STAFF PAPER

10–11 September 2013

IFRS Interpretations Committee Meeting

Project	IFRS 2 *Share-Based Payment*		
Paper topic	Share-based payment transactions where the manner of settlement is contingent on future events		
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Introduction

1. In May 2013, the IFRS Interpretations Committee ('the Interpretations Committee') revisited an issue related to the classification of a share-based payment transaction under IFRS 2 *Share-based Payment* that the Interpretations Committee had decided not to address in January 2010. The request received is seeking clarification on the classification of share-based payment transactions in which the manner of settlement is contingent on either:

   (a) **a future event that is outside the control of both the entity and the counterparty (Issue A);** or

   (b) **a future event that is within the control of the counterparty (Issue B).**

2. In that meeting, the Interpretations Committee noted that paragraph 34 of IFRS 2 indicates a principle that an entity is required to account for a share-based payment 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. The Interpretations Committee noted, however, that IFRS 2 does not provide specific guidance on share-based payment

transactions described in Issue A, and nor do other IFRSs or the *Conceptual Framework*.

3. The Interpretations Committee noted significant diversity in accounting for the share-based payment transaction described in Issue A. The Interpretations Committee therefore asked the staff to explore approaches to providing guidance for the classification of the share-based payment transaction in Issue A.

4. The objective of this paper is to provide the Interpretations Committee with proposed alternative approaches for adding guidance to IFRS 2 for a share-based transaction described in Issue A in order to help the Interpretations Committee decide whether IFRS 2 could or should be amended. In addition, we will provide staff analysis and a staff recommendation on Issue B, which is carried forward from those that were presented in the May 2013 meeting of the Interpretations Committee. This agenda paper contains four questions to the Interpretations Committee.

5. This agenda paper is organised as follows:

   (a) staff analysis for Issue A;

   (b) staff recommendation for Issue A;

   (c) staff analysis for Issue B;

   (d) staff recommendation for Issue B;

   (e) questions for the Interpretations Committee;

   (f) Appendix A—Annual improvement criteria analysis; and

   (g) Appendix B—Illustrative examples

   (h) Appendix C—Excerpt from US GAAP.

Staff analysis for Issue A

Summary of issue A

6. The submitter describes a share-based payment transaction in which an entity grants to its employees its own shares that vest upon a number of years of service. It also has a cash settlement alternative provision by which the granted shares will vest immediately and be settled in cash at the fair value of the shares at the date of settlement, if a specified event that is outside the control of both parties occurs such as a successful initial public offering (IPO)[1]. If such an event does not occur until the date of settlement, the share-based payment is settled in the shares.

7. As discussed in the May 2013 Interpretations Committee meeting, IFRS 2 does not provide specific guidance on this type of share-based payment transaction. Paragraphs 34-43 of IFRS 2 provide guidance only on share-based payment transactions in which the terms of the arrangements provide the counterparty or the entity with a choice of settlement. In addition, it is unclear which guidance in other IFRSs and the *Conceptual Framework* would be the best analogy for the share-based payment transaction. We think that these facts have led to significant divergent views on how to classify the share-based payment transaction.

8. Accordingly, in the following paragraphs, we will explore approaches for adding specific guidance to IFRS 2 so that the Interpretations Committee can decide whether it should recommend to the IASB that IFRS 2 should be amended to solve the divergence. We have prepared illustrative examples in **Example 1** in **Appendix B** that presents journal entries under each alternative approach by using a simplified fact pattern.

[1] With regard to the events outside the control of both the entity and the counterparty, the submission lists IPO and change in control as examples. When the Interpretations Committee discussed this issue in the past, it addressed more general circumstances whereby a contingent event is outside the control of both parties rather than the specific fact pattern in the submission, acknowledging that whether IPO and change in control are outside the entity's control is a matter of judgement that is supplementary to the question of classification. The analysis and discussions below follow the same approach.

