IFRIC Meeting

Staff Paper

Agenda reference **7**

Date **Nov 2009**

Project	**Tentative agenda decisions**
Topic	**IFRS 2 – Share-based payment transactions in which the manner of settlement is contingent on future events - Cover note**

Purpose of this paper

1. This paper provides an overview of the papers for this meeting.

Background

2. In May 2009, the staff received a request, as reproduced in Appendix A, to add to the IFRIC's agenda a project to clarify the classification and measurement of share-based payment transactions in which the manner of settlement (equity instruments or cash) is contingent on future events. The submission is set out as Appendix A.

Papers for this meeting

3. Staff has addressed two general issues arising on both examples submitted (set out in Appendix A) and these are set out in the following papers:

   (a) Agenda paper 7A — Classification of share-based payments where manner of settlement is contingent on future events

   (b) Agenda paper 7B — Measurements of employee share-based transactions with cash alternatives

4. Agenda paper 7A discusses only the classification of share-based transactions where the manner of settlement is dependent on contingent events outside the

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Decisions made by the IFRIC are reported in IFRIC *Update*.

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control of the entity. Agenda paper 7B discusses the measurement of the fair value of the 'debt component' of the compound financial instrument granted for employee share-based payment transactions where the employees can choose the manner of settlement.

Appendix A— IFRIC agenda request

A1. The following IFRIC agenda request was received.

Background

A2. The Standard provides guidance on whether a share-based payment arrangement should be treated as cash-settled or equity-settled in cases where either the entity, or the counterparty, can choose the cash alternative.

A3. In scenarios where the cash settlement is not within the control of either party, it is not clear what principle should be applied. It could be argued that, in the absence of specific guidance, it is appropriate to apply the general principle in IAS 32 and require liability treatment even if cash settlement is contingent. However, IFRS 2 guidance is not always consistent with the requirements of IAS 32. Alternatively, it could be argued that a condition that impacts only the method of settlement, and not whether the counterparty receives payment, should be classified as vesting or non-vesting.

A4. We set out below two examples that demonstrate the different approaches that might be taken in practice and would produce very different outcomes in the financial statements. We note that any principle to be applied to these scenarios would also need to be capable of applying to the opposite situation, where a cash-settled arrangement is settled in equity contingent on the occurrence of an event outside the control of either party.

Issue (a) Contingent cash settlement where neither the entity nor the counterparty can determine method of settlement

A5. An entity issues shares to employees that vest upon a number of years of service. However, if there is an IPO or change in control, the arrangement will vest immediately, and the employees will receive cash equal to the fair value of the shares at that date.

Alternative views

View 1

A6. The table in IFRS 2.IG24 describes a "target based on a successful initial public offering with a specified service requirement" as a non-market vesting condition. Therefore, cash settlement is dependent on this vesting condition of successful IPO, and equity settlement is dependent on vesting condition of the IPO not occurring. The Standard requires the compensation charge to be based on the expectation of whether a vesting condition will be met. If this principle is used, then the expectation of a successful IPO would be assessed at each reporting date and if it is expected that the condition will be met, the share-based payment arrangement will be accounted for as cash-settled. If it is not expected, then the share-based payment would be reflected as equity-settled. In practice this is likely to lead to the arrangement being treated as equity-settled until the IPO/change in control is probable, when it would become a cash-settled arrangement with any equity entry reversed.

View 2

A7. Under this view, the cash settlement provision is not considered to be a vesting or non-vesting condition, and accordingly it is necessary to consider what other guidance may be relevant. The entity does not have control over whether this arrangement is cash-settled and therefore the guidance in the Standard where the counterparty has control might be most appropriately applied (consistent with an IAS 32: Financial Instruments: Presentation approach).

A8. In this example, the probability of meeting the cash settlement criteria is not factored in, such that the fair value of the settlement alternatives is the same at grant date. The fair value is considered to be the fair value of the debt component with the equity component valued at nil. Therefore the whole arrangement would be treated as cash-settled, remeasured at each balance sheet date. If it was ultimately equity-settled, the liability would be reversed to equity.

View 3

A9. Like under view 2, a condition impacting the manner of settlement of an award is not considered to be a vesting or non-vesting condition. Further, there is no specific guidance in IFRS 2 on how to classify share-based payment transactions that are contingently cash-settleable and whose contingent event is not within the control of the entity or counterparty.

