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IFRS® Standard 2 Share-based Payment

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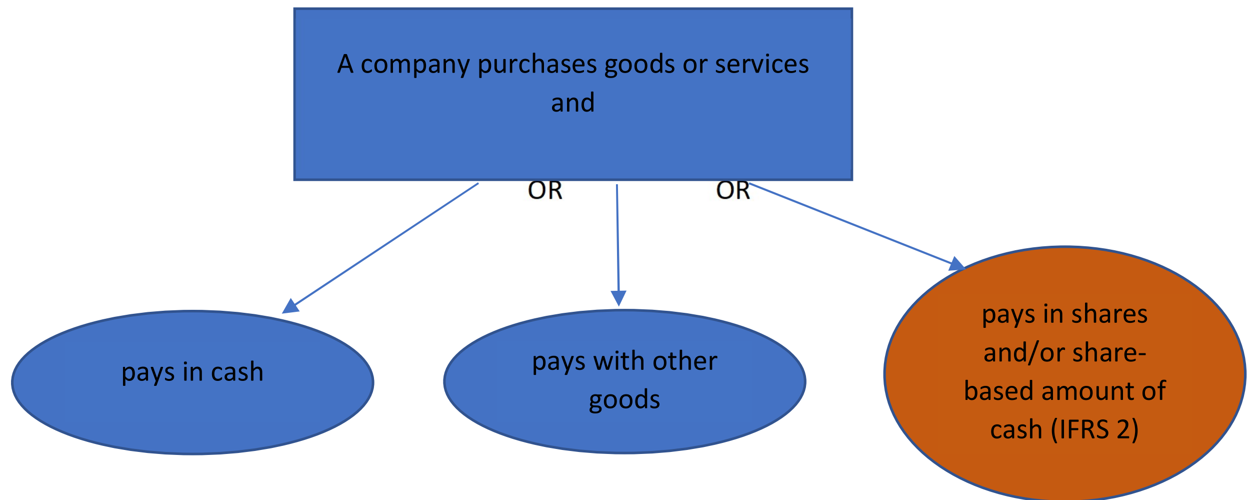
IFRS® Standard 2 Share-based Payment

SCOPE AND KEY DEFINITIONS

IFRS Standard 2 Share-based Payment applies when companies pay for goods or services by granting shares, or rights or options to receive shares, or cash for amounts that are based on the value of equity instruments (see Figure 1).

Figure 1. Scope of IFRS 2



Examples of transactions under IFRS 2 include issues of shares in return for the provision of goods or services, or cash payments (in an amount that is based on the share price) in return for the provision of goods or services. If an entity grants 20 shares or a cash bonus equal to the increase in share price to its employees, provided that they remained in service for the next 12 months, the transactions are under the scope of IFRS 2 and are examples of share-based transactions. But if an entity pays CU50 to its employees provided that they remained in service for the next 12 months, the transaction is outside the scope of IFRS 2, because the value is not related to the share price or value.

IFRS 2 is a complex standard which is applicable to a variety of circumstances, of which transactions with employees represent a central point. The standard requires the recognition of share-based payment transactions in its financial statements. The following definitions are key to understanding and applying the basic principles of IFRS (IFRS2.AppendixA):

Share-based payment arrangement: an agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:

a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares of share options) of the entity of another group entity, or
b) equity instruments (including shares or share options) of the entity or another group entity,

provided the specified vesting conditions, if any, are met.

Share-based payment transaction: a transaction in which the entity:

a) receives goods or services from the supplier of those goods and services (including an employee) in a share-based payment arrangement, or

b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Cash-settled share-based payment transaction: a share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

Equity-settled share-based payment transaction: a share-based payment transaction in which the entity:

a) receives goods or services as consideration for its own equity instruments (including shares or share options), or
b) receives goods or services but has no obligation to settle the transaction with the supplier.

From these key definitions it becomes obvious that central to IFRS 2 is the acquisition of goods and services for which consideration (payment) is in equity or in cash, but with a value that is based on the price of the equity. Coming back to our previous example, if the entity grants 20 shares to its employees provided that they remained in service for the next 12 months, this is an equity-settled share-based payment. But if the entity grants a cash bonus equal to the increase in share price to its employees provided that they remained in service for the next 12 months, this is an example of a cash-settled share-based payment.

