STAFF PAPER

12–13 March 2013

IFRS Interpretations Committee Meeting

Project	**IFRS 2 *Share-based Payment***
Paper topic	Share-based payment awards settled net of tax withholdings

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Introduction

1. As mentioned in Agenda Paper 5, in July 2012, the IFRS Interpretations Committee (the Interpretations Committee) decided to revisit the three issues related to IFRS 2 *Share-based Payment*. This agenda paper addresses, out of the three issues, an issue of the classification of a share-based payment (SBP) transaction in which the entity withholds a specified portion of the shares for purposes of meeting the statutory income tax withholding requirements.

2. The objective of this agenda paper is to provide the Interpretations Committee with updates on the results of our outreach and technical analysis on this issue. This agenda paper contains one question to the Interpretations Committee.

3. This agenda paper is organised as follows:

   (a) summary of the issue

   (b) previous discussions by the Interpretations Committee

   (c) summary of the result of outreach activities

   (d) staff technical analysis

   (e) assessment against the Interpretations Committee's agenda criteria

   (f) assessment against annual improvement criteria

   (g) staff recommendation

(h) question to the Interpretations Committee

(i) Appendix A—Illustrative examples

(j) Appendix B—Submission

(k) Appendix C—Excerpt from outreach request

(l) Appendix D—Excerpt from *IFRIC Update* in March 2011

(m) Appendix E—Excerpt from relevant US GAAP literature

(n) Appendix F—Annual improvement criteria analysis

Summary of the issue

4. In March 2010, the Interpretations Committee received a request to clarify the classification of an SBP transaction in which the entity withholds a specified portion of the shares that would otherwise be issued to the counterparty upon exercise (or vesting) of the SBP award, for the purposes of meeting the statutory income tax withholding requirements.

5. The issue included in the agenda request is an SBP arrangement in which:

(a) the entity is required by tax laws to:

(i) withhold from an employee's compensation (by reducing the number of shares issued to the employee) an amount to satisfy the employee's tax liability incurred as a result of the SBP transaction; and

(ii) pay to the tax authority in cash the amount withheld from the employee's compensation;

(b) the employee will receive shares net of the number of shares equal to the employee's tax liability (that will be satisfied by the entity in (a)(ii) above) upon exercise (or vesting); and

(c) for ease of analysis of the relevant feature, it is assumed that the entire award would be classified as an equity-settled SBP transaction, if the feature creating (a) and (b) did not exist.

6. The submitter of this issue identified two views on whether the portion of the SBP transaction withheld by the entity should be accounted for separately as a cash-settled award.

View A—Separate accounting for each component of the SBP transaction

7. In View A, each component of the single SBP transaction is accounted for in a manner that is consistent with the manner of its settlement. Thus, because the SBP transaction provides for both the payment of equity instruments and payment of cash (or other assets):

   (a) the portion for which the entity has incurred a liability to pay cash is accounted for as a cash-settled SBP transaction, and

   (b) the portion with which the entity settles the compensation obligation by the issue of equity instruments is accounted for as an equity-settled SBP transaction.

View B—Consistent accounting for the entire SBP transaction as equity-settled

8. Supporters of View B note that the issue can be seen as the net impact of two different transactions:

   (a) the equity-settled SBP transaction that is satisfied in its entirety through the issue of equity instruments; and

   (b) the repurchase by the entity of a portion of the equity instruments that was issued immediately before in (a) (paragraph 29 of IFRS 2).

9. For ease of reference, the text of the submissions is reproduced in Appendix B to this paper.

Previous discussions by the Interpretations Committee

10. The Interpretations Committee discussed this issues three times in September 2010[1], November 2010[2], and March 2011 (refer to Appendix D). In those

[1] http://media.iasb.org/IFRICUpdateSEPT10.html

meetings, the staff presented their view that the current requirements in IFRS 2 would lead the entity to View A. In response to the staff's view, divergent opinions and concerns were raised by the members of the Interpretations Committee and also by interested parties, through the comment letters[3] on the tentative agenda decision issued in September 2010. These are summarised as followings:

(a) there would be huge operational challenges in implementing the approach in View A because the entity needs to estimate the impact of future changes in tax rules (eg. tax rates), and employees' relocations across jurisdictions that have different tax rules;

(b) the accounting outcome under View A could be materially different from that of an arrangement in which the entity actually issues the entire award in the form of equity instruments to employees and settle the tax withholding obligation using the proceeds from the sale of some of these equity instruments to the market (eg a 'broker-assisted cashless exercise');

(c) the substance of the transactions is overruled by the form-driven requirements in IFRS 2;

(d) the net-settlement mechanism, which facilitates the settlement of the counterparty's tax obligation, should be seen to constitute an agency agreement rather than the entity being viewed as the principal obligor to the taxation authorities—it is the employee's tax obligation that is being settled, by the entity, on behalf of the employee;

(e) it is not clear whether IFRS 2 allows the entity to divide one award into two awards and account for them separately; and

[2] http://media.iasb.org/IFRICUpdateNov10.html

[3] Refer to Agenda Paper 5 for the November 2010 meeting (http://www.ifrs.org/Meetings/Documents/IFRS-IC-Nov10/1011obs5IFRICIFRS2Equitygrantsettlednetofwithholding.pdf)

(f) we need to consider a need for introducing a specific exception to IFRS 2 in this area, which could be similar to the exception in US GAAP.

