

Applying IFRS

IFRS 2 Share-based Payment

Accounting for share-based payments under IFRS 2 - the essential guide

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What you need to know

- IFRS 2 Share-based Payment requires an entity to measure and recognise share-based payment awards – to employees or other parties – in its financial statements.
- IFRS 2 sets out measurement principles and specific requirements for three types of share-based payment transactions: equity-settled, cash-settled, and when there is a choice of either cash or equity-settled.
- Share-based payment awards are measured at the fair value of the goods and services received. Where the fair value¹ of goods and services cannot be measured reliably, the share based payment is measured by reference to the fair value of the equity instruments granted.
- A share-based payment award generally vests upon meeting specified conditions, which can either be service conditions or performance conditions.
- Awards are expensed as vesting conditions, if any, are satisfied.

¹ IFRS 2 uses the term 'fair value' in a way that differs in some respects from the definition of fair value in IFRS 13 *Fair Value Measurement*. Therefore, when applying IFRS 2, an entity measures fair value in accordance with IFRS 2 and not IFRS 13. For the purposes of this publication, references to fair value are made in the context of IFRS 2 and not IFRS 13.

1. Overview and background

Share-based payment awards (such as share options and shares) are common features of employee remuneration for directors, senior executives and other employees. Some entities also issue shares or share options to pay suppliers, such as providers of professional services.

Prior to the issuance of IFRS 2 *Share-based Payment* (IFRS 2 or the standard), there was no IFRS covering the recognition and measurement of these types of transactions. This became a key issue for executives, entrepreneurs, employees and directors, given the increasing prevalence of share-based payment awards in many countries.

As share-based payment awards became a larger component of employee and executive compensation (e.g., in the Silicon Valley technology companies in the late 1990s), standard-setters came to believe that share-based payment awards are an integral component of a total compensation package. As such, they concluded that an entity should recognise an expense for share-based payments, just as it does for cash compensation.

IFRS 2 was issued in February 2004 and prescribes the measurement and recognition principles for all share-based payment awards within scope of the standard. IFRS 2 applies to share-based payment transactions with employees and third parties, whether settled in cash, equity instruments or other less common assets (e.g., gold). The standard has been amended several times since it was issued. Most recently, it was amended as part of the *Annual Improvements to IFRSs 2010-2012 Cycle* with respect to vesting conditions; these amendments became effective on 1 July 2014.

The application of IFRS 2 involves difficult classification and complex valuation issues and, as described below, is sometimes counter-intuitive. The general principle of IFRS 2 is that an entity recognises an expense or asset for goods or services, with the credit entry recognised either in equity or as a liability (depending on how the share-based payment award is required to be settled). The definitions of 'equity' and 'liability' in IFRS 2 are different from those used in IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments*). IFRS 2 also uses the term 'fair value' in a way that differs in some respects from the definition of fair value in IFRS 13 *Fair Value Measurement*. Therefore, in accounting for share-based payment transactions an entity measures fair value in accordance with IFRS 2, not IFRS 13.

After much debate, the IASB settled on a grant date model to measure share-based payment awards to employees (see sections 4 and 6). Under the grant date model, an entity measures the fair value of a share-based payment award issued to an employee on the grant date. For equity-settled share-based payments, the entity does not adjust the grant date fair value afterwards (even if it becomes more or less valuable or does not ultimately vest), unless the award is modified. Frequently, this results in an entity recognising an expense even if the employee receives no monetary benefit from the award. Although this situation seems counter-intuitive, we believe this model is preferable to entities not recognising any expense for share-based payment transactions.

In this publication, we provide an overview of IFRS 2 and explore some of the basic concepts by providing illustrations of how to apply them. We also include a glossary of terms in the Appendix.

2. Scope of IFRS 2

IFRS 2 encompasses three types of transactions:

- *Equity-settled share-based payment transactions* in which the entity receives goods or services as consideration for its own equity instruments or those of another entity in the same group or a shareholder of any group entity
- *Cash-settled share-based payment transactions*, also referred to as 'liability awards', in which the entity receives goods or services and incurs a liability based on the value of the entity's shares or other equity instruments of the entity or another group entity (e.g., the grant of share appreciation rights to employees, which entitle the employees to future cash payments based on the increase in the entity's share price)
- *Share-based payment transactions with cash alternatives* in which the entity receives goods or services and either the entity (or another group entity) or the supplier of the goods or services (the counterparty) has a choice of the entity settling the transaction in cash, other assets, or by issuing equity instruments

The scope of IFRS 2 is not restricted to transactions with employees.

IFRS 2 provides requirements on group share-based payment plans, which is discussed further in see section 9. 'Group' is defined in IFRS 2 as a parent and its subsidiaries from the perspective of the reporting entity's ultimate parent.

Goods and services referred to above can be received from external suppliers or employees. For example, if an external supplier of goods or services is paid in shares, share options or cash based on the price (or value) of shares or other equity instruments of the entity, IFRS 2 must be applied. Goods do not include financial assets, but do include inventories, consumables, property, plant and equipment, intangibles, and other non-financial assets. Likewise, an employee may receive equity instruments as remuneration for services rendered.

Even if an entity cannot specifically determine the goods or services it receives in return for its shares, it must apply IFRS 2. For example, if an entity grants shares to a charity for no identifiable benefit, that transaction is within the scope of IFRS 2.

IFRS 2 does not cover the following transactions:

- Transactions with shareholders that are acting solely in their capacity as shareholders
- Goods and services received by the entity that are settled by entities or shareholders not within the group
- Transactions within the scope of IAS 32 and IAS 39 (or IFRS 9)
- Share-based payment transactions to acquire goods as part of a business combination to which IFRS 3 *Business Combinations* applies, in a combination of entities or businesses under common control, or the contribution of a business on the formation of a joint venture, as defined by IFRS 11 *Joint Arrangements*
- Transfers of assets in certain group restructuring arrangements

Awards granted to employees of an acquiree in their capacity as employees (e.g., in return for continued service) are within the scope of IFRS 2, as are the cancellation, replacement and modification of share-based payment awards as a result of a business combination or other equity restructuring.

