. fair value of the shares less exercise price) in those "rare cases" in which the fair value of the equity instruments cannot be reliably measured. However this is not simply measured at the date of grant. An entity would have to remeasure intrinsic value at each reporting date until final settlement.

Most performance conditions used for incentive plans will be treated as non-market based conditions.

Another key change from ED2, as noted above, is the distinction in the handling of market based performance features from non-market features. Market conditions are those related to the market price of an entity's equity, such as achieving a specified share price or a specified target based on a comparison of the entity's share price with an index of share prices of other entities. Market based performance features should be included in the grant-date fair value measurement. However, the fair value of the equity instruments should not be reduced to take into consideration non-market based performance features or other vesting features.

Modifications, Cancellations and Settlements

The modification of the terms on which equity instruments were granted may have an effect on the expense that will be recorded. IFRS 2 clarifies that the guidance on modifications also applies to instruments amended after their vesting date.

The determination of whether a change in terms and conditions has an effect on the amount recognised depends on whether the fair value of the new instruments is greater than the fair value of the original instruments (both determined at the modification date).

Modification of the terms on which equity instruments were granted may have an effect on the expense that will be recorded. IFRS 2 clarifies that the guidance on modifications also applies to instruments modified after their vesting date. If the fair value of the new instruments is more than the fair value of the old instruments (e.g. by reduction of the exercise price or issuance of additional instruments), the incremental amount is recognised over the remaining vesting period in a manner similar to the original amount. If the modification occurs after the vesting period, the incremental amount is recognised immediately. If the fair value of the new instruments is less than the fair value of the old instruments, the original fair value of the equity instruments granted should be expensed as if the modification never occurred.

The cancellation or settlement of equity instruments is accounted for as an acceleration of the vesting period and therefore any amount unrecognised that would otherwise have been charged should be recognised immediately. Any payments made with the cancellation or settlement (up to the fair value of the equity instruments) should be accounted for as the repurchase of an equity interest. Any payment in excess of the fair value of the equity instruments granted is recognised as an expense.

New equity instruments granted may be identified as a replacement of cancelled equity instruments. In those cases, the replacement equity instruments should be accounted for as a modification. The fair value of the replacement equity instruments is determined at grant date, while the fair value of the cancelled instruments is determined at the date of cancellation, less any cash payments on cancellation that is accounted for as a deduction from equity.

IFRS 2 is effective for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Transition

All equity-settled share-based payments granted after 7 November 2002, that are not yet vested at the effective date of IFRS 2 which is for annual periods beginning on or after 1 January 2005, shall apply the provisions of IFRS 2. Entities are allowed and encouraged, but not required, to apply this IFRS to other grants of equity instruments if (and only if) the entity has previously disclosed publicly the fair value of those equity instruments determined in accordance with IFRS 2.

The comparative information presented in accordance with IAS 1 shall be restated for all grants of equity instruments to which the requirements of IFRS 2 are applied. The adjustment to reflect this change is presented in the opening balance of retained earnings for the earliest period presented.

IFRS 2 amends paragraph 13 of IFRS 1, **First-time Adoption of International Financial Reporting Standards**, to add an exemption for share-based payment transactions. Similar to entities already applying IFRS, first-time adopters will have to apply IFRS 2 for share-based payment transactions on or after 7 November 2002. Additionally, a first-time adopter is not required to apply IFRS 2 to share-based payments granted after 7 November 2002 that vested before the later of a) the date of transition to IFRS, or b) 1 January 2005. A first-time adopter may elect to apply IFRS 2 earlier only if it has publicly disclosed the fair value of the share-based payments determined at the measurement date, in accordance with IFRS 2.

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