11. In its March 2011 meeting, the Interpretations Committee decided not to add this issue to its agenda, primarily because, considering those concerns, addressing this issue would require an amendment to IFRS 2. The Interpretations Committee thought that this issue would better be addressed by the IASB in a future agenda proposal for IFRS 2.

12. In the July 2012 meeting, the Interpretations Committee decided to revisit this issue and asked the staff to update the analysis and outreach on those issues so that they could discuss them at future meetings. In response to this request, the staff now first provide updates on the results of outreach activities in the following paragraphs.

Summary of the result of outreach activities

13. We requested information from the International Forum of Accounting Standard-Setters (IFASS) and regulators to help us assess the issues against the Interpretations Committee's agenda criteria. Specifically, we asked:

(i) *In your jurisdiction, do you have similar transactions to those described below? If similar, but not identical, please tell us the differences.*

(ii) *If you answered 'yes' to question 1, what is the prevalent accounting for the transactions? And if possible, could you please briefly describe the rationale for that accounting?*

(iii) *On the basis of your response to question 2, to what extent do you observe diversity in the practice for accounting for these types of transactions?*

(iv) *In your jurisdiction, are you aware of any significant divergent interpretations on other issues that are related to IFRS 2?*

(v) *If you answered 'yes' to question 4, please briefly describe the type of transactions and the divergent interpretations.*

14. Excerpts from the outreach request are attached as Appendix C to this agenda paper.

15. We have received 15 responses to the request. The views expressed below are informal opinions from national standard-setters and regulators. They do not reflect the formal views of those organisations. The geographical breakdown of the responses is as follows:

Geographical area	**Number of respondents**
Worldwide	1
Americas	4
Asia/Oceania	5
Africa	1
Europe	4
Total respondents	15

16. Three respondents stated that SBP transactions in which the entity withholds a specified portion of the equity instruments to meet the tax requirements are common in their jurisdictions.

17. Among the three respondents who replied that this issue is common in their jurisdictions, one respondent stated that the prevalent accounting in the jurisdiction is to split the award into two awards (an equity-settled award and a cash-settled award) and account for them separately. However, that respondent also stated that there are many entities that employ the approach adopted in US GAAP, which is generally a full equity classification, because US GAAP has requirements specific to this issue, while IFRS 2 does not. One respondent stated that the approach employed in US GAAP is widely applied and that there is no significant divergence in practice. Another respondent stated that there are divergent views in its jurisdiction.

18. One respondent answered that they also have SBP transactions in which an entity is obliged to pay withholding tax obligations of its employees. However, these are generally structured as being settled by issuing equity instruments to the employees and immediately having the equity instruments sold to fund the tax

obligation in order to achieve the full equity treatment under IFRS 2. The respondent stated that they also have SBP transactions in which an entity withholds a specified portion of the equity instruments and that there are divergent views on how to account for that type of SBP transaction.

Staff technical analysis

19. We have the same view as the ones the staff had in the past meetings (ie View A) for the SBP transaction analysed. In the following paragraphs, we summarise the technical analysis performed by the staff in the past and provide some updates on the previous analysis in response to the concerns raised in the past Interpretations Committee meetings.

20. In addition, in Appendix A to this agenda paper, we have prepared an illustrative example of SBP transactions settled net of tax withholdings to present the difference in the accounting results between View A and View B. The illustrative example also includes the accounting result in the case of a 'broker-assisted cashless exercise'.

Classification under IFRS 2

Principal vs agent analysis

21. Appendix A *Defined terms* to IFRS 2 states [emphasis added]:

> **cash-settled share-based payment transaction**
>
> 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.
>
> **equity-settled share-based payment transaction**
>
> 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**.

22. In the SBP transaction described in paragraph 5, the entity is required by the tax laws or regulations to pay cash to the taxation authorities for the settlement of the counterparty's tax obligation. Thus, opponents to View A argue that the transaction is not a cash-settled SBP transaction, because the entity does not pay cash directly to the counterparty.

23. In our view, although tax rules oblige the entity to pay cash to the taxation authorities, the tax obligation remains that of the counterparty and the entity in question is acting merely as an agent and is settling the tax obligation on behalf of the counterparty. We think that by paying cash to the taxation authorities, the entity is:

(a) fulfilling its obligation to pay cash for the services received from the counterparty. It is acting as a principal in this respect; and

(b) is acting as an agent on behalf of the counterparty in transferring cash to the taxation authorities.

