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IFRS® Standard 2 Share-Based Payment

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CASE STUDY - IFRS 2 SHARE-BASED PAYMENT

Introduction

Sometimes entities purchase goods or services for which payment is made in equity instruments, or in cash, to the extent the cash payment depends on the value of the equity instruments. This is particularly useful to design plans to stimulate employees or other parties to contribute to the entity's performance. A particular case here is represented by the compensation schemes designed for employees.

Aim of this case study is to discuss the impact of such schemes intended to motivate employees on the entities' financial statements.

The Case Information

You are part of the accounting department of Car of the Future Ltd., an entity that designs cars that incorporate the latest technological developments. The management of the entity would like to implement a plan to reward its employees and to increase the staff retention rate. Management is interested in understanding the impact of several types of rewards proposed by the Human Resources Department on its financial statements.

Car of the Future Ltd. is a small car manufacturer, focused on innovation and on responding to clients' expectations. The entity is quite successful in attracting talented and skilful employees, which is critical for this industry and for implementing a strategy that is focused on innovation. However, internal reports indicate that an increasing number of employees leave the entity over the last few years. Consequently, management has requested the Human Resources Department to suggest a plan to motivate staff, in the hope of increasing the staff retention rate.

The Human Resources Department proposed the following plans, and with the following expected consequences on employee retention:

Plans	Details	Number of employees included	Expectations
1	Grant 10 share options to each employee who has a role in innovation and who stays in service for 5 years; the fair value of such an option is CU10.	100	10% of employees were leaving annually until now. This plan is expected to result in retaining more people and having 90 employees at the end of the 5-year period.
2	Grant share appreciation rights (SAR) to department managers if they remain employed for 3 years. SARs give them the right to receive a cash payment equal to the increase of the share price above CU20.	3	It is expected that the 3 managers will remain employed for the 3-year duration. The fair value of SARs that are expected to vest is CU6,000.

3	Grant share options to each employee from the sales department who remains employed for 3 years and contributes to an increase in sales. Each employee will receive 8 share options if the average yearly growth rate is between 5 and 8%; and each employee will receive 10 shares if the average yearly growth rate exceeds 8%. The fair value of an option is CU12.	10	Sales are expected to increase by more than 8% each year, and 9 employees are expected to remain in service for 3 years. However, there are some chances that in year 2, the 3-year average sales increase is estimated between 5% and 8%.

Discussion Questions

What are the implications of these plans on the entity's financial statements, as they were designed? What are the implications of a less optimistic outcome (without providing supporting calculations)?

SOLUTION OF CASE STUDY - IFRS 2 SHARE-BASED PAYMENT

The plans proposed by the Human Resources Department imply concluding an agreement between the entity and its employees. This agreement entitles the employees to receive cash for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity, or to receive equity instruments (including shares or share options), provided that the specified conditions are met. Given that the plans remunerate a service, an expense should be recognised in each period. If the payment is made in cash, the entity should recognise a liability, and if the payment is made in equity instruments, the transaction impacts equity.

The implications of each plan are indicated below:

Plan 1 is an equity-settled share-based payment transaction, resulting in a yearly expense and an increase in equity.

10 options * 90 employees * CU10 = CU9,000

The yearly expense and increase in equity are CU9,000/5 = CU1,800

So, the yearly impact of this plan on the entity's financial statements is reflected as follows:

Dr. Expense	1,800	
Cr. Equity		1,800

If the plan would not yield such an optimistic outcome, it implies that fewer employees will benefit from the plan. This implies a smaller expense and a smaller increase in equity in the year when the outcome is worse than expected and the following ones.

Plan 2 is a cash-settled share-based payment transaction, resulting in a liability being recognised at its fair value.

Based on this plan, the yearly expense and increase in liability is CU2,000 (CU6,000/3).

So, the yearly impact of this plan on the entity's financial statements is reflected as follows:

Dr. Expense	2,000	
Cr. Liability		2,000

Until the liability is settled, the entity shall remeasure its fair value at the end of each reporting period and at the date of the settlement, with any changes in fair value being recognised in profit or loss for the period. If employees leave, or the prospects of having the desired increase in share price decrease, the liability is remeasured (and it results in a lower expense and a lower liability being recognised in that year and the following ones).

Plan 3 is an equity-settled share-based payment transaction, resulting in a yearly expense and an increase in equity. The computations for the expected outcome are:

9 employees * 10 share options * CU12 = CU1,080

An expense of CU360 (CU1,080/3) will thus be recognized each year.

So, the yearly impact of this plan on the entity's financial statements is reflected as follows:

Dr. Expense 360

Cr. Equity 360

If the plan would be less successful, the expected value of the settlement will be impacted, resulting in lower expenses and equity increases. For example, if the 3-year average sales increase is estimated between 5% and 8% in year 2, the computations are as follows:

Total value: 9 employees * 8 share options * CU12 = CU864

Cumulative expense that is needed at the end of year 2: CU864/3 * 2 = CU576

CU360 were already recognised as an expense in year 1

Expense to be recognised in year 2 = CU576-CU360 = CU216