



30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: <http://www.iasb.org>

International
Accounting Standards
Board

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

Project: IFRS 2 *Share-based Payment* – Incremental Fair Value to Employees as a result of unexpected Capital Restructurings (Agenda paper 10(x))

INTRODUCTION

1. The IFRIC has been asked to consider a situation when a sponsoring entity has a capital restructuring after it grants share options to its employees. The sponsoring entity does not expect the occurrence of any capital restructuring at the time when it grants share options to its employees. The fair value of the share options **increases** significantly as a result of the capital restructuring. However, the share option plan does not specify whether adjustments should be made to the plan in the event of a capital restructuring.
2. For example,
 - On 1 January 20X1, Entity A grants each of its 50 employees 100 share options (5,000 share options), with a vesting period of three years.
 - The fair value of each share option at grant date (i.e. on 1 January 20X1) is CU20.

- On 31 December 20X2, Entity A undertakes a share consolidation. As a result, the fair value of each share option on 31 December 20X2 increases to CU30. If corresponding adjustments had been made to the plan, the fair value of each share option on 31 December 20X2 would still be CU20.
 - The share option plan does not specify whether adjustments should be made to the plan in such a situation.
 - Ultimately, no share option adjustments are made. The relevant employees are better off by having a gain of CU50,000 $((CU30-CU20)*100*50)$.
3. This agenda paper focuses on the accounting treatment of the incremental fair value arising from the unexpected capital restructuring. Paragraph 17 of IFRS 2 states that valuation techniques shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price for the equity instruments. Therefore, if capital restructurings are expected at grant date, the estimated effect of the restructurings should be taken into account when the sponsoring entity estimates the fair value of the share options at grant date.
4. The staff believes that whether adjustments should be made to the share option plan is a corporate governance issue, not an accounting issue.

SUMMARY OF THE ISSUE

5. Paragraphs 38 to 41 of Appendix B to IFRS 2 headed *Capital Structure Effects* state that, when a sponsoring entity estimates the fair value of the share options at grant date, it should consider whether the possible dilutive effect of the future exercise of the share options granted might have an impact on the estimated fair value at grant date. The staff does not believe that these paragraphs are helpful to the issue in this agenda paper because these paragraphs focus on capital structures that are known at grant date. By contrast, this agenda paper deals with an issue which relates to unexpected capital restructurings taking place after the share options are granted.

6. IFRS 2 addresses how modifications to the terms and conditions of share-based payment plans should be accounted for. IFRS 2 requires that, if the modification increases the fair value of the equity instruments granted, the incremental fair value¹ should be recognised as an additional expense over the period from the modification date until the date when the modified equity instruments vest (or immediately if the relevant equity instruments granted have already vested) (see paragraph 43 of Appendix B to IFRS 2)².
7. Therefore, the issue is whether the incremental fair value (i.e. CU50,000 in the illustrative example) should be treated in the same way as that arising from a modification to a share option plan in accordance with IFRS 2.

SUMMARY OF THE RECOMMENDATION

8. The staff recommends View 2 (i.e. no modification and no additional expense should be recognised) because there are no changes to the terms and conditions of the original share option plan.
9. The staff understands that it would be rare for an entity not to contain any generic terms and conditions in a share option plan, setting out what actions the parties to the plan would take in the event of an unexpected capital restructuring.
10. The staff believes that the issue is not expected to have widespread relevance in practice. The staff, therefore, recommends that the issue should not be taken onto the agenda. Proposed “rejection” wording has been prepared for your consideration (see paragraph 25 in this agenda paper).

¹ Incremental fair value refers to the difference between the fair value of the modified equity instruments and that of the original equity instruments, both estimated as at the date of the modification (see paragraph 43 of Appendix B to IFRS 2).

² If the modification reduces the fair value of the equity instruments granted, the sponsoring entity shall not take into account that decrease but shall continue to measure the amount of the services received based on the fair value of the equity instruments at grant date (see paragraph 44(a) of Appendix B to IFRS 2).

11. At its meetings in May and June 2006, the Agenda Committee agreed that View 2 (see paragraph 17 of this agenda paper) was the preferable approach. It also recommended that the issue should not be taken onto the agenda.

STAFF ANALYSIS

12. This agenda paper illustrates two different views as follows.

View 1 – Decision not to amend the plan is in effect a modification; and

View 2 – Not a modification and no additional expense is recognised.

View 1 – Decision not to amend the plan is in effect a modification

13. Proponents of View 1 assume that, even if the share option plan is silent as to whether any adjustments should be made to the plan in the case of unexpected events, the sponsoring entity could always make adjustments to the plan if it wished to. In addition, supporters of View 1 argue that, at the time when the sponsoring entity and its shareholders determine whether to undertake a capital restructuring, they are aware that the capital restructuring will grant additional value to the relevant employees. They assert that the sponsoring entity's reaction of not making any such adjustments, in effect, deliberately provides the relevant employees with additional value. Therefore, they believe that there is, in effect, a modification.
14. Proponents of View 1 also note the underlying presumption of the accounting treatment of modifications to the terms and conditions of share-based payment plans, as set out in paragraphs 223 and 224 of the Basis for Conclusions of IFRS 2. Those paragraphs basically state that, when an original share-based payment plan is replaced by a more valuable share-based payment plan, the sponsoring entity expects to receive equivalent additional services from the employees. In the illustrated situation of this agenda paper, the relevant employees are better off as a result of the capital restructuring. Proponents of View 1, therefore, ask why such

incremental value is not accounted for in the same way as that arising from a modification that increases the fair value of the share options.

15. When the share option plan does not state whether any adjustments may be made, the staff believes that consent from the employees or other relevant parties is usually required (if the sponsoring entity wants to make any consequential amendments to the original plan). The sponsoring entity does not necessarily have the ability to amend the terms of the original plan in the case of unexpected events.
16. As mentioned in paragraph 6 of this agenda paper, when a modification increases the fair value of the share options granted, an additional expense should be recognised immediately if those share options have vested. In extreme cases, if unexpected capital restructurings take place 10 years, say, after the share options have vested, View 1 would require that an additional remuneration expense should be recognised. The staff is doubtful whether the presumption that additional services would be received is still valid in those situations.

View 2 – No modification and no additional expense should be recognised

17. Paragraph 16 of IFRS 2 states that, when an entity measures the fair value of equity instruments at grant date, it should take into account the terms and conditions upon which those equity instruments were granted. The fair value of the share options at grant date is a surrogate measure of the fair value of the services received.
18. IFRS 2 sets out requirements as to how to account for modifications to the terms and conditions of a share-based payment plan, as set out in paragraphs 26 and 27 of IFRS 2 and the guidance in Appendix B of IFRS 2. Supporters of View 2 believe that, under grant date measurement, where there are no changes in terms and conditions of the share option plan, the fair value of the share options determined at grant date is not remeasured for subsequent changes in the grant date estimate of fair value.

19. Proponents of View 2 further believe that, if there are no terms and conditions regarding share option adjustments specified in the share option plan at grant date, there are no modifications to the terms and conditions of the share option plan at all. They, therefore, believe that no additional remuneration expense should be recognised.

STAFF RECOMMENDATION

20. The staff agrees with supporters of View 2 that, since there are no changes to the terms and conditions of the plan, there is no modification. Hence, no additional expense should be recognised.
21. [Paragraph omitted from observer notes]
22. [Paragraph omitted from observer notes]
23. [Paragraph omitted from observer notes]
24. The staff believes that the issue in this agenda paper is not expected to have widespread relevance in practice. The staff recommends that the issue should not be taken onto the agenda.
25. [Paragraph omitted from observer notes]