24. Accordingly, the entity is required to pay cash in return for services received from the counterparty in discharging its obligation for which it is acting as a principal. We think that this is consistent with the definition of a cash-settled SBP transaction and inconsistent with the definition of an equity-settled SBP transaction in IFRS 2.

Split accounting for an SBP award

25. Those who disagree with View A question whether the entity can divide one SBP award into two components and account for them separately. Even though IFRS 2 does not address that issue specifically, we are of the view that IFRS 2 indicates in paragraph 35 of IFRS 2 that one SBP award could be divided into an equity-settled component and a cash-settled component. Paragraph 35 of IFRS 2 states (<u>emphasis added</u>):

> 35 **If an entity has granted the counterparty the right to choose whether a share-based payment transaction is settled in cash or by issuing equity instruments, the entity has granted a compound financial instrument, which**

> **includes a debt component (ie the counterparty's right to demand payment in cash) and an equity component (ie the counterparty's right to demand settlement in equity instruments rather than in cash)**. For transactions with parties other than employees, in which the fair value of the goods or services received is measured directly, the entity shall measure the equity component of the compound financial instrument as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

26. Although paragraph 35 of IFRS 2 provides guidance specific to an SBP award in which the terms of the arrangement provide the counterparty with a choice of settlement, we think that IFRS 2 requires an entity to account for an equity component and a liability component separately if the entity has both an obligation to settle in cash, and an obligation to settle in equity instruments, at the same time. In the SBP transaction analysed, the entity has incurred a liability to transfer cash as well as an obligation to deliver equity instruments.

Alternative view

27. Those who support View B believe that, in substance, the entity has repurchased part of the vested equity-settled SBP award through net settlement of the award, which is consistent with the guidance in paragraph 29 of IFRS 2. Paragraph 29 of IFRS 2 states:

> 29 If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

28. In our view, paragraph 29 of IFRS 2 is intended to ensure that an SBP expense is recognised for amounts paid in excess of the fair value of shares repurchased when this forms part of the SBP transaction. This is primarily for addressing a risk of abuse from an entity compensating an employee through repurchasing the equity instruments for more than fair value and avoiding an expense in profit or loss for the excess.

29. We note that paragraph 29 of IFRS 2 does not address the classification of the SBP transaction, but only the accounting for the cash payment. We also note that

in the circumstances analysed, the shares were never issued and therefore could not be repurchased, and consequently paragraph 29 of IFRS 2 could not apply.

30. Furthermore, paragraph 31 of IFRS 2 provides an example of a cash-settled SBP in which the entity grants to its employees rights to receive redeemable shares. We think that this example better describes the substance of the transaction than the example in paragraph 29 of IFRS 2. Paragraph 31 of IFRS 2 is reproduced below (emphasis added):

> 31 For example, an entity might grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time. **Or an entity might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of share options) that are redeemable, either mandatorily (eg upon cessation of employment) or at the employee's option.**

31. With regard to the accounting results under both views, we note that the difference between View A and View B could be significant. As illustrated in Appendix A, the difference in the accounting results would be significant, especially if the fair value of the award increases significantly after the grant of the award. Accordingly, divergence in practice could result in impairing comparability among entities that have similar obligations under applicable tax laws.

US GAAP relevant literature

32. Topic 718 *Compensation - Stock Compensation* in the *FASB Accounting Standards Codification®* includes specific guidance on the entity's withholding regarding broker-assisted cashless exercises and minimum statutory tax withholdings requirements. Under the guidance, the SBP arrangements analysed here do not require liability classification for the portion of the SBP award that is withheld to meet the employer's minimum statutory requirements (subtopic 718-10-25-18). However, the FASB acknowledges that that guidance is inconsistent with the principle of the accounting requirements for SBP transactions (paragraphs B125 and B126 of FAS 123R).

33. We also note that if the entity has no 'statutory withholding obligation', but opts to withhold the tax amount by means of net settlement under the arrangement with the employee, the US GAAP exception would not be available to the SBP transaction. In addition, if an amount is withheld in excess of the statutory minimum requirements, or may be withheld at the employee's discretion, the entire award would be classified as a cash-settled SBP transaction (FASB ASC 718-10-25-18).

34. The full text of the relevant US GAAP literature is reproduced in Appendix E to this agenda paper.

Variation of tax withholding schemes

35. We acknowledge that there may be a variety of types of SBP transaction involving tax withholdings. In order to analyse how the requirements in IFRS 2 would be applied to SBP transactions with obligations of tax withholdings, we used two contrasting examples as follows:

    (a) a 'broker-assisted cashless exercise' represents an SBP transaction involving tax withholdings in which all of the shares that are to be issued in accordance with the SBP arrangement are in fact issued, and the entity facilitates the sale of some of these shares to the market and pays the cash received to the tax authority to settle the counterparty's tax obligation; and

    (b) 'net-settlement for tax withholding requirements', which is exemplified by the transaction in issue, represents an SBP transaction in which the entity is required to issue a reduced number of shares to the counterparty and uses its own cash reserves to settle the counterparty's tax obligation.

