



IFRS 2: Share-Based Payment

By Sean R. Kocan, CPA

Introduction - International Financial Reporting Standard (IFRS) 2, *Share-Based Payment*, of the International Accounting Standards Board (IASB), addresses the recognition of expense for share-based payment arrangements. The objective of IFRS 2 is to specify the financial reporting by an entity when it undertakes a share-based payment transaction.

It requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees. This is important to CFOs of all companies currently implementing or considering share-based payment arrangements as financial statements need to represent the economic consequences of these transactions in order to be properly stated for the statements' users. The proper determination of those consequences can be highly complex and may require specialized knowledge.

Summary of IFRS 2 Requirements	
Scope for new standard?	Employees and non-employees providing goods or services
Recognition as an expense?	Yes – allocated over vesting period, if any
Different types of transactions	<ul style="list-style-type: none"> • Equity-settled • Cash-settled • With cash alternatives
Equity-settled measurement	Fair value measured at grant date only
Cash-settled measurement	Fair value measured at each balance sheet date
Counterparty can choose cash or equity	Equity component measured at grant date only; cash component measured at each balance sheet date

Scope - A share-based payment is a transaction in which the entity receives goods or services as consideration for equity instruments of the entity, 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 encompasses the following transactions:

- Share appreciation rights
- Employee share purchase plans
- Employee share ownership plans
- Share option plans
- Plans where the issuance of shares may depend on market or non-market conditions.

IFRS 2 applies to all entities and there is no exemption for private or smaller entities. IFRS 1, *First-time Adoption of International Financial Reporting Standards*, provides exemptions to share-based payments at the time of IFRS adoption.

There are various exemptions to the general scope of IFRS 2:

1. Issuance of shares in a business combination
2. Commodity-based derivative contracts that may be settled in shares or rights to shares
3. Share dividends
4. Purchase of treasury shares
5. Issuance of additional shares.

Recognition - Goods received or services acquired in a share-based payment transaction should be recognized at the time those goods or services are received or acquired. In an equity-settled share-based payment transaction, equity should be increased. A liability should be recorded for cash-settled share-based payment transactions. IFRS 2 requires the offsetting debit entry to be expensed when the payment for goods or services does not represent an asset (e.g. inventory).

Measurement - 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 share-based payment transactions are with employees, the transaction should be measured by reference to the fair value of the equity instruments granted as this is generally more reliable than a valuation of the services received.

Fair value should be determined at the measurement date. For transactions with employees, the measurement date is the grant date. For transactions with parties other than employees, the measurement date is the date the entity obtains the goods or services. Two key factors when deciding the grant date for employee share-option grants are:

1. Both parties need to 'agree' to a share-based payment, and
2. Both parties must have a shared understanding of the terms and conditions.

For share options granted to employees, in many cases market prices are not available because the options granted are subject to terms and conditions that do not apply to traded options. In this case, the fair value of the options granted should be estimated by applying an option pricing model. Various factors need to be considered when determining the appropriate model. The three most common models are the Black-Scholes model, the binomial model and the Monte Carlo model. IFRS 2 requires, at a minimum, that all valuation models consider the following six basic inputs:

Valuation Model Input	Considerations
The exercise price of the option	Determined based on the share-option agreement.
The life of the option	<p>Factors to consider include:</p> <ol style="list-style-type: none"> a. Length of the vesting period b. Historical actual experience c. Price of the underlying shares d. Expected volatility of the underlying shares e. Employee's level within the entity. <p>IFRS 2 suggests that different groups of employees may have differing expected lives.</p>
The current price of the underlying shares	Determined from a consistent policy typically based on the closing or average price at the grant date.

Valuation Model Input	Considerations
The expected volatility of the share price	<p>Volatility is the measure of the amount by which a share price is expected to fluctuate during a period.</p> <p>Newly listed entities should consider actual historical results for the longest period available in addition to historical volatility of similar entities. Unlisted entities should consider historical or implied volatility of similar listed entities.</p> <p>Other factors to consider:</p> <ol style="list-style-type: none"> Length of time an entity's shares have been publicly traded Appropriate and regular intervals for price observations Factors indicating expected future volatility might differ from past volatility.
The dividends expected on the shares	<p>If the holder of the option is entitled to dividends between the grant date and the exercise date, expected dividends should not be included in the fair value measurement.</p> <p>If the holder 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.</p>
The risk-free interest rate for the life of the option.	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 the expected life of the option.

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 a 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.