Alternative approaches for adding guidance

Approach A—Classify the entire award as cash-settled

9. Under this approach, a share-based payment with a contingent settlement provision would be classified as cash-settled in its entirety and be accounted for in accordance with the requirements for a cash-settled share-based payment transaction in paragraphs 30-33 of IFRS 2. This approach would result in a classification principle that would be consistent with that in paragraph 25 of IAS 32, which addresses the classification of a financial instrument with a contingent settlement feature.

10. Those who support this approach note that paragraph 25 of IAS 32 requires an issuer of a financial instrument with a contingent settlement feature to classify it as a liability, except for limited circumstances such as when the contingent settlement provision in the arrangement is not genuine[2]. They think that the share-based payment transaction that is analysed should be classified in a consistent manner with the financial instrument described in paragraph 25 of IAS 32. This is because an entity does not have an unconditional right to avoid delivering cash or other assets in the share-based payment transaction.

11. However, we note that some could read the wording of paragraph 25 of IAS 32 as simply confirming that the cash settlement provision in the arrangement is a liability. In other words, applying the principle in that paragraph to a share-based payment transaction with a contingent settlement provision would not necessarily lead to a conclusion that the share-based payment should be classified as a liability in its entirety. The principle in paragraph 25 of IAS 32 could also support classifying the share-based payment transaction as a compound instrument.

12. Furthermore, some are concerned that, in a number of jurisdictions, it is common for equity-settled share-based payment arrangements to have a provision that requires cash settlement if a specified unexpected event occurs. That event

[2] Paragraph AG28 in IAS 32 describes 'not genuine' as extremely rare, highly abnormal and very unlikely to occur.

includes, but is not limited to, an initial public offering (IPO), a change in control, and death and disability of an employee. Any provision that requires cash settlement in rare circumstances could result in classifying the entire share-based payment as cash-settled under Approach A. This is because this approach does not take into account the likelihood of the occurrence of such contingent events. They argue that classifying such share-based payments as entirely cash-settled might not provide useful information to users.

Approach B—Classify the entire award as cash-settled if cash settlement is probable

13. Adopting this approach, a share-based payment with a contingent settlement feature would be classified as cash-settled when it becomes probable that the share-based payment transaction will be settled in cash or other assets. This model uses the recognition criteria for a liability in IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*. The share-based payment would be accounted for as equity-settled until cash settlement becomes probable. Once it becomes probable, the share-based payment would be reclassified from equity-settled to cash-settled and be accounted for as cash-settled thereafter unless cash settlement becomes improbable again before the settlement date.

14. Those who support this view would argue that even though there might be a liability for the contingent settlement provision, it would be misleading to users to recognise a liability for an obligation to pay cash for which the likelihood is not probable. On the basis of the results of outreach, many entities are applying similar approaches to this type of share-based payment transaction. We understand that this is primarily because this approach is consistent with that under US GAAP (See **Appendix C**).

15. However, we note an argument that the classification principle in IFRS 2 does not require an entity to consider whether cash payment is probable when deciding the classification of a share-based payment. For example, a share-based payment arrangement in which the counterparty has a choice of the manner of settlement is classified as both cash-settled and equity-settled. In accordance with paragraph

37 of IFRS 2, the entity first measures a liability component at the fair value of cash settlement alternative. The fair value of the cash settlement alternative is calculated on the basis of the assumption that the likelihood of the occurrence of cash settlement is a 100 per cent. This is supported by the guidance in paragraph 37 of IFRS 2, which states "[…] 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. […] In such cases, the fair value of the equity component is zero […]." If the likelihood of the counterparty's choosing the cash settlement alternative is not assumed as a 100 per cent, the fair value of the equity component would never become zero. IG Example 13 of Guidance on implementing IFRS 2 *Share-based Payment* also illustrates this assumption. The equity component is recognised as residual if the fair value of the equity settlement alternative is higher than that of the cash settlement alternative (eg in a case where an exercise price of an option for equity settlement alternative is lower than that of cash settlement alternative). No consideration is given to the likelihood of the occurrence of cash settlement in measuring both components.

