Issues paper on Scope of IFRS 2 *Share-based Payment*

Fact pattern in Malaysia

In Initial Public Offerings ("IPO"), there are various methods used to determine the offer price for the offer shares.

Usually for the smaller offerings, there is only one offer price, which is decided by the Issuer and the Managing Underwriter through various valuation techniques.

For the larger offerings, it is usually split into retail and institutional tranches. The offer price for the institutional tranche is typically determined through a book building exercise/process, while the offer price for the retail tranche is usually tagged to the institutional offer price. Where there are 2 offer tranches (i.e. retail and institutional), there is a possibility that the final offer price for the retail tranche could be lower than the offer price for the institutional tranche.

The issue

There are divergent views whether the issue of shares for the retail tranche at a consideration lower than the institutional offer price (some has referred this different as a "discount" to retail investors) is within the scope of IFRS 2 *Share-based Payment*.

Mechanism to determine the institutional offer price and retail offer price

Institutional offer price

After the issuance of an IPO prospectus, the institutional offer price is typically determined through a book building exercise[1].

During the book building exercise, the prospective investors will be invited to bid for portions of the institutional offering by specifying the price and number of offer shares that they would be prepared to acquire. Upon completion of the book building exercise, the institutional offer price will be fixed in consultation with the "bookrunners" or "global coordinators", where relevant. This price fixing event occurs after the close of the offer.

Settlement by the institutional investors is only required after they have been informed of their allocation.

Retail offer price

Unlike the institutional tranche, retail investors are required to pay for the shares at the time of application. A refund will be made if they are unsuccessful.

The retail price is required to be stated in the prospectus. This precedes the fixing of the institutional price. As such, the retail offer price stated in the prospectus is an indicative retail offer price, i.e. in the event the institutional offer price is lower, a refund will be made (so that the final retail offer price will be equal to the institutional offer price).

However, in the event the institutional offer price is higher, the indicative retail offer price represents the ceiling price that a retail investor is required to pay for the shares. This is because it is not practical (in terms of timing or logistics) to request for additional payment from retail investors.

[1] In cases where there are cornerstone investors, this may create different sub-institutional price.

As such, to fix the indicative retail offer price, the Managing Underwriter will carry out a price discovery process, where a research on the demand of the shares offered in the market is conducted. The indicative retail offer price is determined and agreed after taking into consideration factors like the nature of business, operating history, competitive strengths, business strategies and the results of the price discovery process.

Although the final retail offer price is typically set at a price equal to the lower of the institutional price and the indicative retail offer price (thus the indicative retail offer price is always the ceiling price for reasons stated above), there could be circumstances the Issuer may wish to give a small discount to the retail investors (comparative to the institutional investors) so as to encourage subscriptions from the public if the Issuer wants a larger retail investors profile. Under such circumstances, the final retail offer price will be set at a price equal to the lower of the indicative retail offer price and (100% - x%) of the institutional offer price.

Situation 1

The final retail offer price is set at a price equal to the lower of the indicative retail offer price and the institutional offer price

Illustration

An IPO comprise of the following offers:
- Institutional offering at the price to be determined by way of book building; and
- Retail offering at the lower of RM4.80 per share and 100% of the institutional offer price.

Assuming that the institutional offer price is set at RM5.00 per share by way of book building, the retail offer price shall remain at RM4.80 per share, being the lower of RM4.80 and 100% of the institutional offer price (RM5.00 x 100% = RM5.00).

In this situation, there is no refund to the retail investors.

Issue:

Does the price differential of RM0.20 [RM5.00-RM4.80] represent payment for goods or services received?

Situation 2

The final retail offer price is set at a price equal to the lower of the indicative retail offer price and a fixed percentage, say 95%, of the institutional offer price

Illustration

An IPO comprise of the following offers:
- Institutional offering at the price to be determined by way of book building; and
- Retail offering at the lower of RM4.80 per share and 95% of the institutional offer price.

Assuming that the institutional offer price is set at RM5.00 per share by way of book building, the final retail offer price will be RM4.75 per share, being the lower of RM4.80 and 95% of the institutional offer price (RM5.00 x 95% = RM4.75).