36. As presented above, all of the shares granted are issued and there is no net cash outflow from the entity's own cash resource in the case of broker-assisted cashless exercise. Accordingly, we are of the view that the entity should classify the entire award as an equity-settled SBP transaction in that case. In contrast, the entity pays cash to the taxation authorities from its own cash reserve in the case of the

net-settlement. We think that the difference in these two fact patterns is substantial and warrants the difference in accounting results. Appendix A to this agenda paper illustrates the accounting results in the case of a 'broker-assisted cashless exercise' (Scenario 2).

Operational challenges

37. Opponents to View A argue that the approach under View A would cause an undue burden on an entity that settles SBP transactions net of tax withholdings. This is because, to implement the approach in View A, the entity has to estimate changes in tax laws, including changes in tax rates, which affect the amount to be withheld by the entity on the vesting date or the exercise date. This operational burden would be more serious if the entity had operations in multiple tax jurisdictions that have different tax rules.

38. The illustrative example in Appendix A is prepared on the basis of the assumption that the impacts of those uncertainties are nil when calculating the grant date fair value of the equity-settled component and the cash-settled component. However, we accept that the entities, especially entities with multiple business locations, would have operational challenges in implementing the approach in View A.

Amendments to IFRS 2

39. As mentioned above, we interpret the requirements in IFRS 2 as requiring an entity to take View A for the SBP transaction analysed. However, as discussed above, divergent views were expressed by the members of the Interpretations Committee and interested parties on interpretation of the principles in IFRS 2. Accordingly, we think that resolving the diversity in interpretations requires clarification by amending IFRS 2.

40. On the basis of the discussions above, we think that there would be three alternative approaches to amending IFRS 2:

Approach 1: add guidance to IFRS 2 in line with View A

This approach is to clarify that the portion of the SBP transaction that is withheld for tax obligations, and the portion that is delivered to the counterparty, should be accounted for separately in accordance with applicable requirements in IFRS 2 if the requirements in IFRS 2 require the one portion to be classified differently from the other. This amendment would also make it clear that the portion of the SBP award for which the entity is obliged to pay cash to taxation authorities should be accounted for as a cash-settled SBP. This accounting treatment would also apply to a portion of equity instruments that is repurchased by the entity, in respect of settling the tax obligations of the counterparty, at (or shortly after) the issue of the entire award in the form of equity instruments.

Approach 2: add guidance to IFRS 2 in line with View B

This approach would be to specify that withholding a portion of the SBP transaction to meet the tax obligations is, in substance, a repurchase of the vested equity instruments as described in paragraph 29 of IFRS 2 and therefore the entire award should be accounted for as an equity-settled SBP transaction.

Approach 3: provide specific guidance in IFRS 2 for the SBP transactions with net settlement provisions

This approach would be to provide specific guidance for the SBP transactions similar to that in US GAAP to require that the portion that is net settled in cash for the purposes of meeting the employee's income tax obligations should be classified as equity-settled. The specific guidance could be limited to a situation in which a provision in a law or agreement with the employee requires an entity to withhold a portion of the equity instruments to meet its minimum tax withholding requirements. Accordingly, in other cases such as when an amount is withheld in excess of the statutory minimum requirements, or may at the be withheld employee's discretion, the classification of that portion of the award would be determined in accordance with classification requirements in IFRS 2 and would therefore be classified as cash-settled in accordance with IFRS 2.

41. We are of the view that Approach 3 should be taken if the Interpretations Committee decided to propose an amendment to IFRS 2 to resolve this issue. This is because this approach would be able to accommodate, to a large extent, the

concerns about the operational challenges in implementing the approach in View A and we think the Interpretations Committee could reach a consensus on this approach in a timely basis. In our view, providing an amendment to IFRS 2 for a very limited circumstance would be justified by the fact that the Interpretations Committee was unable to reach a consensus on either View A or View B and that the existence of the significant diversity in practice has been confirmed.

Assessment against the Interpretations Committee's agenda criteria

42. In this section, we assess the issue against the agenda criteria of the Interpretations Committee described in paragraphs 5.16 and 5.17 of the Due Process Handbook. The Interpretations Committee should address an issue:

    (a) that has widespread effect and has, or is expected to have, a material effect on those affected;

    (b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods;

    (c) that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting;*

    (d) that is sufficiently narrow in scope that it can be addressed in an efficient manner, but not so narrow that it is not cost-effective; and

    (e) for which a solution developed by the Interpretations Committee can be effective for a reasonable period of time. If the issue relates to a current or planned IASB project, justification of the short-term improvements is necessary.

43. According to the responses from national-standard setters and regulators to our outreach request and comment letters received on the tentative agenda decision, we think that this issue is widespread in accounting practice. In addition, these responses also proved that there is significant divergence in interpretations on application of the requirements in IFRS 2 to the SBP transaction analysed here.