Many of the share-based contracts (such as the ones with employees) cover a long period of time and imply meeting some performance criteria. For example, when entities grant share options to employees for their service for a period of time of, say, three years, the service received covers three years, and employees have to meet the criteria of working for the entity for three full years to qualify (i.e., vesting condition). Vest and vesting condition are two key terms employed by IFRS 2 and defined as follows ((IFRS 2.Appendix A):

Vest: 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 when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Vesting condition: a condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

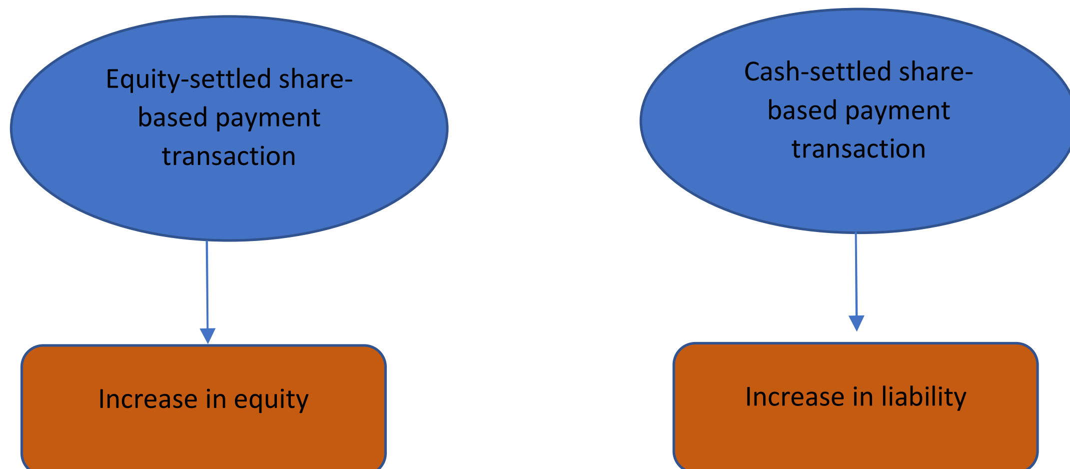
Vesting period: the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

Resuming the previous example, if the entity grants 20 shares to its employees provided that they remained in service for the next 12 months, the date of the agreement is the grant date, and the vesting date is 12 months later, the date when employees are entitled to receive the shares. The period between the agreement (grant date) and vesting date (the end of the 12 months) represents the vesting period. Being employed for 12 months represents the vesting condition.

RECOGNITION AND MEASUREMENT

The basic principle of IFRS 2 is that in a share-based transaction, when the entity receives goods or services it recognizes an asset or an expense, and a corresponding increase in equity or liability, depending on the type of transaction. Figure 2 summarises this principle.

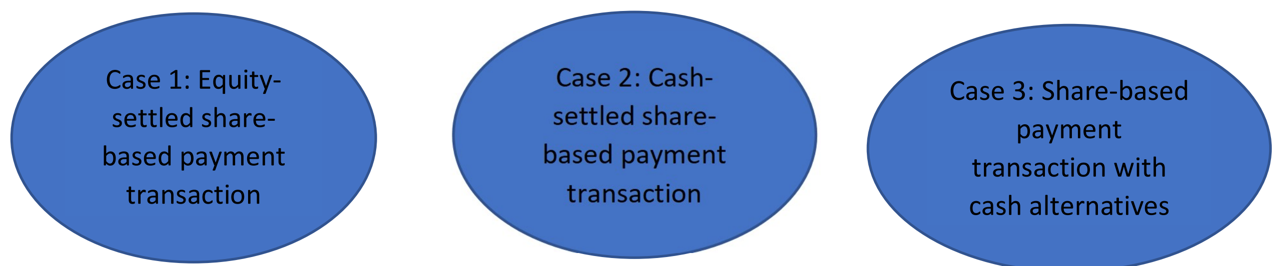
Figure 2. Recognition criteria in share-based transactions



Continuing the previous example, if the entity grants 20 shares to its employees provided that they remained in service for the next 12 months, an expense for the service received and an increase in equity will be recognized. On the other hand, if the entity grants a cash bonus equal to the increase in the share price to its employees provided that they remained in service for the next 12 months, an expense for the service received and an increase in liabilities will be recognized.