3. Basic principles

When an entity enters into a share-based payment arrangement, it needs to determine:

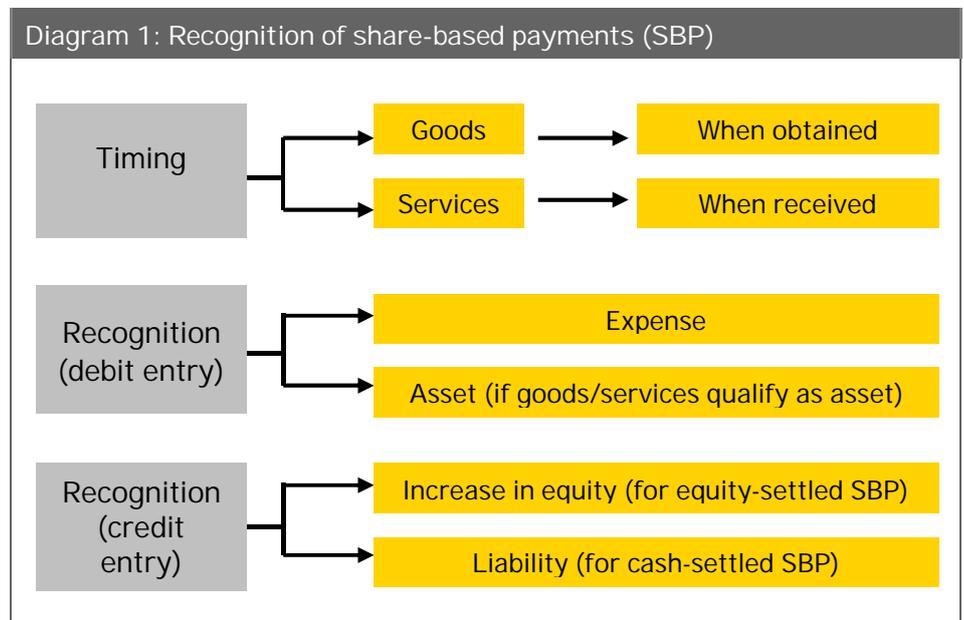
1. The classification of the share-based payment i.e. whether it is equity-settled or cash-settled
2. The grant date (see section 4.2)
3. Vesting conditions, if any, and whether they are market or non-market related (see section 4.3)
4. The period over which the award vests (see section 4.6)
5. The fair value at grant date (see section 4.7)

At each subsequent reporting date until vesting, the entity calculates a best estimate of the cumulative charge to profit or loss at that date, being the product of:

- The grant date fair value of the award
- The current best estimate of the number of awards that will vest
- The expired portion of the vesting period

The charge (or credit) to profit or loss for the period is the cumulative amount calculated above less the amounts already charged in previous periods. Diagram 1 below further illustrates the timing and the recognition under IFRS 2:

- An expense (or an asset if the goods and/or services received meet the criteria for recognising an asset)
- A corresponding increase in equity (for transactions settled in equity instruments) or in liabilities (for cash-settled transactions)



Once the awards have vested, no further accounting adjustments are made to the cost of the award, except in respect of certain modifications to the award.

All of the items above are explained in more detail in this publication.

IFRS 2 distinguishes between the accounting treatment for share-based payment transactions of equity-settled versus cash-settled. A transaction is treated as equity-settled when an entity receives goods or services as consideration for its own equity instruments (including shares or share options), or it receives goods or services but has no obligation to settle the transaction with the supplier. A transaction is considered to be cash-settled when 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.

For a share-based payment transaction in which the terms of the arrangement provide an entity with the choice of whether to settle in cash or by issuing equity instruments, the entity must determine whether it has a present obligation to settle in cash and account for the share-based payment transaction accordingly. 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 no such obligation exists, the entity must account for the transaction in accordance with the requirements that apply to equity-settled share-based payment transactions.

It is important that the share-based payment transaction is correctly classified as this has a consequential impact on the recognition and measurement. How and when the entity measures the award, and whether the entity must remeasure the award, all depend on whether the award is equity-settled, cash-settled, or there is a choice of settlement, and we explore this further in sections 4 and 5 of this publication.

4. Equity-settled awards

4.1 Measurement principle

For equity-settled awards (such as share options), the general principle in IFRS 2 is that an entity measures the fair value of goods obtained or services received, and recognises a corresponding increase in equity. But, if an entity cannot reliably estimate the fair value of the goods obtained or services received, it must measure their value indirectly using the fair value of the equity instruments granted.

However, IFRS 2 requires that:

- For awards to employees, an entity must use the fair value of the equity instruments, measured at the grant date
- For awards to non-employees, there is a rebuttable presumption that the fair value of the goods or services is more reliably determinable, which is measured when the goods or services are received or obtained

The IASB's decision to require entities to measure the equity instruments issued to employees based on their fair value is practical rather than theoretical, in that entities might have difficulty establishing which services relate to which component of an employee's compensation package. Furthermore, if a share-based payment award serves as a bonus, the entity pays additional compensation to receive additional services, but it may be difficult to determine the value of such services.

Equity-settled awards made to employees are measured at the grant date fair value.

As there are often no quoted market prices for share-based payment awards, IFRS 2 requires entities to estimate the grant date fair value of their share-based payment awards using option-pricing models, which we will discuss in more detail in section 4.7.

Diagram 2 illustrates the measurement principle for equity-settled awards:

Diagram 2: Measurement of share-based payments			
Counterparty	Measurement basis	Measurement date	Recognition date
Employee	Fair value of equity instruments awarded	Grant date	Date services received
Non-employee	Fair value of goods or services received	Date goods or services received	Date goods or services received

The grant date can only occur when there is a shared understanding of the terms of the arrangement.

4.2 Determination of grant date

The determination of the grant date is critical to the measurement of equity-settled share-based payment transactions with employees, since the grant date is the date at which the entity measures such transactions.

The grant date is defined as the date on which the reporting entity and the employee have a shared understanding of the terms of the arrangement, based on a legally binding agreement.