44. As mentioned above, we think that it is difficult for the Interpretations Committee to reach a consensus on an interpretation of the requirements in IFRS 2 in respect

of this issue. In this regard, in our view, the Interpretations Committee cannot address this issue efficiently by proposing an amendment to IFRS 2 under either Approach 1 or Approach 2. In the past, the Interpretations Committee decided not to add this issue to its agenda primarily for this reason.

45. However, we think that the Interpretations Committee could resolve this issue in an efficient manner in line with Approach 3 described in paragraph 40. We think that the approach would be widely accepted by the interested parties because it would be to provide entities with a certain level of specific guidance to mitigate the implementation challenges under View A.

46. Consequently, we think that this issue could be addressed by the Interpretations Committee if the Interpretations Committee took Approach 3 described in paragraph 40.

Assessment against annual improvement criteria

47. We think that the potential amendment under Approach 3 could be developed and agreed upon by the IASB on a timely basis. However, we note that the amendment would be perceived as being beyond a clarification and correction of errors of existing requirements in IFRS 2. This is because the potential amendment would add specific guidance that addresses only limited types of SBP transactions for the purpose of resolving the divergence in practice. The amendment would not necessarily be derived from the consensus on an interpretation of principles in IFRS 2. Accordingly, we are of the view that the potential amendment should be exposed separately and performed in a separate narrow-scope amendment project of the IASB. Nevertheless, we think that the Interpretations Committee could perform much of the work on such a narrow-scope amendment, on behalf of the IASB.

48. For the details about the assessment against the annual improvements criteria, please refer to Appendix F of this agenda paper.

Staff recommendation

49. In summary, we think that:

(a) our analysis above confirmed that there is significant divergence in practice and addressing the divergence requires amendments to IFRS 2 to clarify the classification of the portion of the SBP transaction withheld by the entity.

(b) if the Interpretations Committee agreed that IFRS 2 should be amended, the amendments should be in line with Approach 3.

(c) proposing the potential amendment in line with Approach 3 would meet the agenda criteria of the Interpretations Committee; however, it would not meet the criteria of an annual improvement project.

50. Consequently, we recommend that the Interpretations Committee should change the previous decision issued in March 2011 and propose to the IASB that it should amend IFRS 2 in line with Approach 3 in a narrow-scope amendment project to resolve the significant divergence in practice. If the Interpretations Committee can reach a consensus on the principles proposed in Approach 3, we will bring the staff draft of the amendments to a future meeting in line with the principles in Approach 3.

Question to the Interpretations Committee

Question
Does the Interpretations Committee agree with the staff recommendation that it should propose to the IASB that it should amend IFRS 2 in line with Approach 3 in a narrow-scope amendment project?

Appendix A—Illustrative examples

On 1 January 20X0 Entity A grants an award of 100 free shares to one of its employees subject to a four-year service condition. Entity A estimates that the employee will complete his service period. The **employee has the legal obligation to pay income tax** on employee awards which is calculated based on the fair value of the free share on the vesting date. On 31 December 20X0, Entity A expects that the tax rate applicable to the legal obligation to pay the income tax will be 30%. At grant date, the fair value of each free share is CU 2. The fair values of each free share subsequent to the grant date are:

31 December X0: 7
31 December X1: 12
31 December X2: 16
31 December X3: 20

On 31 December X2, **Entity changes its expectation on the applicable tax rate from 30% to 40% due to a change in a tax law.**

Entity A is obliged by tax law to withhold from the employee's taxable compensation for the period the tax obligation imposed on the employee and immediately remit to the tax authority, in cash, the amount of the tax obligation.

<u>(Scenario 1)</u>

Under the terms of the share-based payment arrangement between Entity A and the employee, **Entity A is required to settle the transaction net by issuing a reduced number of shares to the employee to meet the entity's tax withholding obligation. Accordingly, on the exercise date, Entity A issued 60 free shares to the employee and remitted CU 800 (100 shares * CU 20 * 40%) to the tax authority on behalf of the employee**. **Entity A pays the amount of the employee's tax obligation from its own cash resources.**

<u>(Scenario 2)</u>

Under the terms of the share-based payment arrangement between Entity A and the employee, **Entity A is required to settle the transaction gross** by issuing all the vested shares to employees and direct a broker to sell in the market a portion of the shares required to meet the entity's tax withholding obligation. Accordingly, **Entity A issued 100 shares with 60 of the shares being delivered to the employee and 40 shares being delivered to the broker. The proceeds from the sale of the shares by the broker of CU 800 (100 shares * CU 20 * 40%) were remitted** to the tax authority on behalf of the employee. **There is no shortfall in the proceeds received from the sale to cover the tax payment.**