16. In addition, some argue that using the 'probable' threshold could result in inconsistencies in the classification of share-based payments when the relative probability of their outcomes is considered. The inconsistencies could exist if an entity has both (a) a share-based payment transaction in which the counterparty has a choice of settlement and (b) an equity-settled share-based payment transaction in which the manner of settlement is outside the control of both the entity and the counterparty. As stated above, in transaction (a), the entity is required to first measure the cash-settled component at fair value of the cash settlement alternative on the basis of 100 per cent likelihood of occurrence of cash settlement with the equity component, if any, being recognised as a residual. Accordingly, the entity would record a liability at a 100 per cent of the fair value of the cash settlement alternative even if the likelihood of choosing cash settlement is only 1 per cent. On the other hand, under this approach, the entity would classify as equity-settled the share-based payment transaction (b) with 49 per cent likelihood of the occurrence of cash settlement. They think that this

inconsistent classification could lead users to misunderstand obligations to pay cash incurred by the entity.

Approach C—Classify the award as both cash-settled and equity-settled

17. This approach takes a view that a share-based payment transaction with a contingent cash settlement feature should give rise to both a liability and equity. This is because the entity does not have an unconditional right to avoid delivering cash or equity instruments even though the manner of settlement is dependent on an uncertain future event.

18. Those who support this view also insist that this approach would best reflect the principle in IFRS 2 that the entity should account for a share-based payment, or a component of that transaction, as a cash-settled if, and to the extent that, the entity has incurred a liability to settle in cash or other assets (paragraph 34 of IFRS 2).

19. With regard to how to measure each component, we think that there could be three alternative models, as fully explained in the following paragraphs.

Model C-1: Recognise a cash-settled component based on fair value of cash settlement alternative plus an equity-settled component based on the 'expected' threshold

20. Under this model, a cash-settled component would be recognised as a cash-settled share-based payment at fair value, which reflects the likelihood of cash settlement. The fair value of the cash-settled component falls to nil if the share-based payment is finally settled in equity instruments.

21. In addition to the cash-settled component, an equity-settled component is recognised for the entire share-based payment transaction only if it is expected that it will be settled in equity instruments. In effect, this method treats the settlement method as a non-market vesting condition for the equity-settled component. Paragraph 20 of IFRS 2 requires that, for equity-settled share-based payments, an amount of goods or services received must be determined based on the best available estimate of the number of equity instruments expected to vest. This model uses that principle in deciding whether an equity-settled component

should be recognised for a share-based payment with a contingent settlement provision.

22. The equity-settled component would be measured at the grant date fair value of the share-based payment transaction and accounted for as an equity-settled share-based payment as long as equity settlement is 'expected'. If the share-based payment is ultimately settled in cash or the equity settlement becomes 'no longer expected', the cumulative expense recognised for the equity-settled component would be reversed. At the same time, the fair value of the liability will have increased in proportion to an increase of the likelihood of cash settlement.

23. As stated above, during the vesting period, an amount of expense for equity-settled component is recognised on the basis of the grant date fair value of the entire share-based payment if equity settlement is expected. Furthermore, an amount of expense would be recognised for the cash-settled component on the basis of the fair value of that component. Hence, it is likely that an amount of expense is double-counted for part of the share-based payment until the cumulative expense for either component is reversed on the settlement date or when equity settlement becomes 'no longer expected'. Please see the journal entries in **Example 1** in **Appendix B** for details.

Model C-2: Bifurcate into cash-settled and equity-settled based on probability of cash settlement

24. This model would require an entity to determine the initial measurement of both a cash-settled component and an equity-settled component on the basis of the grant date fair value of the share-based payment and the likelihood of each settlement (ie a probability-weighted model). Unlike in Model C-1 (cash-settled at its fair value plus equity-settled if 'expected'), the total fair value of the two components at the initial measurement would become equal to the grant date fair value of the entire share-based payment.

25. Each component would subsequently be accounted for separately, in accordance with requirements for cash-settled share-based payments and equity-settled share-based payments, respectively. The cash-settled component would be

remeasured at fair value taking into account the likelihood of cash settlement. The equity-settled component would not be remeasured and would instead be recognised as an expense on the basis of the grant date fair value allocated to the component.