In practice, the following issues need to be considered:

- How precise the shared understanding of the terms of the award must be
- What level of communication between the reporting entity and the counterparty is sufficient to ensure the appropriate degree of shared understanding

The determination of the grant date is often difficult in practice. Entities need to consider the following circumstances when determining the grant date:

- Services are rendered in advance of grant date or before any communication of awards to employees
- Exercise price depends on a formula or a future share price
- Exercise price is paid in shares
- A fixed-monetary-amount award of equity instruments
- Awards over a fixed pool of shares (including 'last man standing' arrangements)
- Awards with multiple service periods
- Modification or discretionary re-assessment by the entity after the original grant date
- Mandatory or discretionary awards to 'good leavers'
- Special purpose acquisition companies (which are typically established for the purposes of flotation or sale)

The implementation guidance for IFRS 2 indicates that the grant date occurs when there is both a mutual understanding of the terms and a legally enforceable arrangement. Thus, if an award requires board or shareholder approval to be legally binding on the reporting entity, under IFRS 2 the grant date is not until such approval has been given, even if the terms of the award are fully understood at an earlier date. However, if the employee is rendering services for the award beginning on a date earlier than the grant date, the entity estimates the cost of the award and recognises such cost over a period starting with that earlier date. The entity adjusts the fair value estimate to the grant date when approval is given.

How we see it

The determination of whether there is a shared understanding may require the exercise of significant judgement. This may be the case, for example, when: the formula for determining the number of awards to employees is not clearly defined; final substantive approvals are required; or the number of shares ultimately received will not be known until the vesting date. It is important for entities to evaluate all terms of the award and the specific facts and circumstances in making the assessment as to whether there is a shared understanding between the entity and counterparty.

4.3 Vesting conditions

Under IFRS 2, the point at which a cost is recognised for goods or services depends on the vesting conditions. A vesting condition determines whether an entity receives the services that entitle the counterparty to receive the share-based payment award. A share-based payment award generally vests upon meeting specified conditions. Vesting conditions are either:

- Service conditions, which require the counterparty to complete a specified period of service during which the services are provided to the entity
- Or
- Performance conditions, which require the counterparty to complete a specified period of service (i.e., a service condition) and involves specified performance targets to be met while the counterparty is rendering the required service

A performance target can be defined by reference to the entity's own operations or activities, such as achieving a specified EBITDA target or the price (or value) of its equity instruments. A performance target can relate either to the performance of the entity as a whole, or to some part of the entity (i.e., a division) or an individual employee. If the period of achieving the specific target extends beyond the employee's service period, the performance target is a non-vesting condition (discussed below).

A performance condition is further defined as either a market condition or a non-market condition.

A market condition is a performance condition (i.e., requires specified targets to be met) and the performance conditions are related to the market price (or value) of the entity's equity instruments, such as: attaining a specified share price or achieving a specified target that is based on the market price (or value) of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.

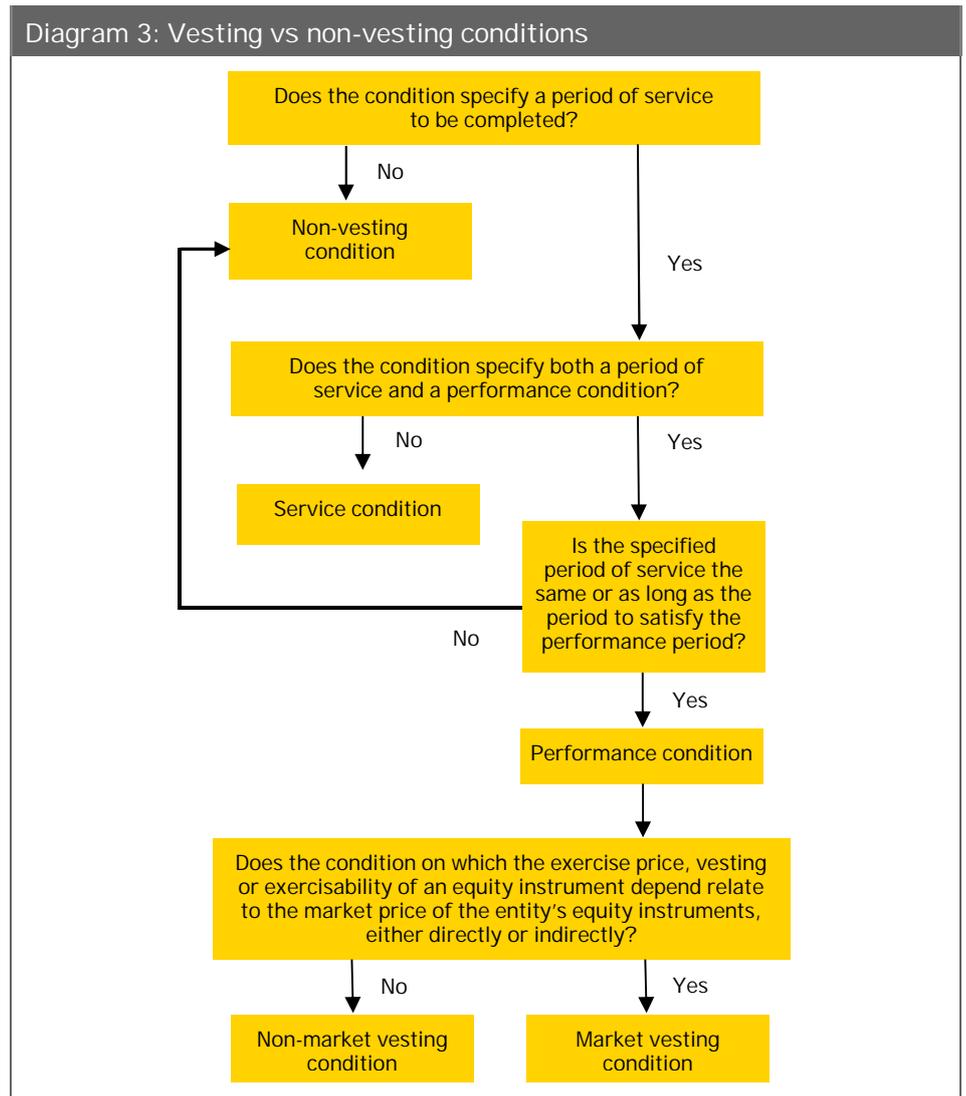
A condition linked to a purely internal financial performance measure, such as profit or earnings per share, is not a market condition. Such measures will affect the share price, but are not directly linked to it, and hence are not market conditions.