In such situation, RM0.05 per share will be refunded to the retail investors.

Issue:

Does the price differential of RM0.25 [RM5.00-RM4.75] represent goods or services received?

View 1: The price differential represents goods or services received

Proponents of View 1 believe that in the event the consideration received by an entity for the issue of equity instruments is lower than the fair value of the equity instruments, the entity is deemed to have received or will receive other consideration which could not be clearly identified. Such other consideration is termed as unidentifiable goods or services in IFRS 2.

Paragraph 2 of IFRS 2 states that in the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (will be) received, in which case IFRS 2 applies. BC18C of IFRS 2 also indicated the IASB position that it is not necessary to identify the specific goods and services received in return for the equity instruments granted to conclude that goods or services have been or will be received. Unidentifiable goods or services, by nature, are not specifically identifiable. Instead, it appears very much like a form of intangible benefits received or to be received by the entity which translates into “the reason” for the entity to issue equity instruments below its fair value.

By offering the shares to the retail investors at a price lower than the institutional investors, it may assist the Company to meet the minimum public shareholding spread of 1,000 public shareholders required under the Stock Exchange. This is an unidentifiable service. An expense should therefore be recognised.

As stated in paragraph 3A of IFRS 2, it appears that the price differential for both Situations 1 and 2 would fall within the scope of IFRS 2 unless there is clear evidence that the equity instruments are issued for a purpose other than for goods or services.

View 2: The price differential does not represent goods or services received

Proponents of View 2 believe that IFRS 2 does not “automatically” apply when the consideration received appears to be less than the fair value of the equity instruments granted.

It is a rebuttable presumption which can be overcome if it is clear that no goods and services were received. For this purpose the reason for the discount needs to be understood to determine whether there are goods and services involved. If there are none, IFRS 2 does not apply.

Situation 1

The indicative retail offer price is set prior to the determination of the institutional offer price and therefore the price differential (if any) is not considered as a discount given to the retail investors.

If the institutional offer price is set above the indicative retail offer price, this is probably due to a “misjudgement” by the Company and its advisor during the price discovery process. Furthermore, there is about a 3 week gap between the 2 events and market could have moved during that time thus resulting in a different risk appetite of the investors. Had the Company and its advisor been able to estimate the retail offer price accurately (i.e. indicative retail offer price equals to the institutional offer price), then there will be no price differential.

Given that the retail offer price is determined using judgment based on best available information and estimates, it is common for price differential to exist. This price differential is not due to any goods or services received from retail investors. Instead, it arose as a result of the inherent risk in the process of estimating the future value of the shares.

Situation 2

The primary objective of the IPO is for the issuer to obtain financing and the discount is to attract the retail investors to subscribe for the shares so as to ensure that the public shareholding spread of 1,000 public shareholders will be met and hence ensuring the success of the IPO. Also, in some cases, the Issuer may want a larger retail investors profile.

The transaction is a transaction with shareholders, whereby, under IFRS 10 *Consolidated Financial Statements*, when a parent of a 100% own subsidiary sells 20% of its interest in the subsidiary without loss of control, that transaction is considered as a transaction with shareholders in their capacity as shareholders (even though the buyer of this 20% interest was not a shareholder of this subsidiary at the point in time of the disposal transaction) - such transaction is clearly excluded from the scope of IFRS 2 (paragraph 4).

Accordingly, such “discount” is clearly not for goods or services and therefore does not meet IFRS 2 ‘share-based payment transactions’ definition.

IFRS 2 Share-based Payment [*emphasis added*]

Paragraph 2

An entity shall apply this IFRS in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including:

(a) *equity-settled share-based payment transactions*,

(b) *cash-settled share-based payment transactions*, and

(c) transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments,

except as noted in paragraphs 3A - 6. In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case this IFRS applies.

Paragraph 3A

A share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services. Paragraph 2 also applies to an entity that

(a) receives goods or services when another entity in the same group (or a shareholder of any group entity) has the obligation to settle the share-based payment transaction, or

(b) has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services

unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them.

Paragraph 4

For the purpose of this IFRS, a transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction. For example, if an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirement of this IFRS.