A grant of equity instruments might be conditional upon satisfying specified vesting conditions such as an employee required to remain in the employ 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.

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 other words, cumulative expense is trued up at each reporting period to reflect events that happen during the vesting period. However, if the equity-settled share-based payment has a market related performance feature, the expense would still be recognized if all other vesting features are met. The entity should estimate the length of the expected vesting period for the performance feature to be achieved at the grant date based on the most likely outcome. This estimate can be revised if subsequent information indicates the length of vesting differs from previous estimates. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in determining the fair value of the options and should not be subsequently revised. The following example is an illustration of a typical equity-settled share-based payment:

Example: Recognition of Employee Share Option Grant

Company grants a total of 1,000 share options to 10 members of its executive team (100 options each) on January 1, 20X8. 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 1,000 options will vest and therefore records the following entry at December 31, 20X8 - the end of its fiscal year:

Debit	Share-based Compensation Expense	\$5,000	
Credit	Equity		\$5,000
		[(1,000 x \$15) x 1/3 periods]	

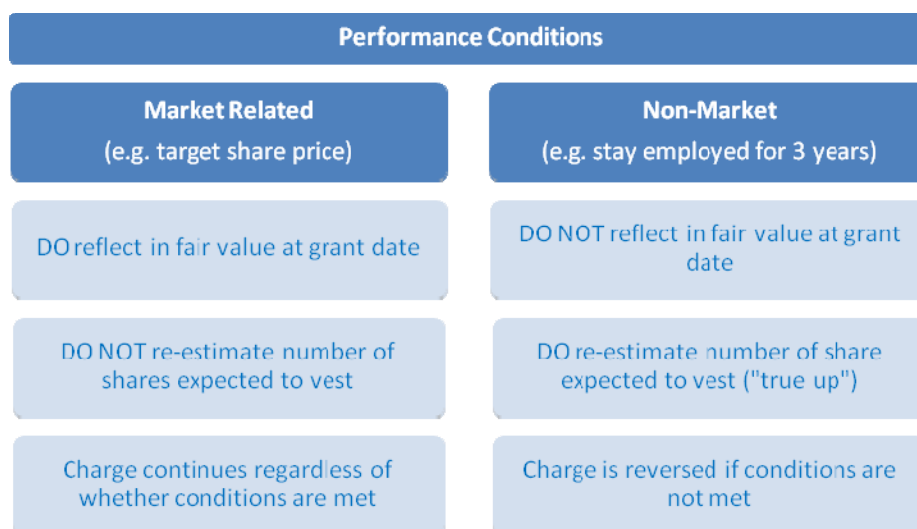
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If all 1,000 shares vest, the above entry would be made at the end of each fiscal year. However, if one member of the executive management team leaves during 20X9, therefore forfeiting the entire amount of 100 options, the following entry at December 31, 20X9 would be made:

Debit	Share-based Compensation Expense	\$4,000	
Credit	Equity		\$4,000
		[[$(900 \times \$15) \times 2/3 \text{ periods}$] - \$5,000]	

IFRS 2 distinguishes between “market conditions” and conditions other than market conditions. The following diagram summarizes the treatment of the two performance conditions:



Modifications, Cancellations, Settlements - The determination of whether a change in terms and conditions has an effect on the amount recognized 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).

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 recognized 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 recognized 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 unrecognized that would otherwise have been charged should be recognized 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 recognized 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.

Disclosures - Required disclosures include:

- the nature and extent of share-based payment arrangements that existed during the period;
- how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and
- the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

Comparison with US GAAP - In December 2004, the Financial Accounting Standards Board (FASB) issues Statement 123R, *Share-Based Payment*. While SFAS 123R is largely consistent with IFRS 2, some differences remain:

Topic	IFRS	US GAAP
Date for measuring share-based payment to non-employees	Modified grant date method.	Earlier of counterparty's commitment to perform or actual performance.
Modification of an award by change in performance condition (Type III: improbable to probable)	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 recognized on an accelerated basis to reflect the vesting as it occurs.	An accounting policy choice exists for awards with a service condition to either (1) amortize the entire grant on a straight-line basis over the longest vesting period; or (2) recognize a charge similar to IFRS.
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 payments being classified as liabilities.
Recognition of payroll taxes levied on share-based payments	Liability is recognized at the grant date or as services are provided over the vesting period.	Liability is recognized in the period when the tax is levied (e.g. exercise).
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.	Deferred tax is computed based on the GAAP expense recognized and trued up or down at realization of the tax benefit/deficit.



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