In order for a market condition to be treated as a performance vesting condition rather than a non-vesting condition, there must also be an implicit or explicit service condition.

4.4 Non-vesting conditions

IFRS 2 does not specifically define a non-vesting condition, but uses the term to describe a condition that is neither a service condition nor a performance condition. A performance condition is distinguished from a non-vesting condition in that it has an explicit or implicit service requirement whereas a non-vesting condition does not. This means that, if an employee is entitled to an award on the grant date and is not required to provide any future services to the entity, such a condition is not regarded as a vesting condition for the purpose of IFRS 2. Instead, it is referred to as a non-vesting condition. Examples of non-vesting conditions include a non-compete clause, a target based on a commodity index or the employees paying contributions towards the exercise price of a share-based payment award. See Illustration 2 in 4.5 below. The decision tree in Diagram 3 illustrates that the difference between a vesting condition and a non-vesting condition is dependent upon whether or not there is a period of service.

The difference between vesting and non-vesting conditions depends on whether there is a service condition to be met.



Market vesting conditions are taken into account when estimating the fair value of the award at grant date. Non-market vesting conditions are taken into account by subsequently adjusting the number of awards expected to vest.

4.5 Impact of conditions on measuring share-based payments

Under IFRS 2, the nature of the condition (i.e., vesting or non-vesting, service, performance, market or non-market) affects the timing of when the expense is recognised and, in some cases, the measurement of the expense. In addition, if a condition is not met, whether or not the entity may reverse the previously recognised compensation expense depends on the nature of the condition that was not met. Therefore, the classification of a condition is a critical step in accounting for share-based payments transactions.

Market conditions are only taken into account when estimating the fair value of the award at the grant date.

Non-market vesting conditions are not taken into account when estimating the fair value of the shares or share options at the grant date. Instead, these vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so as to reflect the number of awards that are expected to vest. Such non-market vesting conditions include a service condition.

Performance conditions can either be market conditions or non-market conditions.

Accounting for share-based payments with conditions

Illustration 1a: Award with only service conditions

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. The entity estimates that 20% of the employees will leave during the three-year period and, therefore, forfeit their rights to the share options.

Application of the requirements:

Yr	Calculation	Expense for period	Cumulative expense
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

Under IFRS 2, an entity only recognises compensation expense for options with non-market performance conditions if such awards ultimately vest. Therefore, if an entity grants options to a large number of employees on one grant date, the entity would need to estimate the number of employees that will terminate employment prior to meeting the non-market performance conditions, i.e., the number of employees that will forfeit awards. The entity adjusts its estimate of awards that will vest at each reporting date so that, on the vesting date, the expense recognised equals the grant date fair value of the options that have vested. This is shown in Illustration 1b.

Illustration 1b: Award with only service conditions – change in estimates

Following from illustration 1a: In year 1, 20 employees leave. The entity revises its estimate of total employee departures over the three-year period from 20% (100 employees) to 15% (75 employees). In year 2, a further 22 employees leave. The entity revises its estimate of total employees over the three-year period from 15% to 12% (60 employees). In year 3, a further 15 employees leave. Therefore, 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 each) vested at the end of year 3.

Yr	Calculation	Expense for period	Cumulative expense
1	50,000 options x 85% x CU15 x 1/3 years	212,500	200,000
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

Illustration 2: Award with market conditions

An entity grants 10,000 share options to a director on the condition that the director remains in employment for three years and the market price of the related shares increased from CU50 at the beginning of year 1 to above CU65 at the end of year 3. The entity determines the fair value at grant that takes into account the possibility that the share price will exceed CU65 at the end of year 3 (and therefore become exercisable) and the possibility that the share price will not exceed CU65 at the end of three years (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.

The possibility that the share price target might not be achieved is already taken into account when estimating the fair value of the options at grant date. Therefore, if the entity expects the director to complete the three-year service period and the director does so, the entity recognises the following amounts in years 1, 2 and 3:

Yr	Calculation	Expense for period	Cumulative expense
1	10,000 options x CU24 x 1/3 years	80,000	80,000
2	(10,000 options x CU24 x 2/3 years) – CU80,000	80,000	160,000
3	(50,000 options x CU24 x 3/3 years) – CU160,000	80,000	240,000

These amounts are recognised irrespective of the outcome of the market condition. However, if the director leaves during year 2 (or year 3), the amount recognised during year 1 (and year 2) will 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.

Illustration 3: Award with non-vesting conditions only

An entity grants share options to a director on the condition that the director does not compete with the reporting entity for a period of three years. The fair value of the award at the date of grant, including the effect of the non-compete clause, is CU150,000.

The non-compete clause is a non-vesting condition, because the entity does not receive any services. On the grant date, the entity immediately recognises the full cost of CU150,000, as the director is not providing any future services. The entity cannot reverse the expense recognised, even if the director goes to work for a competitor and loses the share options.

An entity recognises the cost for goods and services received when all service and non-market vesting conditions are met, regardless of whether the market conditions or non-vesting conditions are met.

4.6 Vesting period

The vesting period is the period during which all the specified vesting conditions of a share-based payment award must be satisfied, which is not the same as the exercise period or the life of the option. An entity recognises expense over the vesting period, as shown in Illustration 3, or immediately, if there is no vesting period.

Illustration 4: Award with service condition only

If an employee remains in service for at least three years from the grant date of the award, the employee can exercise the options at any time between three and ten years from the grant date. The fair value of the award at the grant date, is CU300,000.

For this award, the vesting period is three years, the exercise period is seven years, and the life of the option is ten years.

The requirement to remain employed is a vesting service condition. The entity recognises an expense of CU100,000 each year for three years, with a corresponding increase in equity. If the employee leaves at the end of year 2, the entity reverses the cumulative expense previously recognised (i.e., CU200,000) in the current year.