IFRS 2 provides additional principles for the recognition and measurement in three cases (scenarios), as we summarize in Figure 3 below, and we will detail and exemplify each of them separately.

Figure 3. The main scenarios (cases) in IFRS 2

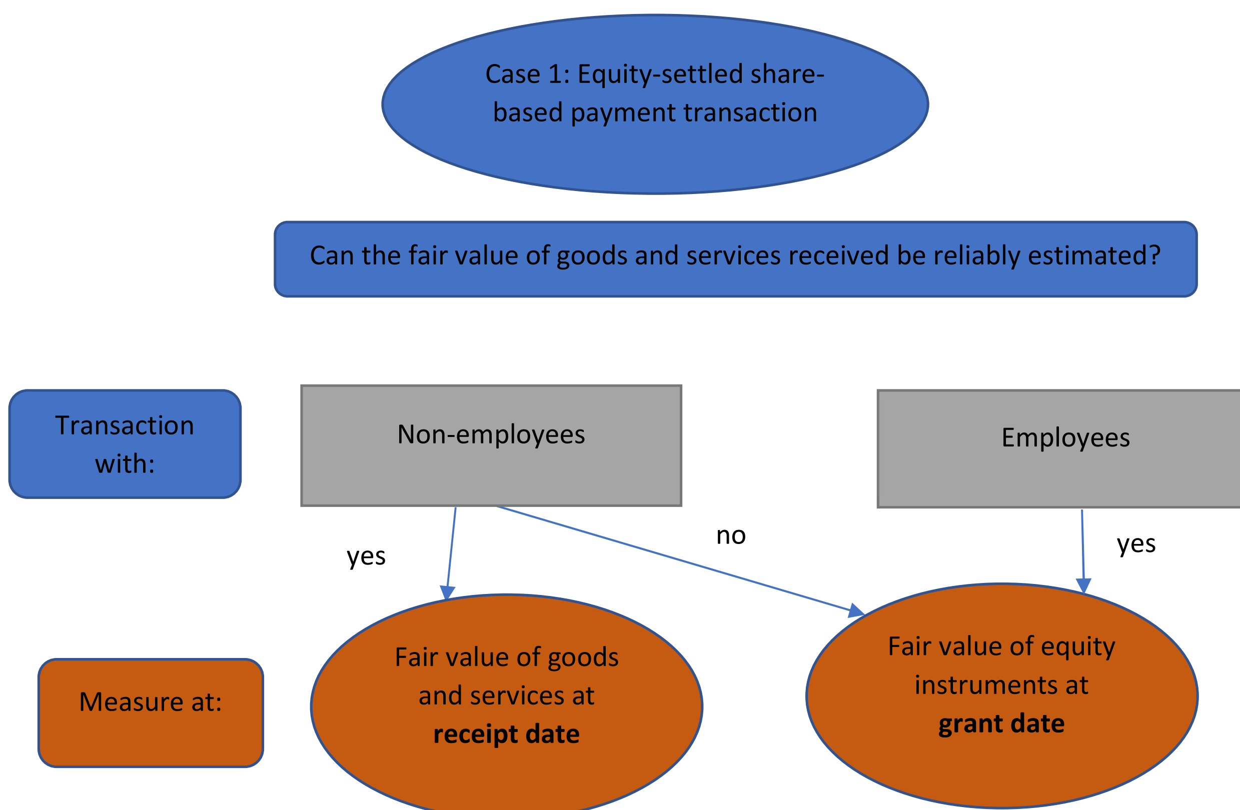


Case 1 Equity-settled share-based payment transactions

For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted (IFRS 2.10)

Given the parties with which the entity interacts in share-based transactions, the measurement principles for equity-settled share-based payment transaction may be summarized as shown in Figure 4:

Figure 4. Measurement principles for equity-settled share-based payment transaction



For example, an entity agrees to issue shares to its lawyers in exchange for their services related to a lawsuit. The entity receives from lawyers an invoice for the fair value of the services rendered, e.g., for CU20,000. Because the fair value of the services can be measured reliably, this is the amount for which the expense (for services received) and the equity increase will be recognized.

