Project **Financial instruments with characteristics of equity**

Topic **Share-based payments—IFRS 2**

Introduction

1. This paper provides information to IASB members on which to base a preliminary decision about whether to retain IFRS 2 for instruments within its scope or to give further consideration to eliminating IFRS 2 in a future meeting. This paper may not provide enough information to make a final decision to eliminate IFRS 2. If the Board is inclined to consider that further, we are prepared to provide a more detailed analysis of what the consequences would be of a decision to eliminate IFRS 2 at a future meeting.

2. IFRS 2 applies to share-based payment transactions in which the entity:

   (a) receives goods or services as consideration for an entity's own shares or share options; and

   (b) pays for goods or services in cash or other assets, and the amount is based on the value of the entity's equity instruments.

3. IFRS 2 also applies to those transactions when either the employee or the employer has a choice for settlement in cash or equity instruments.

4. The following share-based transactions are within the scope of other standards:

   (a) Contracts to buy non-financial items that can be settled net or by exchanging financial instruments if the contracts are not for expected purchase, sale or usage requirements (IAS 32 and IAS 39).

   (b) Equity instruments issued to acquire control of another entity in a business combination (IFRS 3).

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5. Under IFRS 2, cash-settled share-based payment transactions are classified as liabilities, and share-based payment transactions settled with shares or share options are classified as equity. Liabilities are remeasured and equity is not remeasured.

6. The purpose of this paper is to give the Board a general overview to help them decide if the possibility of eliminating IFRS 2 deserves further study. This paper does not attempt to provide details of the many types of arrangements currently in use and compare their classification under IFRS 2 and Approach 4.1. We have considered the potential changes at length, and have concluded that the highly summarised information in this paper should permit you to make a decision about whether you would like to give further consideration to eliminating IFRS 2. We have more detailed information that we will provide later if you choose to give further consideration to eliminating IFRS 2. If you have any questions about specific arrangements now, please contact one of the members of the project team.

7. This paper describes the following two alternatives:[1]

Alternative 1	Eliminate IFRS 2 and apply Approach 4.1 to all share-based payment transactions
Alternative 2	Retain IFRS 2 and continue to apply it to all share-based payment transactions currently within its scope.

8. This paper provides some high-level discussion of the reasons to consider each alternative, but does not address all the possible arguments for each. The issuance of a new standard based on Approach 4.1 would not change the reasons for which IFRS 2 is applied to certain types of arrangements. Although we have researched those reasons in depth, we have not included all of the details in this paper. Most board members are familiar with the arguments for and against the

[1] A third possibility might be to retain IFRS 2 but change its scope. We have not listed that possibility as an alternative because we could not think of any reason for supporting it. It seems to have most, if not all, of the practical disadvantages of alternative 1 and the conceptual disadvantages of alternative 2 without any of the advantages of either.

existing treatment. If you have questions, please contact one of the members of the project team.

Alternative 1—Apply Approach 4.1 to instruments that are currently in the scope of IFRS 2 (eliminate IFRS 2)

9. Approach 4.1 would classify share-settled instruments as liabilities if the issuer is using its shares as currency. Paragraph IN 1 of IFRS 2 acknowledges that an entity entering into share-based payment transactions is using its shares to compensate employees or acquire goods or services from other parties. Thus, under the logic on which Approach 4.1 is based, all share-based payment arrangements should be classified liabilities.

10. However, although the criteria under consideration in Approach 4.1 would result in classifying many types of share-based payment instruments as liabilities, some of the simpler ones (which involve little or no variability in outcomes) would remain in equity. In general, arrangements with the following characteristics would be classified as liabilities by Approach 4.1:

    (a) net settlement is required or permitted

    (b) cash settlement is required or permitted

    (c) variations in the per-share price or in the number of shares that indicate the shares are being used as currency.

11. Variability due to performance conditions, market conditions (other than the price of the entity's shares), and changes in the share count that achieve a fixed market value for the ultimate settlement could cause variation of the type discussed in paragraph 10(c).

