Project **Tentative agenda decisions**

Topic **Classification of share-based payments where manner of settlement is contingent on future events**

Objective of this paper

1. The objective of this paper is to examine in the context of IFRS 2 the classification of share-based payment transactions in which the manner of settlement is contingent on future events.

Background

2. The issues considered in this paper are arising from share-based payment transactions for which the manner of settlement (equity instruments or cash) is dependent on:

   (a) a contingent event that is outside the control of either party[1]; or

   (b) a contingent event that is within the control of the counterparty.

[1] IPO and change in control were provided as examples of the events outside the control of either party by the original submission. However, it is debatable whether IPO and change in control are outside the entity's control. This is a matter of judgement which is supplementary to the question of classification. This paper does not focus on the specific examples, but addresses more general circumstances where a contingent event is outside the control either party.

Issues and Staff analysis

Issue A: Manner of settlement conditional upon an uncertain future event outside the control of either party

3. Consider a share-based payment transaction in which an entity grants shares to employees with a service condition. Also, a cash alternative is attached to it. If a specified event that is outside the control of either party occurs, the granted shares will be settled in cash at the fair value of the shares at that date. The issue is how to classify the share-based payment transaction in terms of cash-settled or equity-settled.

Nature of the issue

4. The transaction in question could be analysed into the following features.
   (a) It is a share-based payment transaction with a cash alternative; and
   (b) Neither party has a right to choose the cash alternative; rather
   (c) The cash alternative is dependent on an uncertain future event which is outside the control of either party.

Staff analysis

5. The staff notes that the possibility of equity settlement and the possibility of cash settlement are cohabiting in a single arrangement. This situation is already addressed in paragraph 34 of IFRS 2, which states:

   Share-based payment transactions with cash alternatives

   34. For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, *the entity shall account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.* [emphasis added]

6. Paragraph 34 provides that a share-based payment transaction should be accounted for as:

   (a) Equity-settled to the extent that it meets the definition of an equity-settled share-based payment transaction[2]; or

   (b) Cash-settled to the extent that it meets the definition of a cash-settled share-based payment transaction[3].

   This indicates that the share-based payment transaction should be divided and accounted for as equity-settled and cash-settled respectively at the same time depending on the degree to which it meets each definition. The distinction between cash-settled and equity-settled is the incurring of a liability or the obligation to settle the transaction in cash, or other assets.

7. Paragraph 34 addresses two specific circumstances:

   (a) where the ***counterparty*** has a right to choose the manner of settlement (Paragraphs 35-40 explains how to recognise and measure this transaction); or

   (b) where the ***entity*** has a right to choose the manner of settlement (Paragraphs 41-43 explains how to recognise and measure this transaction).

8. When the counterparty can choose the manner of settlement, paragraphs 35-40 require the entity to account for the share-based payment transaction as a compound financial instrument which is comprised of a debt component and an equity component. In contrast, when the entity can choose the manner of settlement, paragraphs 41-43 require the entity to classify it wholly as either

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[2] A share-based payment transaction in which the entity
(a) receives goods or services as consideration for its own equity instruments (including shares or share options), or
(b) receives goods or services but has no obligation to settle the transaction with the supplier.

[3] A share-based payment transaction in which 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. [emphasis added]

equity-settled or cash-settled dependent on the assessment of a present obligation.

9. The staff thinks that such difference in the treatment of the two circumstances can be explained from the perspective of entity rather than from the perspective of the counterparty.

   (a) Paragraphs 35-40 address the situation where the entity cannot rule out either manner of settlement on its own, and hence either manner is unavoidable; In contrast,

   (b) Paragraphs 41-43 address the situation where the entity can rule out either manner of settlement on its own or is substantially obligated to cash settlement, and hence at least one manner is avoidable.

10. If paragraph 34 is read from the perspective of the entity, it conveys a general principle than just the two circumstances illustrated. The staff believes that the Board intended that a general principle can apply to all of the share-based payment transactions with cash alternatives and took only two distinctive examples to illustrate the general principle, in the light of paragraph BC256 of IFRS 2 which says:

    > …*There are many possible variations of share-based payment arrangements under which a cash alternative may be paid. For example,* … the employees may be able to elect to receive cash instead of shares or share options … The terms of the arrangement may provide the entity with a choice of settlement… [emphasis added]

    Consequently, the staff believes that it is reasonable to use the principle and guidance in paragraph 34 where the manner of settlement is outside the control of the entity for transactions where the manner of settlement is outside the control of either the counterparty or the employee.