Scenario 1

Accounting under View A

Year	Expense	Equity	Liability
20X0	87.5	-35 *(=CU2*100 shares*70%*1/4)*	-52.5 *(=CU7*100 shares*30%*1/4)*
	Under this view, the award is divided into two parts; the equity-settled part and cash-settled part, and they are accounted for separately afterwards. Future uncertain events that will impact the number of shares to be issued such as changes in tax rates are factored in when calculating the grant date fair value of the equity-settled part and fair value of the cash-settled part(in this example, the impact of them was assumed to be nil).		
20X1	162.5	-35 *(=CU2*100 shares*70%*1/4)*	-127.5 *(=CU12*100 shares*30%*2/4-52.5)*
20X2	335	-35 *(=CU2*100 shares*70%*1/4)*	-300 *(=CU16*100 shares*40%*3/4-(52.5+127.5))*
	At the end of 20X2, the expected tax rate changed from 30% to 40%. However, changes in tax rates are already factored in the calculation of the grant date fair value of the equity award and would not affect the total compensation expense of the equity-settled part (IFRS2.21A). On the other hand, the liability part should reflect the change of the tax rate when calculating the fair value.		
20X3	355	-35 *(=CU2*100 shares*70%*1/4)*	-320 *(=CU20*100*40%*4/4-(52.5+127.5+300))*
	At the end of 20X3, all shares were vested and 60 shares were issued to the employees.		
total	940	-140	-800

Scenario 1

Accounting under View B

Year	Expense	Equity	Liability
20X0	50	-50 *(=CU2*100 shares*1/4)*	0
	Under this view, the entire award is classified as an equity-settled SBP transaction.		
20X1	50	-50 *(=CU2*100 shares*1/4)*	0
20X2	50	-50 *(=CU2*100 shares*1/4)*	0
	Because the award is not divided into two awards, there is no impact from the change in the expected tax rate.		
20X3	50	750 *(=CU2*100 shares*1/4)-800*	-800 *(=CU20*100*40%*4/4)*
	Under this view, it is assumed that all the vested shares were issued to the employees and at the same time 40 shares were repurchased by the entity.		
total	200	-200	0

Scenario 2 (broker-assisted cashless exercise)

In this scenario, the accounting would be the same under both View A and View B.

Year	Expense	Equity	Liability
20X0	50	-50 *(=CU2*100 shares*1/4)*	0
20X1	50	-50 *(=CU2*100 shares*1/4)*	0
20X2	50	-50 *(=CU2*100 shares*1/4)*	0
20X3	50	-50 *(=CU2*100 shares*1/4)*	0
total	200	-200	0

Appendix B—Submission

B1. The staff received the following Committee agenda request. All information has been copied without modification by the staff.

B2. In certain jurisdictions when a share-based award is settled with the employee, the employer will withhold shares from the settlement to the employee in order to settle the employee's tax obligation. In such situations the employee does not have the option to receive the gross settlement of the award but automatically receives the net shares. We understand that certain audit firms apply an interpretation of IFRS 2 that the portion of the award related to the tax withholding should be treated as a cash-settled award from grant date. The inconsistent practice among audit firms may influence a company's plan structure between gross or net settlement of tax withholding. Depending on company plan structure, in some instances it would require the issuance of additional shares out onto the market with the resulting dilutive effects on the share price.

B3. Under U.S. GAAP, this issue is specifically addressed in paragraphs 35 and B125 of FAS 123R (now FASB Accounting Standards Codification Topic 718, Compensation – Stock Compensation) in which for 'pragmatic reasons' it was decided that the tax withholding should not be treated as cash settled:

> B125. Paragraph 35 of this Statement also indicates that a provision for direct or indirect (by means of a net-settlement feature) repurchase of shares issued upon exercise of options (or vesting of shares) to meet the employer's minimum statutory withholding requirements does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. Interpretation 44 also provided that exception for accounting under Opinion 25. In concept, the Board considers a provision for repurchase of shares at, or shortly thereafter, the exercise of options, for whatever reason, to result in the employer's incurrence of a liability. **However, the Board decided for pragmatic reasons to continue the exception for direct or indirect repurchases to meet the employer's minimum statutory withholding requirements**.

B4. We believe that an accounting interpretation to split the award into two parts (one with fixed plan accounting and one with liability accounting) does not give a meaningful accounting answer and brings with it unnecessary complexity. This complexity is especially evident in jurisdictions with variable tax rates (e.g., tax rates based on income levels).

B5. Some awards (common practice with restricted stock) must be exercised on their vesting date, which may occur during a black-out period. Therefore, companies are legally and practically impeded from gross-settling awards with the employee so that an employee is not forced to sell an award when prohibited by regulators. Another pragmatic consideration is that tax withholding requirements are computed based on the fair value of the award at the vesting/distribution date. In situations in which grant accounting is otherwise appropriate, it would be problematic to try to project forward to the distribution date what the tax withholding requirements would be. Lastly an additional issue is the potential risk that the employee who receives gross delivery of the awards fails to remit their taxes. In some tax jurisdictions the employer would be required to bear this risk for these unpaid taxes if the employee defaulted due to the employer's "negligence" in not withholding.