12. Classifying share-based payment transactions settled in shares, or options, as liabilities under Approach 4.1 would drastically change their measurements. Under IFRS 2, share-based payment arrangements classified as equity are measured at grant date and not remeasured. The treatment at grant date is not absolutely clear under Approach 4.1 (because the contract at that time may or may not be a financial liability), but they certainly would be remeasured up to the vesting date. At the vesting date, the employee has performed the necessary

services, and the contract no longer requires an exchange of services for shares or share options. At that time, the employee holds a share or a share option depending on the type of arrangement. Shares would generally not be remeasured after that date, but some share options would be classified as liabilities and remeasured at fair value with changes in earnings.

Alternative 2—Retain IFRS 2 (provide a scope exception for the instruments within its current scope)

13. The second alternative is to retain IFRS 2 and provide a scope exception in the planned replacement for IAS 32. While others may have a different view, the staff cannot provide conceptual support for retaining a separate treatment for share-based payment transactions. As mentioned earlier in paragraph 9 of this paper, paragraph IN 1 of IFRS 2 acknowledges that an entity entering into share-based payment transactions is using is shares to compensate employees or acquire goods or services from other parties. This is a fairly clear statement that the entity is using its shares as currency, and that is the basic principle on which classification as equity of other types of share-settled transactions is based.

14. However, the practical reasons for retaining the exception are significant. First, accounting for share-based payments is even more controversial than the other issues in this project (especially so in the US). Opposition to changes in share-based payment accounting would certainly add significantly to the time necessary to complete the project.

15. Second, many share-base payment arrangements are very complicated and technical, and it is unlikely that IFRS 2 could be eliminated without detailed consideration of the consequences of that action. At a minimum, the Board would need to provide illustrations of the application of Approach 4.1 to share-based payments, which would be a time-consuming exercise. That would also add to the time necessary to complete this project.

16. Third, although the boards' missions do not require them to base decisions on economic consequences, you must sometimes consider them if you are aware of them. There would be a fairly obvious consequence to eliminating IFRS 2. Approach 4.1 would classify some, but not all, share-settled share-based

payments as liabilities (Refer to Appendix A). It would create a powerful incentive for employers to enter into fixed share-based payment contracts with their employees to achieve equity classification. The US experience with such an incentive (during the years APB 25 was in effect) was not good.

Staff Recommendation

17. We recommend that the Board retain IFRS 2 for instruments currently within its scope.

Questions	
Q1.	Should IFRS 2 be retained or should it be considered for elimination?
Q2.	If IFRS 2 is to be considered for elimination, what additional information would you need (other than detailed consideration of consequences)?

Appendix A

This appendix is intended to highlight the major differences between the classification under IFRS 2 and Approach 4.1. This appendix does not consider the many nuances in IFRS 2. Therefore, it should not be used for any other purpose other than discussion at this Board meeting.

No	Description of the share-based arrangement	IFRS 2	Approach 4.1
1.	Arrangements where the exercise price per share and the number of unvested shares, or options, are fixed.	Equity	Equity
2.	The number of unvested shares or share options instruments granted varies but the strike price does not change.	Equity	Liability
3.	Equity-settled where variable number of shares, or options, vests to a fixed monetary amount.	Equity	Liability
4.	The employee can choose settlement in cash or shares.	Compound instrument	Liability
5.	The employer can choose settlement in cash or shares.	Liability, if any one of the following applies: (a) choice of settlement has no commercial settlement (ie the entity is legally prohibited from issuing shares) (b) past practice or a stated policy of settling in cash (c) history of settling in cash on request of the employee. If (a)-(c) above does not exist, then equity.	Liability
6.	Cash-settled SARs	Liability	Liability

No	Description of the share-based arrangement	IFRS 2	Approach 4.1
7.	Net-share-settled arrangements. For example, the employee is permitted to pay the exercise price by surrendering instruments rather than using cash.	Equity	Liability
8.	Options for shares redeemable at a fixed date.	Liability	Liability
9.	Options for shares redeemable on a contingent event or at the option of the holder.	Liability	Equity or (??) (The boards have not discussed how to classify derivatives on an instrument that is separated into components.)