26. However, as the likelihood of cash settlement changes, part of each component needs to be reclassified continuously until the settlement date. The cumulative expense recognised for the both components would be adjusted at each reporting date on the basis of the estimate of probability.

27. Those who disagree with this model would argue that the compound instrument approach in IFRS 2 does not use the probability-weighted approach for dividing a share-based payment into two components. Under Model C-2, one share option would be divided into two components by using the probability of cash settlement. In addition, some would argue that this model would add too much complexity to the accounting for a share-based payment transaction with a contingent settlement provision.

Model C-3: Bifurcate into cash-settled and equity-settled by using the compound financial instrument approach in paragraphs 35-40 of IFRS 2

28. This model employs the compound financial instrument approach required in paragraphs 35-40 of IFRS 2 for a share-based payment transaction in which the counterparty has the choice of the manner of settlement. Using this model, as stated in paragraph 15, the entity would first measure the fair value of the liability component, and then measure the equity component as residual.

29. Like other models in Approach C, each component would subsequently be accounted for separately in accordance with the requirements for cash-settled share-based payments and equity-settled share-based payments, respectively. However, unlike in Model C-1 (cash-settled at its fair value plus equity-settled if ‘expected’) and C-2 (probability-weighted model), the measurement of each component would not be affected by changes in the likelihood of cash settlement in a period before the settlement, because each component is measured on the

basis of a 100 per cent likelihood of the occurrence of cash settlement until the settlement occurs (see paragraph 15).

30. Those who support this model would argue that, from the entity's perspective, a share-based payment transaction with a contingent settlement feature is similar to a share-based payment transaction in which the counterparty has a choice of settlement. This is because the entity does not have an unconditional right to avoid delivering cash or other assets in both cases.

31. However, we note that the compound financial instrument approach does not take into consideration the likelihood of the occurrence of a contingent settlement event. Hence, there could be the same argument as that for Approach A (entirely cash-settled), namely that it would not be useful to users to recognise a liability at full fair value of the cash settlement alternative solely because of events of which the likelihood of them occurring is remote (see paragraph 12).

Staff's view

Classification of the share-based payment

32. In the following paragraphs, we first analyse which approach should be taken for providing guidance on deciding the classification of the share-based payment transaction with a contingent cash settlement provision.

33. We are of the view that, on balance, Approach B (cash-settled if probable) would be the most appropriate approach to developing guidance for this type of share-based payment transaction.

34. In our view, the classification under Approach A (entirely cash-settled) may not provide useful information to users. This is because this approach does not take into consideration the likelihood of the occurrence of a contingent settlement event. This approach could result in classifying the entire share-based payment transaction as cash-settled even if the contingent event occurs only in limited circumstances such as death of employees (see paragraph 12).

35. As stated above, paragraph 34 of IFRS 2 requires an entity to account for a share-based payment transaction, or a component of that transaction, as

cash-settled if, and to the extent that, the entity has incurred a liability to settle in cash or other assets. In this sense, we think that Approach C, in particular, Model C-2 (probability-weighted model) would best match the principle in paragraph 34 of IFRS 2 for the classification of a share-based payment transaction with a cash alternative.

36. However, we agree with the argument that Model C-2 would cause too much complexity in the accounting for a share-based payment with a contingent cash settlement provision. This would require an entity to continuously reclassify part of the share-based payment as the probability of the occurrence of cash settlement changes (see paragraph 26). In addition, we note an argument that this model would not reflect the fact that the share-based payment is settled all in cash or all in equity instruments. An amount allocated to the cash-settled component does not represent an amount to be paid upon the cash settlement at any point in the period before the settlement.

37. We are of the view that Model C-1 (cash-settled at its fair value plus equity-settled if 'expected') is not an appropriate model for measuring each component because of the pattern of expense recognised as stated in paragraph 23 of this Agenda Paper.