Share-based payment awards frequently have one grant date and different vesting periods. An entity must separately determine the fair value of each award with a different vesting period and recognise the expense over the vesting period, as shown in Illustration 5.

Illustration 5: Award with multiple vesting periods

On 1 January 2013, an entity grants an award to an executive for 40,000 share options, such that 10,000 share options vest (or are forfeited) in each of the next four years depending on whether the executive is employed at the end of that year. At 1 January 2013, a mutual detailed understanding of the key terms and conditions is reached.

There is one grant date - 1 January 2013 (and, therefore, one measurement date) for multiple service periods. This award has a graded vesting pattern whereby the 2013 tranche has a one-year vesting period, the 2014 tranche has a two-year vesting period, the 2015 has a three-year vesting period, and the 2016 tranche has a four-year vesting period.

Illustration 5: Award with multiple vesting periods (continued)

However, if the fact pattern were altered such that performance targets were set on 1 January of each respective year, then there would be multiple grant dates. Each respective year would be a separate tranche of options that has a 1 January grant date and a one-year vesting period.

4.7 Valuation of awards

Unless an option with the same or comparable terms is listed (which seldom occurs) an entity cannot obtain the fair value externally. Therefore, it must estimate the fair value of a share-based payment using an option-pricing model. IFRS 2 does not require entities to use a specific option-pricing model to calculate fair value. However, it does require that the adopted valuation technique is consistent with generally accepted valuation methodologies for pricing financial instruments, incorporating all factors and assumptions that knowledgeable, willing market participants would normally consider with respect to that particular award.

The Basis for Conclusions to IFRS 2 refers to the Black-Scholes-Merton and Binomial models as two acceptable methods that entities might use when estimating the fair value of employee share options. For awards that include a market condition or the market value of the entity's equity in a performance condition, such as total shareholder returns, an entity should supplement its valuation by the use of a technique such as Monte Carlo Simulation to estimate the likelihood that a market condition will be reached, and the resulting value of the award.

IFRS 2 requires that, at a minimum, the entity must use six inputs in whichever model is selected. Diagram 4 shows the effects that an increase in any of the six different inputs would have on the fair value of the option (all other terms remaining constant):

	FV increase	FV decrease
Exercise price of the option		a
Current share price*	a	
Expected life of the option	a	
Expected volatility	a	
Expected dividend yield		a
Risk-free interest rate	a	

* Current share price that is quoted is objectively determinable. However, if it is unquoted (e.g., for unlisted entities), the share price may not be objectively determinable.

Of the six required inputs above, only two – the exercise price of the option and the current share price – are generally objectively determinable. The remaining assumptions are subjective and generally require significant analysis and judgement, including consideration of the following factors:

- Expected life of the option: the vesting period, past history of employee exercise, the price of the underlying shares, the employee's level within the organisation and the expected volatility
- Expected volatility: the historical volatility over the same period as the expected life of the option, long-term average level of volatility, the length of time an entity's shares have been publicly traded, and the appropriate interval for price observations
- Expected dividend yield: the current expectation for an entity's dividend policy, and whether an employee is entitled to dividends on the underlying shares while holding the share option
- Risk-free interest rate: the implied yield currently available on zero-coupon government issues denominated in the currency of the market in which the underlying shares primarily trade, over the same period as the expected life of the option

How we see it

- The valuation of awards can sometimes be complex and the services of valuation experts may be needed.
- Take for example, past history of employees' exercise – whilst past exercise behaviour generally serves as the starting point for determining expected exercise behaviour, the past behaviour should be analysed together with other factors before extrapolating into the future. This may result in entities having to look to the exercise history of employees of similar entities to develop expectations of employee exercise behaviour.

For cash-settled awards, an entity measures the fair value of the goods or services received based on the fair value of the liability at each reporting period.

5. Cash-settled awards

For cash-settled awards (such as a share appreciation right), the general principle in IFRS 2 is that an entity measures the fair value of the goods or services received based on the fair value of the liability. However, unlike the grant date model for equity-settled awards for employees, an entity remeasures the fair value of the award at each reporting date and on settlement. The ultimate cost of a cash-settled award is the cash paid to the counterparty, which is the fair value at settlement date. Until the award is settled, an entity presents the cash-settled award as a liability and not within equity. Thus, changes in the measurement of the liability are reflected in the statement of profit or loss and other comprehensive income. IFRS 2 does not specifically address the impact of vesting conditions within the context of cash-settled share-based payment transactions. However, at its November 2013 meeting, the IFRS Interpretations Committee discussed proposed amendments to IFRS 2 and recommended that the IASB amend IFRS 2 to make clear that:

- The effect of a market condition or a non-vesting condition must be reflected in the estimation of the fair value of the cash-settled share-based payments both at the grant date and subsequently.

- Vesting conditions (other than market conditions) must not be taken into account when estimating the fair value of cash-settled share-based payments. Instead, vesting conditions (other than market conditions) must be taken into account in the measurement of the liability incurred by adjusting the number of awards that are expected to vest. Such an estimate must be revised when the liability is remeasured at each reporting date and until the vesting date.
- On a cumulative basis, no amount is recognised for goods or services received if the awards granted do not vest because of failure to satisfy a vesting condition or a non-vesting condition.

These amendments are included as part of the collection of narrow-scope amendments to IFRS 2 and an exposure draft was released on 11 November 2014, with a comment period of 120 days.

For cash-settled share-based payments, the entity recognises the services received and the liability for those services as the employees render them. If an employee is not required to provide a service, as is the case for some share appreciation rights, the entity recognises the expense and liability immediately upon grant date. If the employee is required to provide services over for a specified period in order to vest in the cash-settled award, the entity recognises the expense and the liability over the vesting period, while reconsidering the likelihood of achieving vesting conditions and remeasuring the fair value of the liability at the end of each reporting period.

Illustration 6: Award that is cash-settled

An entity grants 100 cash-settled awards to each of its 500 employees on the condition that the employees remain in its employment for the next three years. Cash is payable at the end of three years based on the share price of the entity's shares on such date.

During year 1, 35 employees leave. The entity estimates that 60 additional employees will leave during years 2 and 3 (i.e., the award will vest for 405 employees). The share price at year-end is CU14.40.