B6. While some believe this form of settlement is akin to a repurchase of vested equity (IFRS 2.29), we recognize that the cash-settled alternative view is present in the market. The FASB has recognized this issue in paragraph B125 of FAS 123R and we recommend that this point be integrated into IFRS 2 as well to avoid confusion in the application of IFRS 2.

Appendix C—Excerpt from outreach request

C1. We sent the following request to the International Forum of Accounting Standard Setters and regulators to solicit information on this issue:

Dear all,

In the July 2012 meeting, the IFRS Interpretations Committee (the Interpretations Committee) decided to revisit the three issues related to IFRS 2 *Share-based Payment*. Previously, the Interpretations Committee decided not to add these issues to its agenda or propose annual improvements because it observed that they should be dealt with by the IASB in a broader project of IFRS 2, which includes a post-implementation review. Because the IASB does not expect to address those issues or undertake a post-implementation review of IFRS 2 in the near future, the Interpretations Committee asked the staff to update the analysis and outreach on those issues so that they can discuss them at future meetings. The three issues should clarify how:

1. to classify and measure share-based payment transactions for which the manner of settlement is contingent on either:
   (i) a future event that is outside the control of both the entity and the counterparty; or
   (ii) a future event that is within the control of the counterparty.
2. to classify a share-based payment transaction in which the entity is required to withhold a specified portion of the shares that would otherwise be issued to the counterparty upon exercise (or vesting) of the share-based payment award in order to settle the counterparty's tax obligation.
3. to measure and account for a share-based payment in situations in which a cash-settled award is cancelled and is replaced by a new equity-settled award that has a higher fair value than the original award.

For further information related to the discussions in the July 2012 Interpretations Committee meeting, please consult the following materials:

- The IFRIC *Update* for the July 2012 meeting (http://www.ifrs.org/Updates/IFRIC-Updates/Pages/IFRIC-Updates.aspx)
- Agenda Paper 9 for the July 2012 meeting (http://www.ifrs.org/Meetings/Pages/IFRICJuly2012.aspx)

In addition to these three issues, we are seeking information on significant divergence in practice on other issues that are related to IFRS 2, if you are aware of it in your jurisdiction.

Questions

For each of the three issues described in the following section, I would very much appreciate your observations on the following aspects:

1. In your jurisdiction, do you have similar transactions to those described below? If similar, but not identical, please tell us the differences.

2. If you answered 'yes' to question 1, what is the prevalent accounting for the transactions? And if possible, could you please briefly describe the rationale for that accounting?
3. On the basis of your response to question 2, to what extent do you observe diversity in the practice for accounting for these types of transactions?
4. In your jurisdiction, are you aware of any significant divergent interpretations on other issues that are related to IFRS 2?
5. If you answered 'yes' to question 4, please briefly describe the type of transactions and the divergent interpretations.

At this stage of the process I am especially interested in the observations that you have made in practice, so please feel free to send them on to me.

I would appreciate receiving your input on this issue by **14 January 2013**.

Best regards,

Ken

<u>Description of the issues</u>

Issue 1: […]

Issue 2: Share-based payment transactions settled net of tax withholding

The Interpretations Committee received a request to consider the classification of a share-based payment transaction in which the entity withholds a specified portion of the shares that would otherwise be issued to the counterparty upon exercise (or vesting) of the share-based payment award. The shares are withheld by the entity in return for settling the counterparty's tax, withholding any obligation associated with the share-based payment.

More specifically, the issue included in the agenda request is a share-based payment arrangement in which:

(a) the entity is required to:
  - (i) withhold (by reducing the number of shares issued to the employee) from an employee's compensation an amount to satisfy the employee's tax liability incurred as a result of the share-based payment transaction; and
  - (ii) pay the amount that is withheld from the employee's compensation to the taxation authority in cash; and

(b) the employee will receive shares net of the number of shares equal to the employee's tax liability (that will be satisfied by the entity in (a)(ii) above) upon exercise (or vesting).

The request received by the Interpretations Committee asked whether the portion of the share-based payment that is withheld should be classified as cash-settled or equity settled.

According to the submission, there are two views as described in the followings:

> *View 1: Separate accounting for each component of the share-based payment transaction*
>
> Under this view, the portion to which the entity has incurred a liability to pay cash to a taxation authority is classified as cash-settled while the portion to which the entity settles the compensation obligation by the issue of equity instrument is classified as equity-settled. The supporters of this view argue that the definition of a cash-settled share-based transaction in IFRS 2 should include a situation in which the entity assumes liability to pay cash to a third-party on behalf of the counterparty.
>
> *View 2: Part of the entire equity-settled share-based payment transaction*
>
> Those who support this view argue that this arrangement should be viewed as the net impact of two different transactions; 1) the equity-settled share-based payment transaction that is satisfied in its entirety through the issue of equity instruments; and 2) the repurchase of a portion of the equity instruments that were just issued in 1) by the entity. They believe that the portion of the equity instruments that is withheld by the entity should be viewed as a subsequent transaction which, in their view, is not a share-based payment to the employees, but, instead, is the entity's repurchase of a portion of the vested shares (IFRS 2.29).