38. With regard to Model C-3 (compound financial instrument approach), we think that it would have the same problem as that of a model under Approach A (entirely cash-settled). That is, both models do not take into consideration the contingent nature of the manner of settlement. Even if a cash settlement event stated in a provision in the arrangement occurs only in rare circumstances, the provision would result in requiring the recognition of a liability that is measured on the basis of a 100 per cent likelihood of the occurrence of cash settlement (see paragraph 31).

39. Those who support Model C-3 may argue that the classification of the share-based payment analysed should be consistent with that of the share-based payment transaction that provides the counterparty with a choice of settlement. Both share-based payment transactions can be regarded as comparable, in that the manner of settlement is outside the control of the entity, and that the share-based

payments are eventually settled all in cash or all in equity instruments rather than in both (see paragraph 30).

40. Nevertheless, we note a difference between the two transactions, which is that in a share-based payment transaction in which the counterparty has a choice of the manner of settlement, the counterparty has a unilateral right to force the entity to pay cash for the share-based payment in any case. On the other hand, in an equity-settled share-based payment transaction with a contingent cash settlement provision, the counterparty does not have such a right.

41. The share-based payment in which the counterparty has a choice of the manner of settlement would match the compound financial instrument model because the entity agreed with the counterparty that the counterparty can choose a manner of settlement independently of uncertain future events. In this case, there would be both a debt component and equity component at the same time from the inception of the arrangement until the settlement. Any future event does not change the agreement that the counterparty can choose either settlement in cash or settlement in equity instruments in any case. In the case of the share-based payment with a contingent settlement provision, it could be viewed that the both parties agreed on a manner of settlement that was most likely to occur at the inception of the arrangement. Afterwards, the most likely scenario changes as the likelihood of the occurrence or non-occurrence of an uncertain future event changes until the settlement occurs. The changes in the most likely scenario could be characterised as a modification of the terms and conditions of a share-based payment arrangement that relates to the manner of settlement even though there is no change in the arrangements themselves.

42. Taking this view, the share-based payment with a contingent settlement provision would never be viewed as a compound instrument but instead would be viewed as a single instrument of which the manner of settlement agreed by both parties changes as the most likely settlement method changes. We think that classifying the entire share-based payment by using the threshold ‘more likely than not’ (ie ‘probable’ or 50 per cent) would best reflect this view.

43. On the basis of the above, we recommend Approach B (cash-settled if probable) in which a share-based payment transaction with a contingent settlement provision is classified as cash-settled **if it is probable that the entity will settle the share-based payment in cash or other assets;** otherwise, it is classified as equity-settled.

Accounting for changes in the classification

44. If Approach B (cash-settled if probable) were to be taken, the share-based payment transaction with a contingent settlement provision would be reclassified from equity-settled to cash-settled or vice versa when a contingent settlement event becomes probable to occur or ceases to be probable to occur. Thus, in the following paragraphs, we are analysing how the changes in the classification of the share-based payment transaction should be accounted for. We think that there could be two alternative methods of accounting for the change in the classification as follows:

    Method 1: *Treat it as a failure to satisfy a non-market vesting condition (paragraph 19 of IFRS 2)*

    Method 2: *Treat as a modification of the terms and conditions of the share-based payment (paragraph 28(c) of IFRS 2)*

45. We have prepared illustrative examples in **Example 2** in **Appendix B** to show journal entries for each method by using a slightly modified fact pattern from that in **Example 1**. In the following paragraphs, we will analyse each method by using those examples.

Method 1: Treat a change in the classification as a failure to satisfy a non-market vesting condition

46. Using this method, the entity accounts for a change in the classification as if an original settlement alternative failed to satisfy a non-market vesting condition. For example, if the share-based payment is reclassified from equity-settled to cash-settled, the entity would undo all the journal entries for the equity-settled share-based payment, and record a liability with the corresponding expense at an amount determined as if the share-based payment had been accounted for as

cash-settled. This method effectively requires an entity to apply the new classification retrospectively to the inception of the arrangement and record catch-up adjustments in the period in which the classification change occurs.