During year 2, 40 employees leave and the entity estimates that 25 additional employees will leave during year 3 (i.e., the award will vest for 400 employees). The share price at year-end is CU15.50.

During year 3, 22 employees leave, so that the award vests for 403 employees. The share price at year-end is CU18.20.

The entity recognises the cost of this award, as follows:

Yr	Calculation	Cumulative expense	Expense for period
1	405 employees x 100 awards x CU14.40 x 1/3	194,400	194,400
2	400 employees x 100 awards x CU15.50 x 2/3	413,333	218,933
3	403 employees x 100 awards x CU18.20 x 3/3	733,460	320,127

For modifications, the cost of the original award as if it had not been modified, must be recognised at a minimum.

6. Modifications, cancellations and settlements

An entity sometimes modifies or cancels share-based payment awards before they vest because the vesting conditions become too onerous to achieve, or the share price of an equity instrument has dropped so far below the exercise price that it is unlikely it will ever be 'in the money' during its life. In such circumstances, an entity may replace the original vesting conditions of the share-based payment award with less onerous conditions, making it easier for the employee to meet the conditions of the award.

If an entity modifies an award, it must recognise, at a minimum, the cost of the original award as if it had not been modified. If the modification increases the fair value of the award, the entity must recognise the additional cost. The additional cost is spread over the period from the modification date until the vesting date of the modified award, which may differ from the vesting date of the original award. Any increase or decrease in the fair value of an award as a result of a modification is determined at the modification date. If an entity modifies a vested award, it recognises any additional fair value given on the modification date.

When an award is cancelled or settled during the vesting period, it is treated as an acceleration of vesting and the entity immediately recognises the remaining amount that it otherwise would have recognised for services over the remaining vesting period.

When an entity pays compensation for a cancelled or settled award:

- Any compensation paid up to the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as a deduction from equity, as being equivalent to the redemption of an equity instrument
- Any compensation paid in excess of the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as an expense in profit or loss
- Any payment made to settle a liability component is accounted for as an extinguishment of the liability

If an entity grants a new award during the vesting period and, on the grant date, identifies the award as replacing the cancelled or settled award, the entity accounts for the new award as if it were a modification of the cancelled award. Otherwise, it accounts for the new award as an entirely new award.

The above provisions of IFRS 2 apply when an award of equity instruments is cancelled or settled, other than a grant cancelled by forfeiture when the vesting conditions are not satisfied. When an award is forfeited, i.e., it does not vest because the vesting conditions are not met, the entity applies the accounting treatment for a forfeiture. Therefore, it must reverse the expense previously recognised, even if the award is cancelled as a consequence of the forfeiture.

In some cases, it is difficult to distinguish between forfeiture and a cancellation. For example, an unvested share-based payment award that expires upon termination of employment by the employer could be argued to be either a forfeiture (i.e., reversal of the cost of the award already recognised) or a cancellation (i.e., acceleration of the cost of the award not yet recognised).

When an award does not vest as the result of a failure to meet a non-vesting condition, the accounting treatment depends on whether the failure to meet the condition is within or outside the control of either the entity or the counterparty. A failure to satisfy a non-vesting condition that is within the control of either the entity or the counterparty is accounted for as a cancellation. However, failure to satisfy a non-vesting condition that is beyond the control of either party does not give rise to a cancellation.

The basis for conclusions for the amendments to IFRS 2 from the *Annual Improvements to IFRSs 2010-2012 Cycle* noted that the amendment to the definition of service condition clarifies that termination of an employee's employment is a situation in which the employee fails to complete a specified service period. Consequently, the service condition is not met and is treated as a forfeiture.

Additional practical difficulties arise when the award includes a non-market performance condition. IFRS 2 requires an entity to determine a cumulative charge at each reporting date based on its best available estimate of the number of awards that will vest.

How we see it

The accounting for non-market performance condition seems to conflict with the requirements of accounting for cancellations, i.e., to recognise the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

It is unclear whether the entity's best estimate at the date of cancellation encompasses employees at the cancellation date, or employees that would have vested if the award had not been cancelled (that is, considering forfeitures that otherwise still might have occurred over the remaining vesting period). It is also unclear whether the entity's best estimate reflects the number of awards expected to vest based on progress towards achieving non-market performance conditions as of the cancellation date (or lack thereof), or the total awards that otherwise could have vested (i.e., the maximum grant).

IFRS 2 appears to support more than one view. Therefore, entities must develop an accounting policy as to how they determine the best available estimate of the number of awards that will vest and apply it consistently.

7. Share-based payment awards with a cash alternative

IFRS 2 gives specific guidance for the situation in which cash settlement is a choice. The accounting differs depending on whether the choice rests with the counterparty or the entity.

If a counterparty chooses settlement of the award in either shares or cash, IFRS 2 treats it as a compound award. A compound award is split into two components: a liability component (the counterparty's right to demand settlement in cash) and an equity component (the counterparty's right to demand settlement in shares). Once split, the entity accounts for the two components separately.

For awards that can be settled in cash as an alternative, it is important to determine whether the choice rests with the counterparty or the entity.

If an entity chooses the settlement method, it treats the whole award as either cash-settled or equity-settled, depending on whether or not the entity has a present obligation to settle in cash. An entity has a present obligation to settle in cash, if any of the following apply:

- The choice of settlement has no commercial substance (e.g., because an entity is prohibited by law from issuing shares)
- An entity has a past practice or stated policy of settling in cash
- An entity generally settles in cash whenever the counterparty asks for cash settlement

If an entity has a present obligation to settle in cash, it is a cash-settled award (i.e., a liability). If an entity does not have a present obligation to settle in cash, it is an equity-settled award.

8. Exchanges of share-based payment awards issued in a business combination

Acquirers in a business combination often exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquired business. These exchanges frequently occur because the acquirer wants to avoid having non-controlling interests in the acquiree, and/or to motivate former employees of the acquiree to contribute to the overall results of the combined, post-acquisition business.