In the rare cases where the fair value of goods and services cannot be estimated reliably, the entity applies the same principles as for its transactions with employees, which are to estimate the fair value of equity instruments at the grant date. The fair value is estimated by using various financial models (e.g., Black-Scholes, Monte Carlo etc.), considering several aspects such as the current share price, expected dividends, volatility and other considerations.

For example, at the beginning of year 1 an entity enters into an agreement with its 10 managers to grant them 100 share options each, on the condition to each stay in service for 3 years. The estimated fair value of a share option at the beginning of year 1 is CU6. However, 2 managers leave the entity during the second year. In this case, the fair value of services rendered by employees cannot be determined, since they are internal to the entity. For measurement purposes the entity will use the fair value of the share options, determined by using financial models. In year 1, the fair value for the three-year agreement is: 10 managers * 100 share options each * CU6 = CU6,000. The total amount of the expense is CU6,000, for three years of service, which implies an amount of CU2,000 for the first year (one third). An expense and an increase in equity will be recognized in year 1 for CU2,000:

Dr. Expense 2,000

Cr. Equity 2,000

In year 2, only 8 managers remain in service, and therefore the agreement is applicable only to them. For the 8 managers the entity will award share options with a total fair value of: 8 managers * 100 share options each * CU6 = CU4,800. The value for two years of service is: 4,800 *2/3 = CU3,200. Since CU2,000 were already recognized in year 1, the entity will recognize the difference (CU3,200 – CU2,000 = CU1,200) as an expense and an increase in equity in year 2.

Dr. Expense 1,200

Cr. Equity 1,200

If there are no changes in year 3, the entity will recognize the remaining CU1,600 (CU4,800 – CU3,200 recognized in the first two years) as an expense and an increase in equity.

Dr. Expense 1,600

Cr. Equity 1,600

The example provided above was a simple one, to understand the general principles of recognition and measurement. Real-life examples are more complex and usually contain performance criteria, which might be internal (e.g., increase sales, profit etc.) or external (e.g., increase in the share price). IFRS 2 requires for market conditions to include the expected probability in the fair value estimate at grant date and not further revise its estimates, while the value for internal conditions should be revised.

We consider now an example of equity-settled share-based transactions with employees, with internal criteria. An entity employs 50 people in its sales department, and grants share options to each, under the following conditions: the employees must remain employed for three years and contribute to increase in sales. If the average sale increase is below 5%, each employee receives 50 share options. If the average sale increase is higher than 5%, each employee receives 100 share options. The fair value of a share option is CU30. The data from the human resources department indicate a 20% employee turnaround, which leads to an estimate of 40 employees to remain in service until the end of the period. In year 1 the annual sale growth is 4%, but in year 2 the annual sale growth is 7%. In year 3 the sales growth is 6%, and the actual number of employees remaining in service is 42. We will now apply the same computational principles from the previous examples and re-estimate at each end of the year the fair value (see Table 1).

Table 1. Computations for an equity-settled share-based transaction with internal performance criteria

Year	Calculation for total fair value	Expense for the period	Cumulative expense
Year 1	50 employees * 80% * 50 share options/employee * CU30/share option = CU60,000	CU60,000/3 = CU20,000	CU20,000
Year 2	50 employees * 80% * 100 share options/employee * CU30/share option = CU120,000	CU80,000 – CU20,000 = CU60,000	CU120,000 * 2/3 = CU80,000

Year 3	42 employees * 100 share options/employee * CU30/share option = CU126,000	CU126,000 – CU80,000 = CU46,000	CU126,000

In this example, the expense and increase in equity recognized every year will be: CU20,000 for the first year, CU60,000 for the second year, and CU46,000 for the third year. The changes in value over time thus reflect the changes in meeting the internal criteria. We only exemplify the journal entry for year 1, as the ones in years 2 and 3 are similar for the respective amounts in Table 1.