47. As shown in **Example 2** in **Appendix B**, under Method 1, the cumulative entries to equity (50) is reversed at the end of 20X2 and a liability (30) is recognised to the extent that the services have been rendered with the corresponding expense at the same amount. In effect, the difference between the proportionate grant date fair value (50) and the proportionate fair value on the date of the classification change (30) is recognised as a gain (negative compensation expense) under this method. As a result, total expense recognised for the entire vesting period would become the same as the amount determined as if the share-based payment had been accounted for as cash-settled from the inception of the arrangement. On the other hand, under Method 2, the decline of the fair value (20) would be debited to equity because, in the case of a modification of the terms of equity-settled share-based payment, the entity is required to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted (paragraph 27 of IFRS 2).

48. Those who support Method 1 argue that the occurrence or non-occurrence of a contingent cash settlement event does not change any terms or conditions stated in the arrangement. They think that it is more appropriate to view the occurrence or non-occurrence of a contingent cash settlement event as a non-market vesting condition. They note that the counterparty, in effect, forfeits a settlement alternative in exchange for a right to another settlement alternative.

Method 2: *Treat a change in the classification as a modification of the terms and conditions of the share-based payment*

49. Using this method, a change in the classification of the share-based payment with a contingent settlement provision would be accounted for as a modification of the terms and conditions of a share-based payment transaction. We are of the view that this method would be the most appropriate method of the accounting for a change in the classification of the share-based payment analysed.

50. Paragraph 28 of IFRS 2 addresses the accounting for a cancellation or settlement of an equity-settled share-based payment transaction. Paragraph 28(c) states (emphasis added):

> if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 and the guidance in Appendix B. […]

51. We acknowledge that this paragraph does not directly address this issue. The changes in the classification of the share-based payment in this case are triggered by the occurrence or non-occurrence of a contingent future event rather than by a modification of the terms of the agreement. However, we think that a share-based payment agreement still continues even after the change in the classification. The counterparty does not forfeit the share-based payment as a result of the occurrence or non-occurrence of an uncertain future event. Undoing all the previous entries would not reflect the fact that the classification has changed in the middle of the arrangement. In addition, as stated in paragraph 41, we are of the view that a change in the classification of the share-based payment can be characterised as a change in the agreement on a manner of settlement.

52. As stated in paragraph 47, we note that Method 1 (non-market vesting condition) intends to record changes in fair value from the grant date to the reclassification date in profit or loss (20 in **Example 2** in **Appendix B**) even if the fair value of the two alternatives at the reclassification are the same. We think that this accounting would be viewed as being counterintuitive because the level of service that entity expects to receive after the reclassification would not change if the fair value of both alternatives at the date of reclassification is the same.

53. Accordingly, we think that a change in the classification arising from a change in an expected manner of settlement should be accounted for in the same manner as modifications of the terms and conditions of a share-based payment (Method 2). We also note that this is consistent with the requirements in US GAAP (see **Appendix C**).

54. In this regard, if the Interpretations Committee agrees with providing guidance for the share-based payment with a contingent settlement provision under Approach B (cash-settled if probable) and Method 2 (modification of a share-based payment), we think that the guidance should also refer to the existing guidance for modifications of the terms of an equity-settled share-based payment in paragraphs 26-29 and B42-B44 of IFRS 2. We think that no specific guidance needs to be developed for the purpose of this amendment for a change in the classification from equity-settled to cash-settled.

55. For a change in the classification from cash-settled to equity-settled, in March 2013, the Interpretations Committee decided to recommend to the IASB that it should add specific guidance to IFRS 2 in a narrow-scope amendment project[3]. Even though details of the amendment have not been presented to the IASB, we think that the proposed amendment would provide guidance for a change in the classification of a share-based payment with a contingent settlement provision. Hence, we think that if the Interpretations Committee agrees that the IASB should provide guidance for a share-based payment with a contingent settlement provision in line with Approach B and Method 2, we will bring the recommendations for the two amendments as a package to a future meeting of the IASB.