IFRS 3 addresses the accounting treatment required in a business combination in which an acquirer:

- Replaces acquiree awards on a mandatory basis
 - Replaces acquiree awards on a voluntary basis, even if the acquiree awards would not expire as a consequence of the business combination
- Or
- Does not replace acquiree awards

If the acquirer is obliged to issue replacement awards in exchange for acquiree share-based payment awards held by employees of the acquiree, then all or a portion of the market-based measure² of the acquirer's replacement awards are treated as part of the consideration transferred by the acquirer. The effect will be to increase goodwill and recognise a corresponding amount in equity. The acquirer is considered to have an obligation if the employees or the acquiree can enforce replacement. Such an obligation may arise from the terms of the acquisition agreement, the terms of the acquiree's award scheme or legislation.

² IFRS 3 requires that the acquirer measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transaction with share-based payment transactions of the acquirer in accordance with the method in IFRS 2 at the acquisition date. IFRS 3 refers to the result of that method as the 'market-based' measure of the share-based payment transaction.

The portion of the replacement award that is treated as the consideration transferred is the amount attributable to past service that the employee has provided to the acquiree. It is determined based on the market-based measure of the awards issued by the acquiree (not the market-based measure of the replacement awards issued by the acquirer). When additional service conditions are imposed by the acquirer, this affects the total vesting period and, therefore, the portion of the awards that is considered pre-combination service. As a result, the portion of the replacement award treated as part of the consideration transferred (i.e., the portion related to past services) is determined, as follows:

- Market-based measure at the acquisition date of the replaced (i.e., acquiree) award X (Vesting period completed/greater of total vesting period³ and original vesting period)

The excess of the market-based measure of the replacement award over the amount treated as consideration transferred at the acquisition date is recognised as a remuneration expense over the period from the acquisition date until the end of the vesting period. Effectively, this means the excess of the market-based measure of the replacement awards over the market-based measure of the acquiree's awards, if any, is recognised as remuneration expense in the acquirer's post-combination financial statements.

If the acquirer is not obliged to issue replacement awards, but elects to do so, none of the replacement awards are treated as part of the consideration transferred, therefore, they have no impact on goodwill and equity. Rather, the replacement awards are a post-combination modification, giving rise to an employee remuneration cost. There is no difference in the basic approach to accounting for a replacement award that the acquirer is obliged to make and one that it makes on a voluntary basis. The accounting is based on the fair value of the replacement award at the date of acquisition, with an apportionment of that amount between the cost of acquisition which is to be expensed as incurred and post acquisition employment expense.

In situations in which the acquiree awards would expire as a consequence of the business combination if they were not voluntarily replaced by the acquirer, none of the fair value of the replacement awards is treated as part of the consideration transferred for the business (and therefore included in the computation of goodwill), but the full amount is, instead, recognised as a remuneration cost in the post-combination financial statements.

It may happen that the acquirer does not replace awards of the acquiree at the time of the acquisition. In such situations, IFRS 3 distinguishes between vested and unvested share-based payment transactions of the acquiree that are outstanding at the date of the business combination, but which the acquirer chooses not to replace.

If vested, the outstanding acquiree share-based payment transactions are treated by the acquirer as part of the non-controlling interest in the acquiree and measured at their IFRS 2 fair value at the date of acquisition.

Careful consideration should be given to understanding whether the replacement awards are issued on a mandatory or voluntary basis, or if they are not meant for the purpose of replacing acquiree awards.

³ Being the period (as determined at the date of business combination) required to satisfy all vesting conditions, including conditions added to, or removed from, the original award by the replacement award.

If unvested, the outstanding share-based payment transactions are fair valued in accordance with IFRS 2 as if the acquisition date were the grant date. The fair value is allocated to the non-controlling interest in the acquiree on the basis of the ratio of the portion of the vesting period completed to the greater of:

- The total vesting period
- The original vesting period of the share-based payment transactions

The balance is treated as a post-combination remuneration expense in accordance with the general principles of IFRS 2.

How we see it

When management is considering replacement of the acquiree's share-based payment schemes, careful consideration should be given at the time of negotiating the arrangement to ensure management's intention is appropriately reflected in the financial statements.

9. Group share-based payment plans

It is common practice for a group to operate a single share scheme covering several subsidiaries. IFRS 2 provides requirements in respect of transactions settled in the equity of either the entity or the parent, as well as cash-settled transactions that are settled by a group entity other than the entity receiving the goods or services.

A parent might decide to grant equity-settled awards to employees of its subsidiary. The subsidiary must account for the services received from its employees as an equity-settled award in its own financial statements.

A subsidiary might grant its employees rights to equity instruments of the parent. The subsidiary accounts for the transaction with its employees as cash-settled. This applies irrespective of how a subsidiary obtains the equity instruments to satisfy its obligation to its employees.

IFRS 2 considers arrangements in which the parent has an obligation to make cash payments to the employees of a subsidiary that are linked to the price of either the subsidiary's equity instruments or its own equity instruments. In both cases, the subsidiary has no obligation to settle the transaction. Therefore, the subsidiary accounts for the transaction as equity-settled, recognising a corresponding credit in equity as a contribution from its parent.

The subsidiary subsequently remeasures the cost of the transaction only for any changes resulting from non-market vesting conditions not being met in accordance with the provisions of IFRS 2. This will differ from the measurement of the transaction as cash-settled in the consolidated financial statements of the group. In both cases (where the parent has an obligation to make cash payments to the employees of the subsidiary that are linked to the price of either the subsidiary's equity instruments or its own equity instruments), the parent has an obligation to settle the transaction in cash. Accordingly, the parent accounts for the transaction as cash-settled in both its consolidated and separate financial statements.

Employee benefit trusts (EBT) (or similar entities) established for employee share option plans, employee share purchase plans and other share-based payment programmes are in the scope of IFRS 10 *Consolidated Financial Statements*. Therefore, the sponsoring entity needs to assess whether it is required to consolidate an EBT based on the control criteria set out in IFRS 10.

10. Taxes on share-based payment awards

IAS 12 *Income Taxes* deals with the tax implications of accounting for share-based payment awards. However, due to differences in local tax laws, the tax implications arising from IFRS 2 are country-specific.