Year 1

Dr. Expense 20,000

Cr. Equity 20,000

Alternatively, we will now take an example of equity-settled share-based transactions with employees, with market criteria. An entity grants 100 share options to each of its 5 managers, under the following conditions: the managers must remain employed for three years and the share price should increase by 25% at the end of the three years. The entity employs a model to determine the fair value of the share option, which considers the probability that the share price increases by at least 25%. The fair value of a share option is CU15. See Table 2 for the relevant computations.

Table 2. Computations for an equity-settled share-based transaction with market criteria

Year	Calculation for total fair value	Expense for the period	Cumulative expense
Year 1	5 managers * 100 share options/manager * CU15/share option = CU7,500	CU7,500/3 = CU2,500	CU2,500
Year 2	5 managers * 100 share options/manager * CU15/share option = CU7,500	CU7,500/3 = CU2,500	CU5,000
Year 3	5 managers * 100 share options/manager * CU15/share option = CU7,500	CU7,500/3 = CU2,500	CU7,500

In this case, the expense and increase in equity recognized every year will be of CU2,500, irrespective of the changes in share price, because the fair value incorporates the possibility of both meeting and not meeting the expected target since the grant date. The only change in amount will only occur if any manager leaves the entity, because this internal criterion was not included in the financial model.

Years 1/2/3

Dr. Expense 2,500

Cr. Equity 2,500

Case 2 Cash-settled share-based payment transactions

The entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period (IFRS 2.30).

For example, an entity issued share appreciation rights (SARs) to 10 managers, on the condition that they remain employed for 3 years. SARs give the right to employees to receive a cash payment equal to the increase of the share price above CU100. The fair value of SARs expected to vest are: CU1,500 at the end of year 1; CU1,800 at the end of year 2, and CU2,000 at the end of year 3. Table 3 presents the relevant computations.

Table 3. Computations for a cash-settled share-based transactions

Year	Total fair value	Expense for the period	Cumulative expense
Year 1	CU1,500	CU1,500/3 = CU500	CU500
Year 2	CU1,800	CU1,200 – CU500 = CU700	CU1,800*2/3 = CU1,200
Year 3	CU2,000	CU2,000 – CU1,200= CU800	CU2,000

The year 1 entry looks like this, with adjusted amounts for years 2 and 3 according to Table 3:

Dr. Expense 500

Cr. Liability 500

Case 3 Share-based payment transaction with cash alternatives

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 entity shall account for that transaction, or the components of that transaction, 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. 34).

If the counterparty has the right to choose the form of the settlement, the entity grants de facto a compound financial instrument, which includes a debt and an equity component. The entity will recognize separately goods and services received for each component of the financial instrument. The liability component is measured first.

For example, an entity grants 100 SARs to a manager, subject to a three-year employment condition. The manager can choose between a cash payment equal to the increase in share price between the grant date and the vesting date (end of the three years) for 100 shares. Alternatively, the manager can exercise 100 share options at an exercise price equal to the share price at the grant date. The fair value of the share option and SAR at the grant date are identical, CU10. In this case, the value of the equity component is CU10 * 100 share options = CU1,000. Moreover, the fair value of the cash alternative is: CU10*100 SARs = CU1,000. Therefore, in this case, the value of the debt component is CU1,000 and the value of the equity component is 0 (CU1,000 fair value – CU1,000 debt component).

Dr. Expense 1,000

Cr. Liability 1,000

If the employees are offered the choice between alternatives of different values, there will be a residual amount attributable to the equity component. For examples, if employees are offered a choice between buying 110 shares and SARs for 100 shares, the fair value of the equity alternative is: CU10 * 110 share options = CU1,100. The fair value of the cash alternative is (the liability component): CU10*100 SARs = CU1,000. Therefore, the fair value of the equity component is: CU1,100 – CU1,000 = CU100.