Assessment against annual improvement criteria

56. We think that the potential amendment under Approach B (cash-settled if probable) 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

[3] See the IFRIC Update for March 2013 (http://media.ifrs.org/2013/IFRIC/March/IFRIC-Update-March-2013.htm#7) and Agenda Paper 5C for the March 2013 Interpretations Committee meeting (http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/March/AP05C%20-%20IFRS%202%20Modification%20of%20a%20SBP%20from%20cash-settled%20to%20equity%20settled.pdf)

because the potential amendment would add guidance on specific types of share-based payment 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 or other IFRSs. 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.

57. For the details about the assessment against the annual improvements criteria, please refer to **Appendix A** of this Agenda Paper.

Staff recommendation for Issue A

58. As stated in the analysis above, we think that the most appropriate approach for providing guidance for the share-based payment transaction analysed is Approach B (cash-settled if probable). In addition, we think that a change in the classification of the share-based payment transaction arising from a change in an expected manner of settlement should be accounted for in the same manner as a modification of the terms and conditions of a share-based payment (Method 2). Accordingly, if the Interpretations Committee agrees that IFRS 2 could be amended, we recommend to the Interpretations Committee that it should propose a narrow-scope amendment to IFRS 2 to the IASB in line with Approach B and with the accounting for classification changes described in Method 2 above.

59. In addition, we think that the Interpretations Committee should propose the amendment together with the proposed amendment for the accounting for a change in the classification from cash-settled to equity settled, which the Interpretations Committee decided to recommend to the IASB in the March 2013 meeting.

Staff analysis for Issue B

60. As another type of cash settlement alternative for a share-based payment transaction, the submitter describes a circumstance in which employees will

receive the cash value of the shares if they deposit the exercise price with the entity over the vesting period; otherwise, the share options granted will be settled in equity. In this share-based payment transaction, the counterparty needs to fulfil a condition that is within the control of the counterparty to receive cash instead of equity instruments. In this sense, the submitter thinks that this transaction could be viewed as being different from a share-based payment transaction in which the counterparty can choose the manner of settlement as described in paragraphs 35-40 of IFRS 2.

61. The submitter states that there are primarily two views on the accounting for this type of arrangement:

- *View 1: the transaction should be viewed as one in which the employees are provided with a choice of settlement.*
- *View 2: the condition should be viewed as a non-vesting condition.*

62. As stated in Agenda Paper 13 for the May 2013 meeting of the Interpretations Committee, no responses to our outreach request stated that this issue is widespread in their jurisdictions. Hence, we are not providing an updated technical analysis on this issue.

Staff recommendation for Issue B

63. On the basis of the above, we think that the Interpretations Committee should not change the previous decision not to add this issue to its agenda because the results of the outreach indicate that this issue is not significantly widespread in practice.

Questions for the Interpretations Committee

Question 1
For Issue A, does the Interpretations Committee think that IFRS 2 could be

amended by a narrow-scope amendment to provide guidance for a share-based payment transaction with a contingent cash settlement provision?

Question 2

If the answer to Question 1 is 'yes', does the Interpretations Committee agree with the staff's proposal that the amendment should be in line with Approach B (cash-settled if probable) and Method 2 (modification of a share-based payment)?

Question 3

If the answer to Question 2 is 'no', what alternative approaches does the Interpretations Committee recommend and why?

Question 4

For Issue B, does the Interpretations Committee agree with the staff recommendation that it should not add Issue B to its agenda?

Appendix A—Annual improvement criteria analysis

A1. In planning whether proposed amendments to IFRSs can be exposed as part of the Annual Improvements project, 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 for 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 on specific types of share-based payment 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 or other IFRSs. Accordingly, we are of the view that it would be beyond a clarification and correction of errors 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 share-based payment transaction with a contingent settlement provision.

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 B (cash-settled if probable) and Method 2 (modification of a share based payment) on a timely basis.

Appendix B—Illustrative examples

At January 20X1, an entity enters into a share-based payment transaction with its employees. The terms of the arrangement are as follows:

- The entity grants one free share to each of 10 employees.
- Each grant is conditional upon the employee working for the entity over the next four years as the vesting period.
- The granted shares will vest immediately and be settled in cash at the fair value of the shares at the date of settlement if a change in control occurs during the vesting period.

