Project	**Tentative agenda decisions**
Topic	**Measurements of employee share-based transactions with cash alternatives**

Objective of this paper

1. The objective of this paper is to examine the measurement of share-based payment transactions in which the manner of settlement (cash or shares) is contingent on future events not within the entity's control.

Background

2. The issue considered in this paper is arising from the submission on share-based payment transactions for which the manner of settlement (cash or shares) is dependent on contingent events outside the control of the entity. As discussed, in agenda paper 7A, staff's analysis is that share-based payment transactions with cash alternatives dependent on a contingent event outside of the entity's control are analogous to share-based payment transactions in which the terms of the arrangement provide the counterparty with a choice of settlement. Consequently, staff thinks that the measurement guidance in paragraph 35-40 of IFRS 2 can also be applied to share-based payment transactions with cash alternatives dependent on contingent events outside of the entity's control. In such circumstances, paragraph 35 states that the entity has granted a compound financial instrument which includes a debt component and an equity component.

3. This paper addresses the request for clarification on the effect that contingent events that affect the manner of settlement have on the valuation of the debt component of that compound financial instrument where the share-based

transaction occurs with an employee[1]. This paper does not discuss the classification of share-based transactions where manner of settlement is dependent on contingent events outside the control of the entity as this is discussed in agenda paper 7A. Instead, this paper assumes that the contingent event(s) in substance provides the employee with the choice of settlement and therefore, the requirements of paragraph 35-40 of IFRS 2 applies.

Issue

4. Paragraph 35 of IFRS 2 requires an entity to recognise a compound instrument when the entity has granted the employee to right to choose whether a share-based transaction is settled in cash[2]. How do the contingent conditions that determine the manner of settlement affect the valuation of the debt component of the compound instrument recognised according to paragraph 35 of IFRS 2?

5. Some constituents are of the view that contingent events should be factored into the valuation of the debt component assuming that they will or have occurred (ie 100% probability). Others are of the view that the probability of the occurrence of each contingent event depends on the facts and circumstances of the contingent event itself and therefore, it should not be assumed that the contingent event will or have occurred in the valuation of the debt component.

Staff analysis

6. The relevant paragraphs of IFRS 2 are reproduced here for convenience.

> 36 For other transactions, including transactions with employees, the entity shall measure the fair value of the compound financial instrument at the measurement date, *taking into account the terms and conditions on which the rights to cash or equity instruments were granted*.

[1] The submission requested that this is dealt with in the context of share-based payments with employees. IFRS 2 has specific guidance in paragraph 35 for such share-based payments with parties other than employees.

[2] Consistent with discussion in paragraphs 35-43 of IFRS 2, all references to cash also include other assets of the entity.

37 To apply paragraph 36, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component—taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the compound financial instrument is the sum of the fair values of the two components. However, share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component.

38 The entity shall account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. *For the debt component, the entity shall recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in accordance with the requirements applying to cash-settled share-based payment transactions (paragraphs 30–33).* For the equity component (if any), the entity shall recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in accordance with the requirements applying to equity-settled share-based payment transactions (paragraphs 10–29). [emphasis added]

7. Paragraph 36 of IFRS 2 requires the terms and conditions on which the rights to cash or equity instruments were granted to be taken into account in the fair value of the compound instrument. Paragraph 37 requires the entity to first measure the fair value of the debt component and then the fair value of the equity component. IFRS 2 defines fair value as the amount for which an asset could be exchanged, *a liability settled*, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction.

8. Also, paragraph 38 provides that the debt component should be treated in accordance with the requirements applying to cash-settled share-based payment

transactions (paragraph 30-33 of IFRS 2). Hence, paragraph 33 of IFRS 2 is also relevant to the measurement of the fair value of the debt component:

> The liability shall be measured, initially and at the end of each reporting period until settled, at the fair value of the share appreciation rights, by applying an option pricing model, *taking into account the terms and conditions* on which the share appreciation rights were granted, and the extent to which the employees have rendered service to date. [emphasis added]

9. The guidance in IFRS 2, when taken together, requires conditions attached to the cash settlement to be considered in the fair value of the debt component of the compound instrument if those conditions are conditions that knowledgeable, willing parties in an arm's length transaction will consider in determining the amount to settle the liability.

10. It is a question of judgement as to how the contingent conditions attached to the cash settlement are factored into the fair value measurement of the debt component. Those contingent conditions should be reflected in the valuation in the manner consistent with its treatment by knowledgeable, willing parties in an arm's length transaction.

Agenda criteria assessment

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

    (a) *Is the issue widespread and practical?*
    Yes. The issue occurs in certain industries and could arise in many jurisdictions in which entities adopt share-based payment transactions with cash alternatives on contingent events as remuneration to employees.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    The submission indicates that divergence is and will be emerging in practice. However, the staff does not expect significantly divergent interpretations, considering that IFRS 2 provides relevant principles on the measurement of share-based transactions (37-38 of IFRS 2) with cash alternatives not within the entity's choice.

(c) *Would financial reporting be improved through elimination of the diversity?*
Yes. The measurement of share-based payment transactions would become more consistent 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?*
Given the variety of share-based arrangements with cash alternatives, staff believed that guidance beyond the above observations could not be developed in a reasonable period of time. Also, staff noted that any guidance that can be given would be in the nature of valuation guidance.

(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. However, the Board does have a project on Fair Value Measurements which may have an impact on the issue raised.

12. Based on the assessment of the agenda criteria in paragraph 11, 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]