Dr. Expense 1,100

Cr. Liability 1,000

Cr. Equity 100

If the entity is provided with the choice of the settlement, the entity shall determine if the obligation is to settle in cash or not. For example, the entity has the obligation to settle in cash if it has a stated policy of settling in cash, or generally settles in cash for comparable transactions. In this case, the entity will account for the transaction in accordance with the requirements of a cash-settled share-based payment transaction. If no such obligation exists, the entity shall account for the transaction in accordance with the requirements applying to equity-settled share-based payment transactions.

DISCLOSURES

IFRS 2 (par. 44-52) provides quite an extensive list of information to be disclosed, to enable the users of financial statements to understand the nature and extent of share-based payment transactions. Some of the most important information include: a description of each type of each share-based payment arrangement – including vesting requirements, method of settlement (cash or equity), number of instruments and exercise prices, option prices model used, volatility, expenses arising from various methods of settlement etc.

EXAMPLE

Grant Co. employs various types of share-based transactions to remunerate its employees. This particular case is about 3 R&D managers, deeply involved in the research projects of Grant. Given their strategic importance, the CEO of Grant Co. would like to grant them a stimulus to remain employed for the next 3 years. Now the entity assesses the choice between three types of arrangements and the accountants are required to discuss the accounting implications of each scenario in line with IFRS 2.

Scenario 1: Grant the 3 employees with 100 phantom shares each (the right to receive an amount of cash equal to the share price).

Scenario 2: Grant the 3 employees with the right to receive 110 shares each. Shares must be kept for at least 2 years after they are received.

Scenario 3: Grant the 3 employees with the right to choose between 100 phantom shares and 110 shares, on the condition that shares must be kept for at least 2 years after they are received.

At the grant date, the share price is 20, and it increases to 21 at the end of year 1; to 21.5 at the end of year 2, and to 22 at the end of year 3. The fair value of the share options at the grant date is 19.

SOLUTION

Scenario 1: this is an example of a cash-settled share-based payment transaction, with the liability being measured at each reporting date, any changes in fair value being recognized in profit or loss for the period. Table 4 presents the computations for scenario 1.

Table 4. Computations for scenario 1 (100 phantom shares are granted)

Year	Total fair value	Expense for the period	Cumulative expense
Year 1	3*100*21 = CU6,300	CU6,300/3 = CU2,100	CU2,100
Year 2	3*100*21.5 = CU6,450	CU4,300- CU2,100= CU2,200	CU6,450 * 2/3 = CU4,300
Year 3	3*100*22 = CU6,600	CU6,600 – CU4,300= CU2,300	CU6,600

Years 1/2/3

Dr. Expense 2,100/2,200/2,300

Cr. Liability 2,100/2,200/2,300

Scenario 2: this is an example of an equity-settled share-based payment transaction with market criteria. In this case, the fair value at the grant date is used. The fair value is: 3*110*CU19 = CU6,270, with CU2,090 being recognized in expenses and equity each year.

Years 1/2/3

Dr. Expense 2,090/2,090/2,090

Cr. Equity 2,090/2,090/2,090

Scenario 3: this is an example of a share-based payment transaction with cash alternatives, and the employees having the right to choose between the alternatives. In this case the entity grants a compound financial instrument, which includes a debt and an equity component. Table 5 presents the calculations.

At the grant date:

The fair value of the equity alternative = 3*110*19 = CU6,270

The fair value of the cash alternative = 3*100*20 = CU6,000

The fair value of the equity component is: CU6,270 - CU6,000 = CU270

Table 5. Computations for scenario 3 (choice between two alternatives)

Year	Liability			Equity	
	Total fair value	Expense for the period	Cumulative expense	Equity	Expense
Year 1	3*100*21 = CU6,300	CU6,300/3 = CU2,100	CU2,100	CU270/3 = CU90	CU90
Year 2	3*100*21.5 = CU6,450	CU4,300- CU2,100= CU2,200	CU6,450 * 2/3 = CU4,300	CU270/3 = CU90	CU90
Year 3	3*100*22 = CU6,600	CU6,600 – CU4,300= CU2,300	CU6,600	CU270/3 = CU90	CU90

At the end of year 3, if the cash alternative is selected, the cash paid will be: 3*100*CU22 = CU6,600. If shares are issued, their value is: 3*110*22 = CU7,260.