Assumptions:

- No employees are expected to leave the entity over the next four years.
- At the grant date and the end of 20X1, the management estimates the likelihood of the occurrence of a change in control in the vesting period at 40 per cent.
- At the end of 20X2, the management changed the estimate from 40 per cent to 60 per cent.
- At the end of 20X3, a change in control occurs and employees receive cash.
- The fair value of each free share remains the same at CU10[4] per share from the grant date to the settlement date.

	Approach A (Entirely Cash-settled)		Approach B (Cash-settled if probable)		Approach C-1 (Use probability and 'expected')		Approach C-2 (Probability-weighted)		Approach C-3 (Compound instrument)	
20X1										
Employee expense	25		25		35		25		25	
Liability	-25	(a)	0		-10	(b)	-10	(b)	-25	(a)
Equity	0		-25	(a)	-25	(c)	-15	(d)	0	

*(a) CU10*10*1/4-0*
*(b) CU10*10*40%*1/4-0*
*(c) CU10*10*1/4-0*
*(d) CU10*10*60%*1/4-0*

	Approach A		Approach B		Approach C-1		Approach C-2		Approach C-3	
20X2										
Employee expense	25		25		-5		25		25	
Liability	-25	(a)	-50	(b)	-20	(d)	-20	(d)	-25	(a)
Equity	0		25	(c)	25	(c)	-5	(e)	0	

[4] In this Agenda Paper, currency amounts are denominated in 'currency units' (CU).

*(a) CU10*10*2/4-25*
*(b) CU10*10*2/4-0*
(c) Reversal of cumulative charges (CU25) for equity component
*(d) CU10*10*60%*2/4-10*
*(e) CU10*10*40%*2/4-15*

20X3

Employee expense	50		50		70		50		50	
Liability	-50	(a)	-50	(a)	-70	(b)	-70	(b)	-50	(a)
Equity	0		0		0		20	(c)	0	

*(a) CU10*10*4/4-(25+25)*
*(b) CU10*10*4/4-(10+20)*
(c) Reversal of cumulative charges (CU20) for equity component

Total

Employee expense	100	100	100	100	100
Liability (cash)	-100	-100	-100	-100	-100
Equity	0	0	0	0	0

<u>Example2</u>
All the facts and assumptions remain the same except that the fair value of the share-based payment decreases from CU10 to CU6 at the end of 20X2. After that, the fair value of share-based payment remains the same at CU6 until the settlement date.

Journal entries under Approach B

	Method 1 Modification of terms		Method 2 Retrospective reclassification	
20X1				
Employee expense	25		25	
Liability	0		0	
Equity	-25	(a)	-25	(a)

*(a) CU10*10*1/4-0*

20X2				
Employee expense	25	(a)	5	(d)
Liability	-30	(b)	-30	(b)
Equity	5		25	(c)

*(a) CU10*10*2/4-25*
*(b) CU6*10*2/4-0*
*(c) (CU10*10*2/4-25) - CU 10*10*2/4 (Reversal of cumulative charges for equity component)*
*(d) CU10*10*2/4-25 - a gain from the decline of fair value (20=CU10*10*2/4-CU6*10*2/4)*

20X3

Employee expense	50	(a)	30	
Liability	-30	(b)	-30	(b)
Equity	-20		0	

*(a) CU10*10*4/4-(25+25)*
*(b) CU6*10*4/4-30*

Total

Employee expense	100	60
Liability (Cash)	-60	-60
Equity	-40	0

Appendix C—Excerpt from US GAAP

C1. The following are excerpts from US GAAP (emphasis added).

FASB Accounting Standards Codification
718-10

> Determining Whether to Classify a Financial Instrument as a Liability or As Equity

25-9 Topic 480 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. <u>A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.</u>

b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

25-11 Options or similar instruments on shares shall be classified as liabilities if either of the following conditions is met:

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. <u>A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control</u>

(such as an initial public offering) would not meet this condition until it becomes probable that event will occur.

> Change in Classification Due to Change in Probable Settlement Outcome

35-15 An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.