In many jurisdictions, entities receive tax deductions for share-based payment awards. For example, jurisdictions might give a tax deduction based on the following:

- Fair value of the award at the vesting date
- Fair value of the award at the exercise date
- Amount charged to a subsidiary by its parent

Both the amount and timing of the expense for tax purposes probably differ from the amount and timing of the expense recognised under IFRS 2, which results in deferred tax consequences, as described in IAS 12.

11. Disclosures

Among other things, IFRS 2 requires entities to disclose the following:

- The type and scope of agreements existing during the reporting period
- Descriptions of each type of arrangement, including general terms and conditions of the arrangement (e.g., settlement methods, vesting conditions)
- The number and weighted-average exercise price of share options (outstanding at the beginning of the reporting period and at the end of the reporting period, granted, vested, exercised, expired and forfeited during the period)
- The average share price of exercised options
- The range of exercise prices and weighted average remaining contractual life of options outstanding at the end of the reporting period
- The valuation method used to estimate the fair value of the awards (model and input values, etc.)
- The impact on the income statement (i.e., total expense) and the financial position (e.g., carrying amount of liabilities) of share-based payment awards

Detailed disclosure requirements in IFRS 2 are limited to stock option plans. Hence, judgement is needed to apply the disclosure principles to the wide variety of plans that exist in practice.

Entities must also consider the impact of any interaction with the disclosure requirements in IAS 24 *Related Party Disclosures* on key management compensation. In addition, entities may need to consider additional local disclosure requirements on compensation.

Sample disclosures can be found in the implementation guidance for IFRS 2, or in our illustrative financial statements, *Good Group (International) Limited*, which can be found on our website at www.ey.com/ifrs.

Careful consideration should be given to determine appropriate disclosures.

12. Transition to IFRS

IFRS 1 *First-time Adoption of International Financial Reporting Standards* sets out the transitional provisions for entities adopting IFRS for the first time.

Under IFRS 1, IFRS 2 is applicable for equity settled awards granted after 7 November 2002 (publication date of the exposure draft of IFRS 2) that have not vested as of the date of transition to IFRS. However, an entity must make some disclosures about outstanding awards for which it has not applied IFRS 2 (such as the number of awards outstanding and weighted-average exercise price).

On first time adoption of IFRS, IFRS 2 is applicable to cash-settled awards that are settled on or after the date of transition to IFRS. A first-time adopter is encouraged, but not required, to apply IFRS 2 to cash-settled awards that were settled before the date of transition to IFRS.

13. Concluding remarks

IFRS 2 requires significant analysis in terms of classification, measurement and disclosures. It is therefore crucial that those involved in designing plans are familiar with IFRS 2 and the related expense ramifications to avoid unexpected accounting consequences. Decision-makers must also consider 'hidden' share-based payment awards that may fall within the scope of IFRS 2 such as a situation in which:

- A non-corporate shareholder of an entity gives shares to employees of the entity
- Employees receive a cash pay-out equal to the increase in an index of shares
- An entity gives an employee a limited recourse loan to acquire shares

As discussed above, various vesting conditions affect the expense charged to the income statement differently. If an option has a market vesting condition, an entity might still recognise an expense even if that condition is not met and the option does not vest. By contrast, an award subject only to a non-market vesting condition does not result in an expense under IFRS 2 if the condition is not met.

Entities offering share-based payment awards should keep abreast of new developments as and when they arise and involve accounting, tax and human resource professionals.

How we see it

Applying IFRS 2 requires significant analysis in respect of classification and measurement. The accounting implications should be considered at the outset when developing a plan, rather than after the fact. Professional assistance may be useful to assess the appropriate accounting and disclosures.

Appendix: IFRS 2 Glossary

Term	Definition
Cash-settled share-based payment transaction	A share-based payment transaction in which an 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 <ol style="list-style-type: none"> a) Receives goods or services as consideration for its own equity instruments (including shares or share options) <p>Or</p> <ol style="list-style-type: none"> b) Receives goods or services but has no obligation to settle the transaction with the supplier.
Grant date	The date at which an entity and another party (including an employee) agree to a share-based payment arrangement, beginning 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 (e.g., by shareholders), the grant date is the date when that approval is obtained.
Intrinsic value	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 the counterparty is required to pay for those shares. For example, a share option with an exercise price of CU15 per share with a fair value of CU20 has an intrinsic value of CU5.
Market condition	A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), such as: <ol style="list-style-type: none"> a) Attaining a specified share price or, a specified intrinsic value of a share option <p>Or</p> <ol style="list-style-type: none"> b) Achieving a specified target that is based on the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), relative to an index of market prices of equity instruments of other entities
Measurement date	The date at which the fair value of the equity instruments granted is measured for the purposes of this standard. For transactions with employees and others providing similar services, the measurement date is the 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.
Performance condition	A vesting condition that requires: <ol style="list-style-type: none"> a) The counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit; and b) Specified performance target(s) to be met while the counterparty is rendering the service required in (a). <p>The period of achieving the performance target(s):</p> <ol style="list-style-type: none"> a) Shall not extend beyond the end of the service period; and b) May start before the service period, on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

Term	Definition
Performance condition (continued)	<p>A performance target is defined by reference to:</p> <p>a) The entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e., a non-market condition)</p> <p>Or</p> <p>b) The price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (i.e., a market condition).</p> <p>A performance target might relate either to the performance of the entity as a whole, or to some part of the entity (or part of the group), such as a division or an individual employee.</p>
Reload feature	A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using an entity's shares (rather than cash) to satisfy the exercise price.
Service condition	A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance condition target to be met.
Share-based payment arrangement	<p>An agreement between an 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</p> <p>a) Cash or other assets of the entity for amounts that are based on the price (or value) of the equity instruments (including shares or share options) of the entity or another group entity</p> <p>Or</p> <p>b) Equity instruments (including shares or share options) of the entity or another group entity provided the specified vesting conditions, if any, are met.</p>
Share-based payment transaction	<p>A transaction in which the entity</p> <p>a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement; or</p> <p>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.</p>
Share option	A contract that gives the holder the right, but not the obligation, to subscribe for an entity's shares at a fixed or determinable price for a specified period.
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 conditions	A condition that determines whether an 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.

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A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting, to key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

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