11. From the perspective of the entity, paragraph 34 may be analysed as follows:

    (a) Circumstances where the entity has no right to choose; and

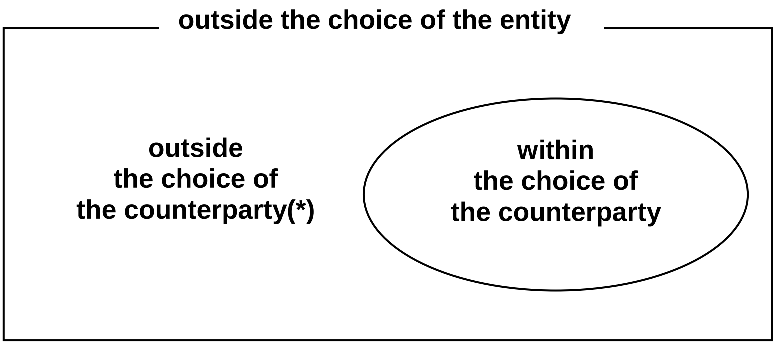
    (b) Circumstances where the entity has a right to choose.

12. Furthermore, the circumstance where the entity has no right to choose includes the sub-cases:

    (a) where ***neither party*** has a right to choose; and

    (b) where the ***counterparty*** has a right to choose.

    The following diagram illustrates this.



(*) a case where the cash alternative is
(i) within the choice of another party; or
(ii) conditional upon an uncertain future event

13. As mentioned earlier, a share-based payment transaction where a cash alternative is within the choice of the counterparty is specifically addressed in paragraphs 35-40. The staff thinks that the principle and example set out in the paragraphs represent the general principle applicable to all share-based payment transactions where cash alternatives are outside the choice of the entity.

14. The guidance in paragraphs 35-40 classifies the share-based payment transaction as a compound financial instrument which is comprised of a debt component and an equity component. The staff's view is that this guidance is appropriate to apply to circumstances when the manner of settlement is outside the control of either party. (Agenda paper 7B discusses the measurement issues raised by the submission.)

Issue B: Manner of settlement conditional upon an event within the control of the counterparty

15. There might be another type of a cash alternative. The example provided in the submission is one where if the employees save the exercise price with the entity

over the vesting period, the employees will receive the cash value of the shares on vesting, or otherwise the options will be settled in equity. Again, the issue is how to classify the share-based payment transaction in terms of cash-settled or equity-settled.

Nature of the issue

16. The transaction in question could be analysed into the following features.

    (a) It is a share-based payment transaction with a cash alternative; and

    (b) The counterparty has a right to choose the cash alternative; but

    (c) The right is realised only if the counterparty fulfils a condition which is within his or her control.

Staff analysis

17. The transaction in question is considered to fall into the category of share-based payment transactions where the counterparty has a right to choose a cash alternative because the counterparty can choose to perform the condition. Consequently, the transaction should be classified as a compound financial instrument which is comprised of a debt component and an equity component in accordance with paragraphs 35-40 of IFRS 2.

Agenda criteria assessment

18. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    Yes. The issue is observed in practice and could arise in many jurisdictions in which entities adopt share-based payment transactions as remuneration to employees.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    The submission indicates that divergence will be emerging in practice. However, the staff does not expect significantly divergent interpretations, considering that IFRS 2 provides a relevant principle on the classification of share-based payment transactions with cash

alternatives which are outside the choice of the entity (paragraph 34 and 35-40 of IFRS 2); and

(c) *Would financial reporting be improved through elimination of the diversity?*
Yes. The classification and measurement of share-based payment transactions would become more reliable and comparable among companies through elimination of diversity, if there is any.

(d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*
These issues are sufficiently narrow in scope to be dealt with in a timely fashion by the IFRIC, but too narrow to be cost-effective, considering that IFRS 2 provides a relevant principle.

(e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require completing its due process.)*
No. The Board does not have any projects on its agenda to revise IFRS 2.

19. Based on the assessment of the agenda criteria in paragraph 18, the staff recommends that the IFRIC not add these issues to its agenda. Proposed wording for the tentative agenda decision is set out in Appendix A.

Questions for the IFRIC
1. Does the IFRIC agree with the staff recommendation that the issues should not be added to the agenda? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision (see Appendix A)?

[Appendix A has been omitted from this observer note]