A10. Guidance exists in IAS 32 for the classification as a financial liability of an equity instrument with contingent cash-settlement terms. However, the IASB concluded that the requirements in IAS 32 should not be applied in IFRS 2 (see IFRS 2.BC 106-110 and IFRS 2.BC 266). Consequently, an entity should not refer to IAS 32 to determine the classification of a share-based payment transaction under IFRS 2.

A11. By analogy with the treatment of contingent liabilities under IAS 37, the classification of a contingently cash-settleable plan whose contingent event is not within the control of the entity or counterparty depends on whether the contingent event is probable.

A12. If the event's occurrence is not probable, and the share-based payment would otherwise be classified as equity, then it shall be classified as equity-settled. If the event's occurrence is probable, then the share-based payment shall be classified as cash-settled, with any previous equity entry reversed.

View 4

A13. There is another view expressed by some constituents, that an award with a contingent cash settlement provision should be accounted for as two mutually exclusive awards. One award is equity-settled, the other cash-settled.

A14. For the equity settlement alternative, a charge is recognised to the extent that the award is expected to be settled in equity. The charge to equity will reflect the fair value of the award at grant date. If equity settlement was no longer probable or did not subsequently occur, the charge would be reversed.

A15. For the cash settlement alternative, the fair value would be assessed, reflecting the probability of cash settlement, and this liability recognised and remeasured

at each reporting date. While the value of the award is affected by the probability of the IPO occurring, the award always has a fair value over the vesting period, falling to nil if the award is settled in equity.

A16. In summary:

	View 1	**View 2**	**View 3**	**View 4**
	Cash linked to vesting condition:			
Classification if IPO not probable	Equity-settled	Cash-settled	Equity-settled	Equity-settled and Cash-settled portion
Classification if IPO probable	Cash-settled	Cash-settled	Cash-settled	Cash-settled
Measurement	If the IPO is not probable the equity charge will represent the grant date fair value. If the IPO is probable a liability will be recognised and remeasured at fair value. If the IPO subsequently becomes probable the equity charge would be reversed and a liability at fair value would be established. If the reverse occurs, then the liability would be reversed to equity	The liability is continually measured at fair value. If it is ultimately settled in equity the entry would be: Dr Liability Cr Equity	Same treatment as view 1.	The probability of cash settlement is factored into the initial fair value such that total fair value equals the fair value of the liability plus the equity residual. The equity piece remains at the grant date fair value and the liability piece is remeasured throughout. If the IPO became not probable the liability portion's fair value would be zero.

Issue (b) Contingent cash settlement dependent on non vesting condition within the control of the counterparty

A17. An entity issues share options to employees that vest conditionally upon three years of service. However, if the employees save the exercise price with the entity over the three years, the employees will receive the cash value of the shares on vesting. If the employees do not save, the options will be settled in equity.

Alternative Views

View 1

A18. This arrangement could be viewed simply as one in which the employee has control of whether to receive cash rather than share options. This is because the employee has control over whether to save the exercise price, and therefore whether this is cash-settled. Applying the guidance applicable to awards for which the counterparty has a choice of settlement and taking into account the fact that the value of the two settlement options is the same, the scheme will be treated as a cash-settled scheme unless and until it is settled otherwise.

View 2

A19. An alternative view is that while the scheme is considered one in which the counterparty has control over whether to receive cash, this is not a simple counterparty choice, but is linked to a non vesting condition, the requirement to save the exercise price. This is consistent with View 1 of Example A above.

Other Views

A20. The principles expressed in views 2 and 4 above in relation to Example A, are also possible views for this example.

Reasons for the IFRIC to address these issues

A21. The effective date of the amendment to IFRS 2 is for annual periods beginning on or after 1 January 2009, so we are not yet aware of divergence in practice.

However, we are aware that constituents are not clear on which is the most appropriate of the views to adopt on implementation and therefore divergence in practice is expected. Given the range of possible outcomes, such divergence could lead to significant variance in financial results.

A22. A clear rational for treatment in the above scenarios would enable wider application of principles agreed and positions reached.

A23. We believe that these matters are sufficiently narrow in scope to be capable of interpretation, and note that revisions to IFRS 2, as previously amended, are not currently on the agenda of the IASB. Hence, this issue of interpretation is relevant today and will continue to be.