For further details I have attached the relevant extracts from the submission. In addition, Agenda Papers used in the meetings and the IFRIC *Update* can be viewed at:

- The IFRIC *Update* for the March 2011 meeting (http://media.ifrs.org/IFRICUpdateMar11.html)
- Agenda Paper 7 for the March 2011 meeting (http://www.ifrs.org/Meetings/Pages/IFRS-Interpretations-Committee-March-2011.aspx)
- Agenda Paper 5 for the November 2010 meeting (http://www.ifrs.org/Meetings/Pages/IFRS-Interpretations-Committee-4-November-2010.aspx)

- Agenda Paper 14 for the September 2010 meeting (http://www.ifrs.org/Meetings/Pages/IFRIC-Meeting-2-September-2010.aspx)

Issue 3: […]

Appendix D—Excerpts from *IFRIC Update* in March 2011

IFRS 2 Share-based Payment—share-based payment awards settled net of tax withholding

The Interpretations Committee received a request to consider the classification of a share based payment transaction in which the entity withholds a specified portion of the shares that would otherwise be issued to the counterparty upon exercise (or vesting) of the share-based payment award. The shares are withheld by the entity in return for settling the counterparty's tax withholding obligation associated with the share-based payment. The request received by the Committee asked whether the portion of the share-based payment that is withheld should be classified as cash-settled or equity settled.

The Committee identified a number of issues arising from the submission for which the application of the requirements of IFRS 2 caused concern, such as separately classifying components of a single award.

The Committee decided not to add the issue to its agenda because addressing these concerns would require an amendment to IFRS 2. Instead, the Committee decided to recommend to the Board that this issue should be included in a future agenda proposal for IFRS 2.

Appendix E—Excerpt from relevant US GAAP literature

E1. The followings are excerpt from the relevant US GAAP guidance (<u>emphasis added</u>)

FASB Accounting Standards Codification

718-10

25-16 A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

25-17 A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

25-18 Similarly, **a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.**

25-19 Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

Basis for Conclusions of FAS 123R

B125. Paragraph 35 of this Statement also indicates that a provision for direct or indirect (by means of a net-settlement feature) repurchase of shares issued upon exercise of options (or vesting of shares) to meet the employer's minimum statutory withholding requirements does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. Interpretation 44 also provided that exception for accounting under Opinion 25. **In concept, the Board considers a provision for repurchase of shares at, or shortly thereafter, the exercise of options, for whatever reason, to result in the employer's incurrence of a liability. However, the Board decided for pragmatic reasons to continue the exception for direct or indirect repurchases to meet the employer's minimum statutory withholding requirements.**

B126. Certain respondents to the Exposure Draft asked that the exception for minimum statutory withholding requirements be extended to encompass amounts in excess of the minimum statutory withholding requirements. As noted in paragraph B125, **the Board included the exception for minimum statutory requirements for pragmatic rather than conceptual reasons**. The Board therefore declined to extend the exception beyond the minimum statutory requirements to which the related exception in Opinion 25 and Interpretation 44 applied.

Appendix F—Annual improvement criteria analysis

F1. In planning whether proposed amendments to Standards can be exposed as part of the Annual Improvements, the IASB assesses the proposed amendments against the criteria described in paragraphs 6.10-6.14 of the Due Process Handbook. We have assessed the potential amendment to IFRS 2 described in this agenda paper against the criteria of Annual Improvements, which are reproduced in full below:

Annual Improvements criteria	Staff assessment of the amendment
(a) The amendments are limited to changes that represent either: (i) clarifying the wording in a Standard, which involves either: • Replacing unclear wording in existing Standards; or • providing guidance where an absence of guidance is causing concern. A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs and does not propose a new principle, or a change to an existing principle. (ii) correcting relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards A correcting amendment does not propose a new principle or a change to an existing principle.	**Not met** The potential amendment would provide guidance specific to limited types of SBP transactions for the purpose of resolving the significant diversity in practice. The amendment would not necessarily be derived from an interpretation of the principles in IFRS 2. Accordingly, we are of the view that it would be beyond a clarification and correction of the existing requirements of IFRS 2.
(b) The proposed amendment is well defined and narrow in scope.	**Met** This issue is sufficiently narrow and well-defined because the potential amendments would be limited to a SBP transaction in which the entity withholds a specified portion of the shares for purposes of meeting the statutory income tax withholding requirements.

Annual Improvements criteria	Staff assessment of the amendment
(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.	**Met** We think that the IASB will be able to reach a consensus on the potential amendment under Approach 3.